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American Academy of Actuaries' IFRS Task Force Response to IASB Discussion Paper on Accounting for Insurance Contracts

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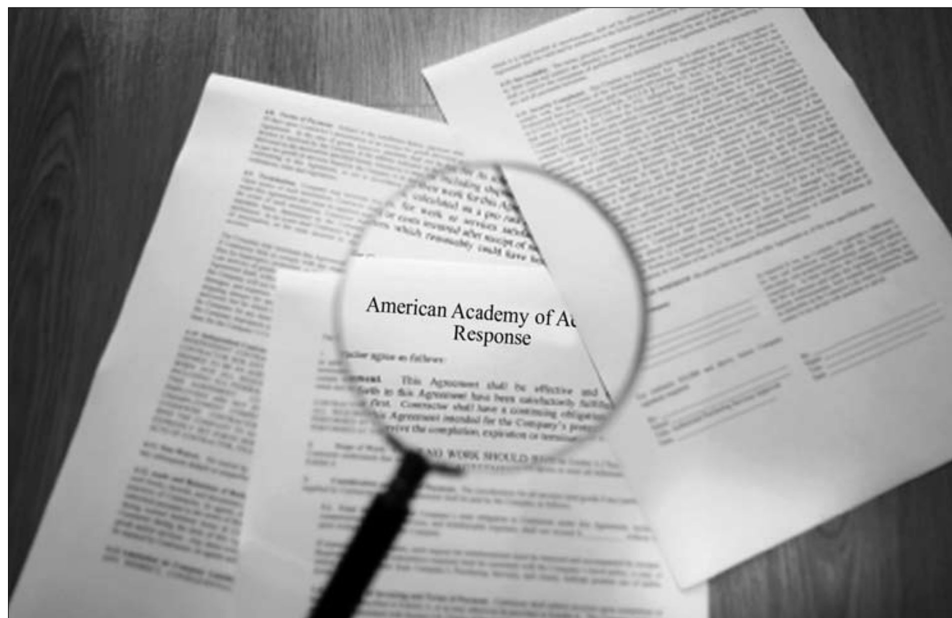
This article does not address any of the authors' personal views on the Discussion Paper or the Academy's response, nor those of any of the authors' employers.



These are certainly interesting times for U.S. life insurance valuation actuaries. On the regulatory front, the National Association of Insurance Commissioners (NAIC) is working with state insurance departments to replace the existing rules-based valuation laws with principle-based valuation laws. On the GAAP front, both the International Accounting Standards Board (IASB), which sets GAAP accounting guidance for many countries outside the United States, and the Financial Accounting Standards Board (FASB), which promulgates GAAP guidance in the United States, are moving toward a "current estimate" standard of valuation, which often results in a fair value or similar measurement basis.

This article reviews the IASB's discussion paper on insurance valuation and the American Academy of Actuaries' (Academy) response to it. But before U.S.-only actuaries skip to the next article, be warned: the SEC is currently considering a rule allowing domestic companies to choose to file under IASB accounting standards if they wish. And many knowledgeable people (including Robert H. Herz, Chairman of FASB[1]) believe it is only a matter of time before the SEC mandates that U.S. companies file under international standards as well. Even if these developments do not materialize, many people expect FASB to join the IASB in this project as part of the overall convergence effort. So, the IASB paper may form the basis of new FASB insurance accounting guidance as well.

Last Spring, the IASB issued its discussion paper, "Preliminary Views on Insurance Contracts."[2] In November, the Academy's International Financial Reporting Standards Task Force (IFRS Task Force or Task Force) submitted its comments to the IASB responding to the paper's request

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[1] http://www.fasb.org/testimony/10-24-07_prepared_statement.pdf

[2] For a full discussion of the provisions of the discussion paper see, "An International Financial Reporting Standards (IFRS) Phase II Discussion Paper Primer," by Mark J. Freedman and Tara J. P. Hansen in the December issue of Financial Reporter.

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for comments to 20 specific questions. The Task Force's response included views from members of the various sub-committees that are responsible for health, P&C, and life insurance accounting issues. The Academy's Life Financial Reporting Committee (LFRC), part of the Life Practice Council, drafted responses for most of the life-themed questions. The full response is available on the Academy Web site and on the IASB Web site,[3] but we would like to highlight some of the most important issues here. Since the Financial Reporter's focus is on life insurance issues (i.e., not P&C) we will focus on those issues.

