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Update on Developments in Financial Reporting

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Financial reporting affects all actuaries, even those not directly involved in valuation. Several large projects to update financial reporting frameworks are currently underway. This article is a high-level update on three of the main developments: principle-based reserving for U.S. statutory, Solvency II and the IFRS Insurance Contracts project. The Actuary of the Future Section, in conjunction with the Financial Reporting Section, plans to cover this topic in more detail in the near future.

IFRS FOR INSURANCE CONTRACTS

The International Accounting Standards Board (IASB) promulgates International Financial Reporting Standards (IFRS), which are the reporting basis used by most of the world. U.S. companies generally report under US GAAP (Generally Accepted Accounting Principles), governed by the Financial Accounting Standards Board (FASB). For several years the IASB has been engaged in a project to develop reporting standards for insurance contracts. They issued an exposure draft in 2010 and a re-exposure draft in 2013. The final standard (IFRS 4 Phase 2) is currently expected in 2015, and would come into effect three years later.

The IASB developed the proposals in the exposure draft jointly with the FASB, and it was expected that the FASB would revise the U.S. standards to be close to the new IFRS standard. However, in February 2014, following a comment period on the exposure draft, the FASB decided to limit its project to targeted improvements to the current U.S. standards; this means that the IASB and FASB's standards will not be as close as was originally expected. In the United States the IFRS standard will only apply to firms that report under IFRS, which means that most U.S. firms may have fewer adjustments, since the FASB's standards are likely to be much closer to existing US GAAP. The FASB began its discussion of improvements to the current U.S. standards for long-duration insurance contracts in August 2014. At that meeting the FASB decided to require that assumptions be updated annually, in the fourth quarter, with the effect of changing assumptions presented in net income. The assumptions will not include a provision for adverse deviation. In addition the premium deficiency test will be eliminated.

Under the new IFRS standard certain contract components must be separated ('unbundled') from an insurance contract. Distinct investment components and embedded derivatives will be measured under the financial instruments standard, while the insurance component and non-distinct investment components will be measured under the insurance standard. The proposed IFRS insurance standard (for long-duration contracts) consists of four building blocks: expected future cash flows, time value of money, risk adjustment, and the contractual service margin.

Estimates of expected future cash flows for a contract or portfolio of contracts should be explicit, unbiased and probability-weighted. All inflows and outflows within the boundaries of existing contracts should be included. The cash flows are discounted to reflect the time value of money. The standard does not prescribe a method for determining the discount rate, but it should be consistent with the market rate for a financial instrument with cash flows similar to those of the insurance liability (e.g., in timing, currency and liquidity). The discount rate should exclude factors not relevant to the insurance liability, and should also reflect dependence on asset returns.

The risk adjustment is the compensation the insurer requires for bearing the uncertainty in the amount and timing of the contract's cash flows. It would take into account factors such as the availability of claims data and the length of the contract. The contractual service margin represents the unearned profit as service is provided. It arises when the present value of future cash outflows, plus risk adjustment, less cash inflows is less than zero, i.e., it removes day-one gains and releases them systematically over the life of the contract. A day-one loss would be recognized immediately.

The expected future cash flows, the discount rate and the risk adjustment are updated at each reporting cycle. The contractual service margin is also unlocked, though negative margin is not permitted.

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PRINCIPLE-BASED RESERVING (PBR)

Currently U.S. statutory reserves are calculated using a formulaic approach, prescribed by state regulations. The formulae do not always accurately reflect the risks and the true cost of the liabilities to an insurer, resulting in excessively conservative reserves for many products. In addition, the formulaic approach needs to be frequently updated as new product designs are introduced.

PBR aims to replace the formulaic approach with a risk-based approach that more closely reflects the actual risks of products. This should, in theory, produce reserves that are the "right size," especially for more complex products. Under PBR, state laws will establish principles upon which reserves are to be based, rather than specific formulae. The details of reserving methods will be included in the Valuation Manual, which is established by the Standard Valuation Law (SVL). Companies will hold the higher of a reserve using prescribed factors and a reserve calculated using justified company experience, considering a wide range of future economic conditions. In addition, under the new system reserve assumptions will be adjusted as economic conditions change and as insurers accumulate credible experience. This is in contrast to the current system where reserve assumptions for some products are locked in at issue.

PBR will apply to new business only and will be phased in over three years, starting once the revisions to the SVL have been adopted by at least 42 states, representing 75 percent of total U.S. premium. Initially reserving methods will change only for life products, but the expectation is that PBR will be phased in for other products later.

SOLVENCY II

This is a European Union directive that aims to harmonize insurance regulation in the European Union and enhance consumer protection. The start date has been pushed back several times, and it is now expected to come into force in January 2016. Solvency II will apply to insurance and re-insurance companies that are based in the European Union, or which have subsidiaries or a parent based in the European Union. Solvency II consists of three pillars: pillar 1 (quantitative basis), pillar 2 (qualitative requirements) and pillar 3 (reporting and disclosure).

Pillar 1 covers the technical provisions and the Solvency Capital Requirement (SCR). These can be calculated either using a standard model prescribed by the regulator, or using a company's own internal model, which must be approved by the regulator. The technical provisions are based on best-estimate assumptions, plus a risk margin, and represent the amount a company would have to pay currently to transfer its obligations to a third party. The SCR is the capital required to ensure that the insurance company will be able to meet its obligations over the next 12 months with a probability of at least 99.5 percent. A Minimum Capital Requirement (MCR) must also be calculated; this is the threshold below which the regulator would intervene.

Pillar 2 sets standards for governance and risk management requirements. The main requirement is that companies must provide an Own Risk and Solvency Assessment (ORSA), which is an internal assessment of a company's solvency and risk management processes. ORSA is intended to be an ongoing process that demonstrates that risk management is embedded in the company's governance. The regulator may impose higher capital standards if it deems that the company's assessment of risk-based capital is inadequate, or if it is dissatisfied with the company's risk management.

Pillar 3 contains enhanced reporting and disclosure requirements, with the aim of demonstrating to the regulator that the analysis supporting the other two pillars is dependable. Public disclosures include a Solvency and Financial Condition Report and additional private disclosures to the regulator are required. Disclosures should follow the principles of proportionality and materiality.

CONCLUSION

This article was a brief overview of some of the upcoming developments in financial reporting, particularly the effect on U.S. companies. We hope to bring you more detailed coverage of this topic in 2015. ☆