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From Those Wonderful Folks Who Brought You the Subprime Crisis

by Henry Siegel

Just about everything that took place on the international front this quarter was influenced to some degree by the subprime crisis. Every week, it seemed, there was an article either blaming the crisis on bad accounting or countering that argument. Two members of the top leadership of Lehman Brothers were ousted but the bank itself held on, refusing to follow Bear Stearns into oblivion. AIG fired its CEO and is looking for a new CFO. Other banks and insurers continued to report losses on investments but as of this writing the worst seems to be over.

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What this implies for insurance accounting is still hard to know. But clearly there are people who are questioning whether using a fair value accounting basis for financial instruments lacking a deep trading market makes sense. This is further evidenced by the IASB and FASB decisions on revenue recognition (see below). Nevertheless, the IASB again reiterated that the insurance contracts project is expected to be completed by 2011 with implementation in 2013.

APRIL

The first event of April was the Insurance Working Group of the IASB. As I reported in the last Financial Reporter, this meeting was largely notable for the comments by board members that threatened the future of the insurance project. By the end of the quarter, this concern had not completely disappeared. The Financial Stability Forum[1] issued a report putting additional pressure on the IASB to take immediate steps to improve accounting standards in certain areas. This could take emphasis and resources away from the insurance project. Although most think that the IASB will move forward on the project, it's not clear whether the 2011 time frame for completion will be met.

On March 31, Treasury Secretary Paulsen had set out the Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure. Included in this rather lengthy paper was an intermediate proposal to have an Office of Insurance Information in the Treasury Department responsible, among other things, for negotiating international treaties on behalf of the U.S. insurance industry. This could include both accounting and solvency regulation as well as rules for reinsurance. Most people felt these proposals would go nowhere in this Congress.

It was somewhat to my surprise, then, when Representative Kanjorski introduced a bill in late April to create just such an office. This bill would not only give the Treasury authority to negotiate international treaties, but would allow it to overrule state rules to the contrary. Of further concern, the bill did not mention any role for the actuary in its initial terms.

The Academy has established a Financial Regulation Reform Task Force to work on the general topic of Federal Financial Regulation with the goal of assuring that the actuarial profession has a role in any such Federal office. One way to characterize the Academy's position is that it is not philosophically in favor of or opposed to a Federal regulatory role in insurance; it just wants to be sure that whoever makes the decision is properly advised on actuarial issues, including accounting and solvency.

Kanjorski's bill is, of course, far from being passed although a hearing has been held on it. Nevertheless, the possibility of a federal role in negotiating U.S. standards for accounting and solvency could have an important impact on future thinking on these topics.

MAY

The key event in May was the FASB Insurance Forum on the 6th. Uppermost in everyone's mind was whether FASB would agree to join the Insurance

FOOTNOTES:

[1] See *FSForum.org* for more information on this group, which consists of the largest central banks of the world.

Project, making it a full joint project between FASB and the IASB.

The industry representative made a strong plea that FASB join the project. Key among their arguments was that the U.S. has a unique legal, tax and regulatory system and that FASB's participation could better assure that those uniquenesses are properly taken into account. The Academy also urged the FASB to join in the project. Some members of FASB, on the other hand, observed that they don't know much about insurance and therefore questioned what they bring to the discussion that would help the project.

The most recent information continues to be that this decision will be made during the third quarter, probably in September. So by the time you read this the decision may be out.

At its May 14 meeting, the FASB discussed Revenue Recognition again. This time they tentatively adopted a customer consideration methodology that is very different from the current exit value approach that the IASB had been promoting. Under the customer consideration model, the initial liability is tied to the initial payment so that there is no gain at issue.

Unfortunately, the examples in the Meeting Handout leave many questions unanswered. For instance, in allocating revenue by year, does one use the gross cost or the discounted cost? If the latter, a single premium whole life contract would have nearly no revenue allocated to the latter years it's in force. This is not necessarily a problem, but it would produce an interesting income statement for those years when almost all income would be investment income for the contracts still in force.

Another question is whether the costs are measured as incurred or paid. In the Meeting Handout, the costs are assumed to be incurred and paid simultaneously, but this would not be true, for instance, for health insurance. It would make most sense for it to be based on incurral date with a claim reserve being held for IBNR. Whether that's the intent isn't clear. Finally, it appears in their decision that the FASB did not allow any deferral of acquisition expenses and they also did not allow for any unlocking of assumptions. How these decisions will work for insurance also requires further discussion.

The following week the IASB also tentatively adopted the customer consideration model, but in their discussion they allowed for prospective unlocking. Again, how this would influence the insurance project remains to be seen, but it appears that the current exit value model may not prevail.

JUNE

The IAA held its semi-annual committee meetings in Quebec from June 11-14. The meeting got off to an exciting start as a freak storm blew in the window of the Loew's Hotel Lobby where the meeting was being held. You can find a video of the situation on Youtube if you search on Freak Storm, actuaries, Quebec.

At the meeting, the Accounting Committee discussed a number of topics. Most importantly, it decided on a few projects on which further work would be undertaken. These included Revenue Recognition, Financial Statement Presentation, Cash Flow Recognition and Alternative Measurement Attributes. These are all issues that are important to Phase II of the insurance contracts project.

The Risk Margin Task Force reviewed all the comments it had received on its last Exposure Draft. They announced that they will attempt to incorporate all those comments into the paper and issue a final draft. No further exposure drafts will be issued. If someone feels a topic is not adequately covered in the 200-plus pages, they are free to draft another paper on that subject. It is the expectation of the Accounting Committee that this will happen.

The Actuarial Standards Subcommittee recommended that there be two types of standard; Actuarial Notes which would be similar to Academy Practice Notes and Model Standards of Practice which would be similar to NAIC model laws. Like the NAIC model laws, model standards would only take effect if adopted by the standard setter in a particular jurisdiction. As of today, all the standards issued by the IAA would be Notes.

At the Financial Accounting Standards Advisory Committee meeting on Jun 24th, SEC Chief Accountant, Conrad Hewitt, announced that the SEC staff is working on a blueprint on how the conversion from US GAAP to IFRS will work. According to Hewitt, there will be a firm date set for the conversion, but that the date won't be known for two years, depending on the progress that the FASB and IASB make on important projects like the Conceptual Framework, Revenue Recognition and Presentation.

NEXT QUARTER

The next quarter should see further discussion at the IASB on how to proceed with the insurance project. In September the IASB will discuss a holistic approach to various accounting models for insurance (sorry, don't know how to interpret those words, but that's what Peter Clark said). Shortly before that the FASB will probably decide whether or not to join the project.

Insurance accounting is too important to be left to the accountants. ■