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IFRS Exposure Draft on Insurance Contracts

By William Hines

In July of this year the International Accounting Standards Board (IASB) issued the long awaited exposure draft (ED) of a full accounting standard for insurance, "Insurance Contracts." This is a major milestone in a project that has been ongoing in one form or another for 13 years. A final standard is expected in mid-2011. This article summarizes the major provisions of the exposure draft and provides some observations on the potential impact on U.S. products currently accounted for in accordance with US GAAP.

BACKGROUND

While the IASB has been working on the standard for many years, the U.S. Financial Accounting Standards Board (FASB) joined in the project as recently as 2008. The project has been conducted jointly since that time. Prior to 2004 the IASB had no accounting standard for insurance. International Financial Reporting Standard (IFRS) 4 was introduced as a temporary standard during Phase I of the project. It defined what constitutes an insurance contract but allowed significant diversity of measurement of such contracts. The recently released ED is a product of Phase II of the project and is designed to bring consistent and comparable measurement of all insurance contracts. The ED was issued by the IASB alone. The FASB has reached different conclusions on some key issues and plans to release a discussion paper on this topic later this year. The remainder of this paper deals with the IASB's ED.

SCOPE

The exposure draft applies to insurance contracts issued, reinsurance contracts held and financial instruments with discretionary participation

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CHAIRPERSON'S CORNER

ANOTHER YEAR COMES TO AN END

We began the 2010 fiscal year with a nearly cleaned pipeline of education and research projects. All projects were then beyond the early development stages.

Seeing the challenges faced by the previous council to keep up with the increasing number of section activities, I recommended that the new council form a webcast team and appoint a volunteer coordinator, both with the idea of increasing the involvement of volunteers who are not on the section council. The council agreed to both additions, and decided to go one further by forming a research committee.

Under the leadership of two new council members, the webcast and research teams were quickly formed and a new volunteer eagerly assumed the role of volunteer coordinator. Besides easing some of the time demands on council members, I expect that these roles will allow for greater continuity between years. No longer will the continuity of research and webcast planning depend on a careful handoff between key council members.

Even after a delayed start, while we were organizing the new teams and gathering information from you about your interests for both education and research, we are on track to complete five webcasts this year and have a sixth in development. We have committed funds to five research projects, with more in line for consideration by the next council. Of course, we continue to sponsor educational sessions at the annual meeting and the spring meeting, now known as the Life and Annuity Symposium. We again hosted a valuation actuary forum at the end of the Valuation Actuary Symposium. And, recognizing the seemingly inevitable move to international financial reporting standards, our annual GAAP seminar was adapted to include IFRS.

Thank You

More than three years ago, I hesitantly accepted an invitation from my long-time friend, Jerry Enoch, to run for a term on this council. At the time, I had no inkling that I could or would chair the council before my term was over. Had you asked me then whether I would take on such a responsibility, I likely would have answered quickly and negatively. Yet, here I am, at the end of my term on the council and as its chairperson.

In retrospect, I think the council did me a favor by selecting me as its chairperson last year. About all I've had to do is organize the council meetings, pen this column, plant a few ideas, do a little recruiting, and get out of the way. That has sometimes been inconvenient, but it has not been difficult. The real work, the challenging work, has all been done by others on the council, by numerous people on the SOA staff and by other volunteers not on the council.

The list of volunteers and staff supporting this section is too long to put into this short column. Please take a look at the section's leadership webpage to see the names of many people who support our work. To all on that list, and to others who helped in the section's work over the past year—thank you!

Hand-Off

To everyone—make use of the many resources provided by the section and look for opportunities to help make the section even better. I leave you in the capable hands of our new council, under the leadership of Craig Buck, its new chairperson. ■



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features. The ED maintains the definition of insurance contract set down in IFRS 4, Insurance Contracts which states:

“A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.”