Current Exit Value

The IASB has not yet released its analogue to FASB Statement No. 157, which provides an overall definition of fair value for GAAP reporting purposes. So therefore, the IASB discussion paper does not technically propose the measurement basis for insurance contracts to be considered "fair value." However, as expected, the IASB discussion paper's starting point for insurance valuation is very similar to fair value, a measurement basis the IASB calls "current exit value." Paragraph 104 of the discussion paper notes that the IASB has not identified significant differences between fair value and current exit value. The IASB's proposed definition of current exit value comes from paragraph IN21:

> *This paper defines current exit value as the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity.*

This definition is similar to FASB's new standard contained in paragraph five of FAS 157:

> *Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*

In its response, the Task Force pointed out that often, there is no liquid market for the liabilities held by insurance companies, so the term "current exit value" will likely be impossible to actually measure and could create the impression that such a market exists. A recurring point was that just because an item can be measured in theory does not mean there is any practical way to measure the item in reality.

Of the questions asked in the discussion paper, Question 2 is probably the most fundamental. That question asks whether insurance liabilities should be measured using the three building blocks of current exit value identified in the paper:

1. explicit, unbiased, market-consistent, probability weighted and current estimates of the contractual cash flows,
2. current market discount rates that adjust the estimated future cash flows for the time value of money, and
3. an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).

Many knowledgeable people believe it is only a matter of time before the SEC mandates that U.S. companies file under international standards as well.

In its response, the Task Force agreed that the measurement of life insurance liabilities should reflect a current estimate of all future cash flows, appropriately discounted and with a risk margin to reflect the market view of the risk inherent in the liability. However, it noted that much of the language in the discussion paper on this subject is actually actuarial guidance that should be promulgated by the actuarial profession. It recommended that the accounting standard should simply state the measurement and recognition principles and objectives and allow the actuarial profession to write the detailed measurement guidance.

The Task Force also noted that it may not be possible to separate inputs that are level 1 and level 2 under FAS 157 into the building blocks in a non-arbitrary manner. It also noted that the definition specifies using "market consistent" inputs, whereas in reality most inputs that a knowledgeable buyer would use to value insurance liabilities would be "entity-specific" inputs that account for characteristics of both the target and the acquirer.

With respect to the specific building blocks, the Task Force objected to the requirement that cash flow estimates always be "market consistent" and

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[3] http://www.iasb.org/NR/rdonlyres/DAE50622-0FAF-4CE0-9F55-2494DBC7A890/5173/20071116171127_AcademycommentsonIASBDP.pdf

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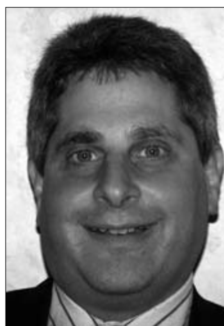

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"probability weighted." The discussion paper would require the probability weighted cash flows to reflect "all possible scenarios." But in reality it is impossible to know all the "possible" scenarios to be used (for example, prior to 9/11 no insurer would likely have included such a scenario in its probability weighted scenarios). And even if reflecting "all possible scenarios" were possible, it is extremely impractical to use "all currently available information" each reporting period. Finally, for many assumptions the effect of probability-weighted scenarios can be adequately approximated without the use of stochastic modeling. The Task Force also concluded that the estimate of cash flows should be permitted to reflect entity specific experience.

On the issue of discounting the cash flows, the Task Force expressed general agreement with the requirement, but noted that the first two building blocks need to be properly integrated. For example, each separate cash flow scenario needs to be discounted using interest rates associated with that specific scenario. Also, the discount rates need to be consistent with any investment returns used in projecting the cash flows for each scenario.

The Task Force stated that any separation of margins, such as risk versus service, is likely to be arbitrary and meaningless. The Task Force expressed the view that determining the proper margin is likely to be subjective unless the margin can be calibrated in some manner. It also noted that where markets exist for non-insurance financial instruments the risk margin is incorporated by using biased probability weights on cash flows, rather than by separately generating an unbiased estimate of probability weighted cash flows and an unbiased estimate of a separate risk margin.

Question 4 of the discussion paper asks what role the actual premium charged should play in calibrating margins. This involves the issue of whether it should be permissible to recognize a gain at issue, or whether income should be recognized only as the insurer is released from risk. If the margins are calibrated to the actual premium charged (net of relevant acquisition costs) gains at issue would be eliminated. A minority view within the IASB conforms to this position that gains at issue should be eliminated by calibrating the margin to actual premiums charged and releasing that margin as the insurer is released from risk.

However, the IASB majority view is that margins should not be calibrated to actual premiums charged. This view holds that gains at issue should be permitted if the current exit value calculated in accordance with the three building blocks is less than the premium charged net of relevant acquisition costs. In its response, the Task Force disagreed with the majority view, but did not quite conform to the IASB minority view either. Rather, the Task Force took a middle ground: there should be a rebuttable presumption that the margin implied by the actual premium is the market consistent margin, and that the evidence needed to rebut the presumption, especially if it results in a gain at issue, should be overwhelming.

