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The New IFRS for Insurance

It is important that actuaries understand and be able to explain the financial statements of insurance companies that report under IFRS. Even actuaries who are in insurance companies that do not use IFRS will need to understand the financial statements of those who do. BY JIM MILHOLLAND

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"IFRS for insurance is just around the corner." I've been saying this for at least eight years. Now it appears that I may at last be right.

The International Accounting Standards Board (IASB) is entering the final phases of its deliberations on International Financial Reporting Standard (IFRS) for insurance. The IASB website shows only that it has slated deliberations for 2015, but the chairman of the IASB, Hans Hoogervorst, has said that the IASB intends to issue a standard by the end of the year. The list of topics for deliberation is short, so finishing this year seems feasible notwithstanding the fact that the most difficult topic—measuring liabilities for participating contracts—is still outstanding.

The chairman also said that reporting on the new basis would be no earlier than 2019. Three years for implementing the new standard may seem like a long time, but it is a significant departure from many current accounting regimes, especially for

long-duration contracts, and presents many accounting and actuarial challenges. Any shorter period might jeopardize effective implementation.

THE NEW IFRS FOR INSURANCE

It is important that actuaries understand and be able to explain the financial statements of insurance companies that report under IFRS. Even actuaries who are in insurance companies that do not use IFRS (those that use U.S. GAAP or mutual companies) will need to understand the financial statements of those who do. Financial statements provide valuable peer company information, even if the information is not directly comparable to their own.

Consider the following broad description of the proposed standard. This description is not comprehensive, but it addresses the most important concepts and challenges.

Current Measurement

The measurement of insurance liabilities is a current measurement, one that is refreshed at each reporting date. In short, the standard proposes the measurement of insurance liabilities as the sum of fulfillment cash flows and the customer service margin (CSM). The fulfillment cash flows are the present value of all cash inflows and cash outflows that relate directly to the fulfillment of the portfolio of contracts (namely, premiums, payments to policyholders, claims-handling costs, directly attributable acquisition costs, policy administration costs, and premium taxes), together with an explicit provision for risk (the risk adjustment).

The CSM is the amount that—when added to the liability at contract inception—prevents profit at issue. It is amortized over the coverage period into profit and loss in relation to the services provided under the contract. Sometimes referred to as deferred profit, and sometimes as the value of future profits, the amortization of the CSM is key to reported profits, and it will be a focus of the attention of actuaries and others who are analyzing insurers' financial performance.

The liabilities are separated for presentation between liabilities for remaining coverage and liabilities for incurred claims. This is a useful distinction for discussion purposes as well.

The dynamic nature of the measurement by itself makes the standard different from the historic-cost, or locked-in, basis found in many countries for long-duration contracts. It also significantly increases the effort to complete periodic valuations.

Cash Flows

Projected future cash flows are expected values, hence not biased toward a conservative estimate. The term "expected value" implies that consideration of multiple scenarios may be necessary, although it is not specifically a requirement. It's up to the insurer to determine how much analysis is necessary to be able to assert that projected cash flows are expected values. Contracts with significant options, such as equity-based guarantees, may in fact require stochastic modeling.

Risk Adjustment

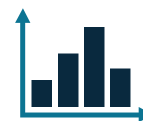
The risk adjustment represents the amount that the insurer would require as consideration for the uncertainty in the future cash flows. It is not market-based, but rather reflects the company's own assessment of risk and its appetite for risk. One of the required disclosures is the confidence level that corresponds to the risk adjustment. The standard does not require use of a confidence level to set the risk margin, and in fact does not prescribe a technique at all, but it does require disclosure of the confidence level.

Discount Rate

The discount rate is the rate that reflects the characteristics of the insurance contract. It is based on current observable interest rates, with adjustments from the observable rates to align the rate to the characteristics of the insurance contract. The characteristics specifically mentioned are the timing, currency, and liquidity of cash flows. A common interpretation is that the appropriate rates for nonparticipating contracts are risk-free rates with an upward adjustment reflecting contract illiquidity. Rates for participating contracts will likely reflect the dependence of the participating features on investment results. The owner of a participating contract shares in the risk of changes in investment returns. The characteristics of the insurance contract include some investment risk and the discount rate reflecting that risk can be higher than for nonparticipating contracts, but still a bit less than the total expected return on the supporting assets if there are minimum guarantees. The level of the discount rate for participating contracts will depend on the strength of the guarantees.

Acquisition Costs

Acquisition costs are recognized in expenses over the coverage period of the contracts. The amortization follows the pattern of the amortization of CSM.



Simplified Approach

The approach described so far is commonly referred to as the building blocks approach. Insurers may measure short-duration charge contracts by a simplified approach. The simplified approach is essentially an earned premium approach. It is referred to as the "premium allocation approach." The standard allows the premium allocation approach when it is a reasonable approximation to the building blocks approach or if the coverage period of the contract is one year or less.

