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The Home Stretch

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Many people have described the past three months as the home stretch for the International Accounting Standards Board's (IASB's) insurance contracts project. This reminded me of some of my favorite quotes about horse racing. Probably the most actuarial of them is the Damon Runyon quote: "The race is not always to the swift, nor the battle to the strong, but that's the way to bet." My other favorite "actuarial" quote is anonymous, but it's particularly relevant to actuaries who are in the risk management business: "Never bet on a sure thing unless you can afford to lose."

These quotes are particularly apt as the IASB and FASB discuss their major remaining issues at the same time that the International Association of Insurance Supervisors (IAIS) is trying to finalize their principles for international statutory accounting. The International Accounting Standards Board (IASB) is trying to finish its standard by June of this year. To do so they have undertaken a schedule that is incredibly tight and demanding. They have the "strength" to get it done, but the results are still uncertain. You'll see from the long description below that they have tackled most of the major issues, but have still not reached conclusions on many of them. I still think the smart money is to bet that the IASB will finish by the end of June, but it is by no means a done deal.

At the same time, the IAIS is trying to finish their principles for accounting. At one time they thought they would simply adopt IFRS, but the delays in getting IFRS finished have led them to proceed along their own path. While many of the principles that they have adopted are similar to where the IASB will come out, there are differences. Probably the most major difference is that the IASB does not allow a gain at the issue of the contract while the IAIS does. The IASB decided some time ago after pressure from the industry that gains at issue made no sense. It's not clear why the IAIS feels differently.

A major concern for U.S. insurers is that the IAIS principles would essentially make it impossible for the NAIC to retain its current statutory accounting system. This would have major implications not only for solvency regulation, but potentially for taxation as well. Again, it might be too far down the road, too far in the home stretch, for the IAIS to reverse itself. The implications of such a statutory accounting system could be very material for all U.S. insurers.

The remainder of this article discusses what the IASB and FASB have been talking about during the first quarter of 2011. It will be interesting to see how different the results that emerge from the subsequent three months are from where we are at the end of March.

JANUARY

In January, the IASB and FASB began to reconsider the insurance contracts project. While they made no decisions, there were two education sessions.

1. They discussed the feedback received in the comment letters on the IASB's exposure draft Insurance Contracts (ED) and the FASB's discussion paper Preliminary Views on Insurance Contracts (DP).
2. The boards had invited three guest speakers to discuss potential methods for calculating discount rates for non-participating insurance contracts. Both boards had proposed a bottom-up determination of the discount rate that starts with a risk-free interest rate and adds an adjustment for illiquidity. The guest speakers provided presentations on, as an alternative, various top-down approaches that start with the return on a specified portfolio of assets and then deduct components that do not reflect the characteristics of the insurance liability being measured. The approaches discussed were:
    i. Economic Default Adjusted Discount rate (EDAR), speaker: Rob Esson, National Association of Insurance Commissioners (NAIC) and the International Association of Insurance Supervisor (IAIS);
    ii. Reference asset portfolio-based discount rate, speakers: Francesco Nagari and Andrew Smith, Deloitte LLP;
    iii. Asset-linked discount rate, speaker: Nick Bauer, Eckler Ltd.

By the end of the quarter, the question of how to calculate the discount rate had become one of the two or three most important outstanding issues.

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FEBRUARY

February 1-2 Meeting

The IASB and FASB discussed how insurers should account for acquisition costs for insurance contracts. The boards tentatively decided that the contract cash flows should include those acquisition costs that relate to a portfolio of insurance contracts. This was supported by all IASB board members present and by three of the FASB board members. Previously, the boards had proposed measuring acquisition costs at the contract level which was much more limited.

The boards discussed whether acquisition costs included in the initial measurement of the cash flows should include only those associated with successful selling efforts. All FASB board members tentatively supported this approach as included in their recently adopted Accounting Standard Update (ASU). The IASB did not reach a consensus on this issue, but it was clear that a difference between the boards exists on this issue.

February 11 Education Session

William Hines and Steve Strommen of the American Academy of Actuaries presented an education session to the FASB on discount rates for insurance contract liabilities. This presentation was based on a paper written by the Academy and published in late 2009. This presentation was well received by FASB whose members seemed to agree with many of the points being made. The presentation can be found on the Academy website:
http://www.actuary.org/pdf/risk/FASB_presentation_Feb_3_2011.pdf
The earlier paper can be found at:
http://www.actuary.org/pdf/finreport/discount_091509.pdf

February 15-18 Meeting

Before discussing insurance contracts, the board discussed the general topic of measuring items with uncertainty. This subject is germane to several board projects including insurance, revenue recognition, and leases. Following this, the boards discussed and made tentative decisions on several major issues on the insurance contracts project.