Beneficial Policyholder Behavior

Questions 6 and 7 address beneficial policyholder behavior. Question 6 asks generally about whether beneficial policyholder behavior (i.e., policyholder behavior that reduces the liability if recognized, such as lapses on a lapse supported policy) should be recognized, and if so, whether it should be reflected through a reduction in the liability or as a separate asset. The Task Force took the position that the expected beneficial behavior should be reflected, preferably as part of the liability.

Question 7 refers to the issue that probably has the greatest potential to produce non-intuitive results: whether future premiums should be recognized in the valuation. The IASB position is that such premiums should be recognized if any of three conditions are met:

1. The premiums are contractually required to be paid;
2. Recognizing the premiums and any associated benefits and expenses would increase the liability; or
3. The premiums are required for the policyholder to retain guaranteed insurability.

The first two criteria are non-controversial. But the third criteria was actually a concession within the discussion paper. Under the IASB's principles, future premiums that do not meet either of the first two criteria are not part of a liability, but an intangible asset representing the possibility that the insurer will collect these premiums. But under the IASB's accounting framework, internally generated intangible assets cannot be recognized. Since recognition trumps measurement within the accounting

framework, premiums that do not meet either of the first two criteria could not normally be included in the valuation. However, the IASB recognized that for insurance products excluding future premiums would produce meaningless results. Therefore, the discussion paper makes a concession for premiums necessary to retain the insured's guaranteed insurability, on the theory that such premiums are so closely related to the underlying liability that it is appropriate to include them.

While this concession potentially resolves the premium issue for traditional insurance contracts, it would still exclude most future premiums on universal life type contracts. This would produce very different results for universal life and whole life valuations—likely overstating the appropriate liability for universal life contracts—even though the products are similar. Furthermore, in an acquisition, i.e., a transaction that would indicate an exit value, the acquirer would almost certainly include expected future universal life premiums in the valuation. Therefore, in its response, the Task Force favored including all expected future premiums in the insurance liabilities measurement.

Other Important Issues

Question 8 of the discussion paper asks whether a deferred acquisition cost (DAC) asset should be accrued or whether acquisition costs should be expensed as incurred. The Task Force agreed with the discussion paper conclusion that a DAC asset should not be necessary, since the margins in future premiums to recover acquisition costs would already be reflected in the valuation. However, the Task Force noted that if recognition of expected future premiums in the valuation was restricted (as proposed in the discussion paper) then some sort of DAC asset would be necessary.

Question 13 relates to unbundling. The IASB discussion paper proposes bifurcating a contract between an insurance element and a deposit or service element under certain circumstances. The Task Force objected to this proposal, in a response similar to the one we sent to the FASB when it proposed bifurcation of insurance liabilities in 2006. We think it's a bad idea.

Question 14 asks whether the measurement of the insurance liability should reflect the insurer's credit standing. Similar to FAS 157, the IASB discussion paper suggests that an insurance liability reflect the insurer's own credit standing. This would reduce the liability if an insurer's credit standing declined, and increase the liability if an insurer's credit standing increased. The Task Force objected to this proposal because it did not agree with the contention that reducing a liability if credit standing declined would provide useful information to users of financial statements. It also noted that due to regulatory constraints in many jurisdictions, any attempt by an insurer to actually realize the "benefit" of its reduced credit standing would likely not be possible for the insurer as a going concern.

Finally, in its other comments, the Task Force reminded the IASB that the proposed guidance is a radical departure from existing guidance.

Question 16 asks how to recognize policyholder dividends on participating contracts. The discussion paper suggests recognizing future policyholder dividends only if the insurer has either a legal or constructive obligation to pay those dividends as of the reporting date. The discussion paper also suggests similar treatment for interest credits on universal life contracts in excess of guarantees.

This is essentially the converse situation of that in Questions 6 and 7. In the situations covered by Questions 6 and 7 the discussion paper suggests ignoring future premiums from the valuation if the policyholder has no compulsion to pay. Here, the discussion paper suggests ignoring future dividends if the insurer has no compulsion to pay. Similar to the responses to Questions 6 and 7, the Task Force favored incorporating all expected future cash flows in the liability valuation. This would include policyholder dividends on participating contracts and non-guaranteed elements on universal life contracts.

The Task Force also responded to other questions, including those on: recognition and de-recognition of insurance liabilities, whether premiums are revenue or deposits, and the treatment of reinsurance.

Finally, in its other comments, the Task Force reminded the IASB that the proposed guidance is a radical departure from existing guidance. Therefore, the cost of any implementation will be significant. Furthermore, as much time as possible should be allowed for implementation after the guidance is finalized.