Participating Contracts

Participating contracts are those for which performance, from the policyholder's perspective, depends on investment or underwriting results. The IASB is looking for a model that works for traditional participating contracts, universal-life-type contracts, fixed deferred annuities and variable contracts, to name a few. At the time that this is being written, the measurement approach for participating contracts is the most significant issue outstanding. It has been the most intractable. Finding a single model that works across the range of product types, investment strategies and regulatory regimes is proving to be difficult. Industry input has been extensive, but also varied. Suggested solutions work well for products common in some parts of the world but not very well for products found in other parts of the world.

Claims Liabilities

Claims liabilities are measured as the present value of expected payments within an adjustment for risk; in other words, the fulfillment value under the building blocks. There is no CSM associated with claims liabilities.

Revenue Recognition and Presentation in the Performance Statement

For contracts that use the simplified approach, revenue is the premium earned in relation to coverage provided. It is not very different from current U.S. GAAP.

For long-duration contracts the proposal treats premiums as deposits. Revenue is the sum of:

- Amounts that are released from the liability for the period that are intended to provide for benefits and expenses
- Amortization of CSM
- The change in the risk adjustment
- Amounts allocated to the period to cover the amortization of acquisition costs.

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An interesting ramification of this definition of revenue is the fact that the top-line number in the statement of profit and loss will come from actuarial models.

It is important to note that the benefits are insurance benefits. Payments of cash values and endowments are not benefits; rather they are returns to policyholders, again similar to the U.S. GAAP treatment for universal-life-type contracts. Excluding repayments to policyholders from profit and loss puts the investment components of insurance contracts on the same playing field as investment contracts, whether issued by insurance companies, banks or other deposit-taking institutions. Companies accustomed to reporting premiums as revenue and cash surrenders as expenses will see a significant reduction in revenue and expense.

Experience Differences, Effects of Changes in Estimates of Expected Cash Flows, Re-Measurement of the Risk Margin, and Effects of Changes in Discount Rates

Experience differences are the differences between actual and expected benefits. These are reported in profit or loss when they occur.

The effects of changes in assumptions and of re-measurement of the risk adjustment are offset by an equal and opposite change in the CSM. The IASB has concluded that changes in assumptions should not create profit or loss.

Companies have the option to report the effects of changes in discount rates in profit or loss or in other comprehensive income (OCI). The expectation is that insurers will take the option that best corresponds to the accounting for supporting assets.

Disclosures

There are a number of required disclosures. They provide additional information about the amounts recognized in the financial statements, the significant judgments—and changes in those judgments—made when applying the standard, and the nature and extent of the risks that arise from insurance contracts. One of the most important of these is a reconciliation of the measurement of contracts at the end of the reporting period to the measurement at the begining of the period.

IFRS, IASB, FASB and More

FOR MORE INFORMATION on the IFRS, read "Are You Ready for the New Accounting Rules?" by Jim Milholland in the June 2013 issue of *The Financial Reporter,* the newsletter of the SOA's Financial Reporting Section **(http://bit.ly/1L37KLL).** Also check out the article, "The Mini-Series Continues" by Henry Siegel, FSA, MAAA, in the June 2014 issue of *The Financial Reporter* **(http://bit.ly/1NPJKKZ).**

This reconciliation will present some items not found in profit and loss, such as premiums and surrender benefits. Interestingly, there is no prohibition on a net negative (debit balance) measurement of insurance contracts. Portfolios of insurance contracts that are in an asset position will be presented separately from those in a liability position.

HOW DIFFERENT IS THE PROPOSED NEW STANDARD FROM CURRENT PRACTICES?

How the proposals differ from current practices depends of course on which set of current practices one compares them to. In many parts of the world—notably Canada, Australia and South Africa—insurers already use a current measurement with an adjustment for risk. For these companies the measurement differs in relative respects; e.g., the definition of the risk adjustment and the amortization of the counterpart to CSM, if any. They will find the biggest difference in the revenue recognition and presentation in the performance statement.

Companies converting from U.S. GAAP will need much more complex and dynamic models for long-duration contracts than they currently use. The different principle for revenue recognition will affect long-duration traditional insurance products, but will be less pronounced for universal-life-type and investment contracts. For many insurers, especially property-casualty insurers, the biggest differences will be the effects of discounting claims liabilities and adding an adjustment for risk.

But there may not be many companies converting from current U.S. GAAP to IFRS. The Financial Accounting Standards Board (FASB) in the United States had partnered with the IASB in a joint project for insurance contracts, but left the joint project and went in its own direction in 2013, when it became apparent that the two boards would not be able to reach agreement on some significant aspects of the standard.

At about the same time that the IASB exposed its proposed standard for IFRS, the FASB exposed its proposal for a new U.S. GAAP standard. The FASB proposal, although different as mentioned, had much in common with the IASB's proposal; namely, current estimates, discounting of loss reserves, and revenue recognized as amounts are released from the liability to provide for benefits and expenses.