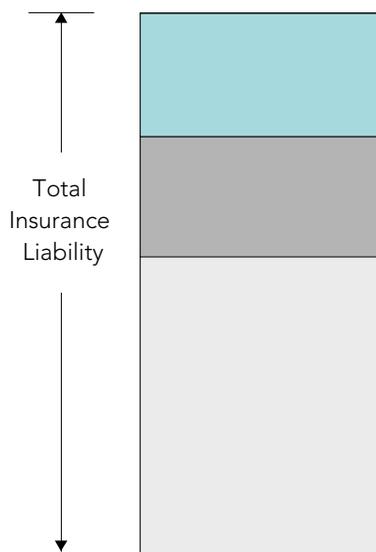
Insurance risk is defined as risk, other than financial risk, that is transferred from a contract holder to the insurer. The risk must be pre-existing to the contract holder. It cannot be created by the contract (e.g., lapse risk, expense risk). Significance is measured on a present value basis. At least one scenario of commercial substance must exist where significant additional benefits are paid if the insured event takes place versus not taking place. Significant additional benefits are deemed to be paid when the present value of cash outflows exceeds the present value of cash inflows. Uncertain future events can refer to timing or amount risk or both. Financial instruments are contracts that transfer financial risk but not significant insurance risk. Discretionary participation features add contractual rights to receive significant additional benefits whose

amounts and timing are at the discretion of the insurer, and are contractually based on the earnings of a specified pool of contracts, a specified pool of assets or the profit or loss of the company or fund that issues the contract.

MEASUREMENT MODEL

The ED proposes to use two models for measuring insurance contracts; one for pre-claims liabilities of short duration contracts and one for all other contracts and claim liabilities. For short duration contract pre-claims liabilities, an unearned premium model is proposed. For all other contracts and claim liabilities, current fulfillment value (CFV) is to be used. Current fulfillment value is equal to the sum of:

1. The expected present value of future cash outflows less future cash inflows that will arise as the insurer fulfills the insurance contract, adjusted for the effects of uncertainty about the present value of those cash flows, and
2. A residual margin that eliminates any gain at inception of the contract.



Residual margin

To be recognized over life of contract period.

Risk adjustment

Adjustment for risk of ultimate cash flows exceeding expected.

Expected present value of future cash flows

The amounts the insurer expects to collect from premiums, payout as claims, benefits and expenses estimated as of the valuation date.

FUTURE CASH FLOWS

CFV takes into measurement only those cash flows that the insurer will incur in fulfilling the rights and obligations of the contract being valued. Only incremental cash flows are to be included. Incremental cash flows are those that would not otherwise be incurred if the contract had not been issued. Commissions would be considered incremental, but some acquisition related costs, such as salaries of insurance company employees involved in the issue or underwriting process may not be considered incremental. Some expenses are not directly incremental to an individual policy but are incremental to a group or portfolio of policies. It appears that CFV is taking a narrower view of what can be considered in measurement than what may have been considered deferrable acquisition expenses in historic Deferred Acquisition Cost assets calculations under US GAAP.

The ED requires an expected present value approach to valuing the cash flows. This implies quantification of multiple scenarios or distributions of expected cash flows. The ED does not require actual scenarios to be generated. If an insurer can represent the expected cash flows using a known distribution that can be represented by a few parameters, it is sufficient to estimate those parameters to calculate the expected value of the cash flows. Because CFV reflects a distribution of expected cash flows, cash flows resulting from participation features are to be reflected in the measurement just like any other contractual cash flow.

The ED requires only those cash flows arising from the current contract to be included; and not cash flows from future contracts. The ED defines cash flows from the current contract to be those that result from premiums paid that the insurer can compel the policyholder to pay, or up to the point that:

- The insurer is no longer required to provide coverage, and
- The insurer can reassess the risk and resets the price to fully reflect that risk.