The IASB and FASB continued their discussions on insurance contracts by considering project axioms and assumptions, the discount rate for non-participating contracts, the cash flows included in the model, explicit risk adjustment, the recognition of gain or loss at inception, unlocking the residual or composite margin and a refresher on the presentation models.

Project axioms and assumptions

The boards tentatively confirmed the axioms and assumptions (listed below) that will underlie the development of the project's future direction. Those axioms and assumptions will provide a common understanding of the factors that will influence the staff in their analysis and will be a starting point for further decisions. In addition, the IASB noted that the model would be developed on the assumption that the financial assets backing the insurance contracts would be measured in accordance with IFRS 9 *Financial Instruments*. The IASB has no current plans to change the classification and measurement requirements in IFRS 9, but this changed a bit later in the quarter.

Axioms

- *An ideal measurement model would report all economic mismatches (including duration mismatches) that exist and would not cause any accounting mismatches.*
- *An ideal accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts.*
- *Money has a time value and an entity more faithfully represents its position when it measures its liabilities in a way that includes the time value of money.* Nevertheless, many P&C companies worldwide do not support discounting of claim reserves.

Assumptions

- *The boards will develop a standard for insurance contracts, rather than requiring current or proposed generic standards that might otherwise apply.*

- *The standard will deal with the accounting for insurance contracts from the perspective of the insurer, and not for the assets backing the contracts*

or for the entities that issue those contracts. For the IASB, the financial assets backing the contracts would be measured in accordance with IFRS 9.

- *The boards will develop a standard based on an accounting model that regards insurance contracts as creating a bundle of rights and obligations that work together to generate a package of cash inflows and outflows.*
- *In general, the final standard will measure insurance contracts at the portfolio level.*
- *The accounting model should be based on current estimates, rather than carrying forward estimates made at contract inception, and inputs that are consistent with observable market data, where available. This assumption is potentially problematic since it may preclude use of an Other Comprehensive Income (OCI) approach to dealing with discount rate volatility, as was subsequently discussed during March.*
- *The cash flows incorporated in the measurement of the insurance liability are those that will arise as the insurer fulfils the insurance contract.*
- *The model will use the expected value of future cash flows rather than a single, most likely outcome. This means that the values should be a mean rather than either a mode or a median.*
- *The measurement of the liability will not reflect changes in the insurer's own credit standing.*

All IASB and FASB members supported these axioms and assumptions, noting that the axioms and assumptions will be revised if necessary.

Discount rate for non-participating contracts
The boards tentatively decided to confirm the approach in the ED and the DP that the objective of the discount rate is to adjust the future cash flows for the time value of money and to reflect the characteristics of the insurance contract liability. Exactly what this means remains somewhat unclear.

The boards tentatively decided not to prescribe a method for determining the discount rate and that the discount rate should:

- be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including timing, currency and liquidity, but excluding the effect of the insurer's non-performance risk;
- exclude any factors that influence the observed rates, but that are not relevant to the insurance contract liability (e.g., risks not present in the liability but present in the instrument for which the market prices are observed, such as any investment risk taken by the insurer that cannot be passed to the policyholder); and
- reflect only the effect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.

All IASB and FASB members supported those decisions, but further discussions would be held on exactly how this would be accomplished.

Cash flows included in the model
The boards discussed the proposed requirement that an insurer should measure an insurance contract using an explicit, unbiased and probability weighted estimate (i.e., expected value) of the future cash outflows, less future cash inflows, which will arise as the insurer fulfils the insurance contract.

In relation to **expected value,** the boards tentatively decided to clarify:

- that the measurement objective of expected value refers to the mean that considers all relevant information; and
- that not all possible scenarios need to be identified and quantified provided that the estimate is consistent with the measurement objective of determining the mean.

In relation to costs included in fulfillment cash flows, the boards tentatively decided:

- to clarify that all costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts should be included in the cash flows used to determine the insurance liability, including:
  - costs that relate directly to the fulfillment of the contracts in the portfolio, such as payments to policyholders, claims handling, etc.;

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The ED and the DP proposed that discounting should be used in the measurement of all insurance liabilities.

- costs that are directly attributable to contract activity as part of fulfilling that portfolio of contracts and that can be allocated to those portfolios; and
- such other costs as are specifically chargeable to the policyholder under the terms of the contract; and

- to confirm that costs that do not relate directly to the insurance contracts or contract activities should be recognized as expenses in the period in which they are incurred.

The majority of IASB members (one voted against) and the majority of FASB members (one voted against) supported this decision.

Explicit risk adjustment

The ED proposed to include an explicit risk adjustment in the measurement of an insurance liability. The DP did not include an explicit risk adjustment in the measurement of an insurance liability. The boards tentatively decided that, if there are techniques that could faithfully represent the risk inherent in insurance liabilities, the inclusion of an explicit risk adjustment in the measurement of those liabilities would provide relevant information to users.