The FASB received almost entirely negative comments on its exposure draft. Commenters did not see significant improvements to financial reporting resulting from the proposal, and believed that the shortcomings of U.S. GAAP could best be addressed by selective improvements rather than by a complete overhaul. In response to the comment letters, the FASB decided to no longer pursue the proposed new standard. It affirmed the current accounting model for short-duration contracts and embarked on a new project to make targeted improvements to accounting for long-duration contracts.

Foreign companies that are registered with the Securities and Exchange Commission (SEC) can file required reports using IFRS. Domestic registrants must use U.S. GAAP. At one time the SEC seemed to be on track to allow domestic registrants to use IFRS, then backed away, and now seems open again to the idea. As reported by the *Wall Street Journal* in November 2014, the new chief accountant of the SEC has said that he hopes to make a recommendation in the next few months.[1]

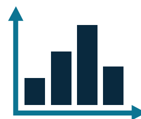
As things now stand, some actuaries in U.S. companies will be using U.S. GAAP, and others—in subsidiaries of foreign insurers, for example—will be using IFRS. The Society of Actuaries (SOA) may be confronted by the challenges of training actuaries in both sets of accounting rules.

IS IT WORTH IT?

In the United States, the answer is in. The insurance industry has said "no" to the FASB's proposal for a revised U.S. GAAP. Commenters to the exposure draft said that the benefits are not worth the cost; and in fact, the consensus view is that the proposals wouldn't bring a net improvement to financial reporting at all. As already noted, the FASB is exploring targeted improvements to U.S. GAAP.

In other parts of the world, the jury is still out. The real answer will come when companies begin to report under the new IFRS and feedback from preparers and users of financial statements becomes available.

Clearly, having a global standard to replace the multiplicity of reporting bases is a point



in favor of a new standard. Capital markets in Europe and elsewhere will benefit from having insurers provide financial statements that are comparable.

More important than comparability is the usefulness of financial reports. Insurance accounting in the United States and in Europe is generally regarded as opaque for long-duration contracts. In Europe the response to the shortcomings of the various GAAPs has been to provide supplemental information in the form of embedded values. In the United States, users bemoan the opacity of U.S. GAAP, but have made their peace with it. There has not been an outcry for embedded values or other supplemental information.

An important test of IFRS in Europe will be whether it obviates supplemental reporting information. I believe that it will and that the usefulness of IFRS will quickly become apparent.

Here is why I think IFRS will prove to be useful:

The balance sheet will have current values. Insurers will report the value of expected cash flows, and they will separately display their quantification of the risk associated with the uncertainty in the estimates. No longer will users have to guess about how much the insurer thinks it really needs and how much conservatism is in the measurement. As experience develops, the differences to expected claims and expenses will reveal any bias in the estimates, something that is already apparent for short-duration contracts. Updated assumptions and the corresponding change in CSM will reveal trends, positive or negative, in experience, and may reflect as well on the insurer's ability to make realistic estimates. Profit or loss will show if capital is growing, and OCI will give insights into the effectiveness of asset/liability management.

Profit and loss will be more understandable. Underwriting profits for long-duration contracts will be the excess of insurance revenue over benefits and expenses, just like it already is for short-duration contracts. Users will find the definition of revenue much more rational than premiums as revenue, and the underwriting results will be transparent. The financial contribution to profit or loss, the excess of investment income over interest accredited on liabilities, will also be more transparent. No longer will users have to puzzle over the mysterious "change in reserves" that comes from the actuary's black box, and be left wondering what's driving profits.

The CSM will become a focus of attention, and for good reason. An analysis of the change in the CSM is a required disclosure. Users can see if the CSM is growing and why. Already some actuaries are referring to CSM as the value of future profits. The statement of profit or loss will show the current results, which will be driven in large part by the amortization of the CSM. The CSM on the balance sheet will show the prospects for the future (a sort of embedded value!). Additions to the CSM from new business will indicate if margins are being maintained.

The risk adjustment will be seen as another source of future profit, although not as assured and likely more volatile. The amount of risk adjustment will indicate the perceived uncertainty in the cash flows. The change in the adjustment risk will provide insight into the insurers' changing perspective on risk or changing appetite for risk.

In short, I believe that the information provided by the new IFRS for insurance will be a significant improvement over the information provided by most current accounting regimes. The challenge to insurers will be managing the message that the information sends. Input from actuaries will be critical to communicating and explaining the results. The challenge starts long before the first report under IFRS. As soon as the accounting standard is adopted, directors of insurers will start to ask what the effects of the conversion to the new standard will be. Not long after that, shareholders will want to be informed about what's coming. So the word to the wise is "it's just around the corner," and the demands will come quickly. A

END NOTE

[1] *Wall Street Journal*, Nov. 6, 2014.

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