The recognition of gain and loss at inception

The boards tentatively confirmed as included in the ED and the DP that an insurer should not recognize any gain at inception of an insurance contract. The boards also tentatively confirmed that an insurer should recognize any loss on day one immediately when it occurs, in profit or loss (net income).

Education session on unbundling

The purpose of this education session was to give the boards information on the effect, costs and benefits of unbundling. The external presenters were Gail Tucker and Sam Gutterman from PricewaterhouseCoopers and Leonard Reback from MetLife.

MARCH

March 1-2 Meeting

Effective dates and transition methods

In October 2010, the boards each published a document requesting views about the time and effort that will be involved in adopting several new standards (including insurance contracts) and when those standards should be effective. Following discussion, the boards indicated that they would determine the effective dates for the projects by taking into account the significance of the accounting changes required, the methods of transition and the time needed for stakeholders to apply the new requirements. No specific date was decided upon for insurance.

Insurance contracts

The IASB and FASB continued their discussions on insurance contracts by considering the following subjects: locking-in the discount rate, discounting non-life contract liabilities, scope, financial guarantee contracts, and acquisition costs.

Locking in the discount rate

The boards tentatively confirmed the proposal in the ED and the DP that the discount rate used to measure all insurance contracts should be a current rate that is updated each reporting period (i.e., not to lock-in the discount rate for any insurance contract).

Discounting non-life contracts

The ED and the DP proposed that discounting should be used in the measurement of all insurance liabilities. The boards tentatively decided to require discounting for all non-life long-tail claims. All IASB and FASB members present supported this decision. The boards tentatively agreed that discounting of insurance liabilities should not be required when the effect of discounting would be immaterial. Many P&C companies worldwide still oppose this position.

Scope

The boards tentatively confirmed the standard should exclude from its scope some fixed-fee service contracts that have as their primary purpose the provision of services. The boards will consider in a future meeting how to identify such contracts. The boards tentatively confirmed all the other scope exceptions that had been proposed by the ED/DP.

Financial guarantee contracts
The IASB's ED proposed that the insurance contracts standard would apply to all financial guarantee contracts, as defined in IFRSs. However, at this meeting, the IASB tentatively decided:

a) to retain the existing approach in IFRSs that:
   i) permits an issuer of a financial guarantee contract (as defined in IFRSs) to account for the contract as an insurance contract if the issuer had previously asserted that it regards the contract as an insurance contract; and
   ii) requires an issuer to account for a financial guarantee contract (as defined in IFRSs) in accordance with the financial instruments standards in all other cases.
b) it would not create an exception from the accounting for financial guarantee contracts for intra-group guarantees.

The FASB decided to consider this subject at a future meeting.

Acquisition costs
The boards continued their discussion on how insurers should account for acquisition costs. The FASB tentatively decided that the acquisition costs included in the cash flows of insurance contracts will be limited to:

a) those costs related to successful acquisition efforts; and
b) direct costs that are related to the acquisition of a portfolio of contracts.

The IASB tentatively decided that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the costs that the insurer will incur in acquiring the portfolio, including costs that relate directly to the acquisition of the portfolio, such as commissions. No distinction would be made between successful efforts and unsuccessful efforts.

March 14-15 Meeting
The IASB and FASB continued their discussions on insurance contracts by considering the following topics: alternative presentation models, allocation of the composite margin in profit and loss, whether the boards should permit or require a practical expedient for the discount rate, education sessions on the risk adjustment and on an alternative approach to deriving a discount rate, the discount rate for participating contracts, the timing of initial recognition and the definition of an insurance contract.

Alternative presentation models
The boards discussed several presentation approaches for the performance statement for insurers. The boards directed the staff to seek input on these approaches from the Insurance Working Group and from other users of insurance financial statements to help the boards to understand which approaches are most likely to meet the needs of users and whether those approaches would cause practical difficulties for the preparers of the financial statements.

Practical expedient for the discount rate
The boards discussed whether a practical expedient should be provided for determining the discount rate for a particular subset of entities. The boards tentatively decided not to provide a practical expedient for determining the discount rate.

Discount rate for participating contracts
The boards discussed the discount rate for insurance contracts that contain participating features. The boards tentatively decided to:

a. clarify that the objective of the discount rate used to measure participating insurance contracts should be consistent with the discount rate used to measure non-participating insurance contracts, and
b. provide guidance that to the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the insurer should adjust those cash flows using a discount rate that reflects that dependency.

Recognition
The boards tentatively decided that insurance contract assets and liabilities should initially be recognized when the coverage period begins, and to require the recognition of an onerous contract liability in the pre-coverage period if management becomes aware of onerous contracts in the pre-coverage period. This was

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contrary to the position in the ED and was based on a FASB staff recommendation.

Definition of an insurance contract

The ED and the DP proposed to define an insurance contract as "a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder." The boards tentatively decided to confirm the proposal in the ED and DP that:

a. an insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario are significant, and
b. a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the insurer can suffer a loss, with loss defined as an excess of the present value of net cash outflows over the present value of the premiums.

Education session on the risk margin

The boards heard a presentation on how in practice a risk margin is calculated using a cost of capital approach and the linkage to the determination of the best estimate liabilities. The external presenter was Joachim Oechslin from Munich Re.

Education session on an alternative approach to deriving a discount rate

The IASB and FASB invited guest speakers to present an approach that derives a yield curve for a discount rate for all cash flows expected at a given duration by:

- identifying those liability cash flows that are matched in duration with the cash flows from the insurer's existing asset portfolio,
- considering the reinvestment needs for cash flows that are not matched in duration, and
- considering the effect of options and guarantees embedded in the liabilities.

The external presenters were Jean-Michel Pinton and Baptiste Brechot from CNP Assurances and Eric Meistermann from Deloitte.

March 21-23 Meeting

The IASB and FASB continued their discussions on insurance contracts by considering the following topics: unbundling, objective of the risk adjustment, discount rate for ultra-long contracts, practical implementation of the risk adjustment and the contract boundary for insurance contracts.

Unbundling

The boards discussed the objectives for separating insurance contracts into non-insurance components and insurance components. The boards made no decision on the subject.

The boards did confirm that an insurer should account separately for embedded derivatives that are contained in a host insurance contract that is not closely related to the embedded derivative.

Objective of the risk adjustment

The boards tentatively decided:

- to remove references in the objective of the risk adjustment proposed in paragraph 35 of the ED to "the amount the insurer would rationally pay to be relieved of the risk" and to a "maximum amount." As a result, the objective of the risk adjustment would be as follows:

  "The risk adjustment shall be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected," and

- to provide application guidance that this amount would reflect both favorable and unfavorable changes in the amount and timing of fulfillment cash flows.

This change reflects strong comment from the actuarial profession and, when the wording is clarified, will be an important step towards making this guidance more operational.

Discount rate for ultra-long duration contracts

The boards discussed the effects of changes in the discount rate where the yield curve is extended beyond observable market prices—so-called "ultra-long duration" contracts.

The boards indicated that they did not want the staff to develop a separate approach that deals solely with changes in the discount rate for this particular type of contract.

Risk adjustment education session

The IASB and FASB invited guest speakers to continue the education session from March 15, 2011 on explicit risk adjustment. The purpose of this education session was to give the boards information on how a risk margin is calculated in practice, by using a probability of sufficiency approach (akin to a confidence interval) for financial reporting in Australia and a cost of capital approach to report under Economic Value Management (EVM).

The external presenters were Tony Coleman from Lonergan, Edwards and Associates, and Mark Swallow and Leopoldo Camara from Swiss Re.

Contract boundary

The boards tentatively decided that:

1. Contract renewals should be treated as a new contract:
    a. when the insurer is no longer required to provide coverage, or
    b. when the existing contract does not confer any substantive rights on the policyholder.
2. A contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.
3. In addition, for contracts for which the pricing of the premiums does not include risks relating to future periods, a contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.
4. All renewal rights should be considered in determining the contract boundary whether arising from a contract, from law or from regulation. All IASB and FASB members supported this decision.

March 25 Insurance Working Group Meeting

At the Insurance Working Group meeting there were three primary topics. The first topic was the discount rate that should be used for non-participating contracts. The second topic was presentation. The third topic was whether the residual/composite margin should be unlocked for changes in assumptions about the future.

The first topic concerned how one should do a top-down discount rate. The basic issue concerned whether the discount rate should reflect the assets held by the insurer or not. The industry representatives at the table asserted that it should reflect the assets supporting the liability. The board and staff, however, insisted that the discount rate should not reflect the assets supporting the liability.

With regard to presentation, the preparers at the table urged that companies should be allowed to use OCI to offset changes in asset and liability values due to changes in interest rates. Board members and staff again insisted they would not be opening IFRS 9 so that OCI for assets would not be available.

There was general agreement around the table that allowing the residual/composite margin to offset changes to assumptions made sense. Staff will be preparing a new paper to discuss this issue further.

By the time you read this it is likely that the IASB will have adopted a new standard for insurance contracts. Exactly what that standard will look like is still unclear. Furthermore the FASB will still be working on their standard and is not likely to adopt an exposure draft for at least an additional month.

Once the IASB has developed their own standards then the two boards, if there are differences, will need to converge them. Whether this will be successful or not still remains to be seen. The actions of the SEC will also be important in determining the final outcome of the project.

Nevertheless:

Always remember, insurance accounting is too important to be left to the accountants! ■