DISCOUNT RATE

The ED requires explicit discounting. The discount rate is to reflect the characteristics of the liability (e.g.,

The risk adjustment is an allowance for the risk that the ultimate cash flows exceed the expected cash flows as of the valuation date.

timing, currency, liquidity) and exclude characteristics that are not relevant to the liability itself (e.g., default risk on assets backing the liabilities, asset-liability mismatch). For cash flows that do not depend on the performance of an underlying pool of assets, the discount rate will be equal to a risk-free yield curve plus an adjustment for illiquidity. The non-performance risk of the insurer is not to be reflected in the expected present value of future cash flows.

RISK ADJUSTMENT

The risk adjustment is an allowance for the risk that the ultimate cash flows exceed the expected cash flows as of the valuation date. The specific wording used in the ED is:

“The risk adjustment shall be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected.”

The wording suggests that the risk adjustment has a market-based focus (what they would be willing to pay to be relieved of the risk) and is one sided (the risk of actual cash flows exceeding those expected), rather than a two-sided risk of deviation.

To quantify the risk adjustment, the ED has limited the techniques to be used to three:

- Confidence Level (also known as Value at Risk)
- Conditional Tail Expectation or CTE (also known as Tail Value at Risk)
- Cost of Capital

While the ED limits the techniques to be used, it does not specify the target level of confidence or the level of capital to be used. The ED does require the level of confidence used to be disclosed.

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RESIDUAL MARGIN

The residual margin is an amount that eliminates any gain at inception of the contract. It is floored at zero and will be positive when the sum of the expected present value of future cash flows and the risk adjustment is positive (i.e., when the present value of expected future outflows plus the risk adjustment is less than the expected present value of future inflows). In the situation where the expected present value of future cash flows plus the risk adjustment is negative, the insurer will recognize a loss immediately. When determining the residual margin at inception, only incremental expenses are considered in the present value of future cash flows. All other expenses will be recognized as incurred. This will force a loss at issue at least equal to the non-incremental acquisition costs incurred.

The residual margin is to be determined at the portfolio level by aggregating similar contracts with similar dates of inception and similar coverage periods. This margin is to be amortized over the coverage period based on the passage of time or based on expected claims and benefits if that pattern is different from the passage of time. Interest is to be accreted to the residual margin. On the date of transition to this new standard the ED proposes to exclude the residual margin from the liability calculated for existing business.

UNBUNDLING

An insurance contract can often contain elements other than pure insurance coverage, the most common of which are investment and service components. If the contract was not defined as insurance, these other components would be accounted for under other IFRS. Under the ED proposal the insurer must unbundle these non-insurance components and value them separately

if these components are not “closely related” to the insurance component of the contract. The term “closely related” is not clearly defined in the ED, however, three specific types of components are identified in the ED as ones that should be unbundled. These are:

- Account balances on products that are credited with an explicit return and the crediting rate is based on the investment performance of the underlying investments and passes on all investment performance (e.g., a variable annuity separate account),
- Embedded derivatives that is separated from the host contract in accordance with IAS 39, and
- Contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.

REINSURANCE

Reinsurance contracts issued by a reinsurer are to be treated in the same manner as direct contracts by a direct insurer. Reinsurance assets held by a direct writer are to be shown separately from the gross insurance liabilities. The reinsurance asset would be determined in the same way as the direct liability and would have an additional adjustment to reflect the non-performance risk of the reinsurer.

CONTRACTS ACQUIRED IN A PORTFOLIO TRANSFER OR BUSINESS COMBINATION

The proposed approach in the ED for business combinations is to measure the insurance liabilities at the higher of the risk adjusted present value of fulfillment cash flows or fair value. If the fair value is higher, a residual margin is set up equal to the difference. If the risk adjusted present value is higher, the difference is recognized in goodwill. Similar treatment is required for contracts acquired in a portfolio transfer, except that if the fair value is lower, the difference is recognized immediately in profit and loss rather than in goodwill.

The residual margin is an amount that eliminates any gain at inception of the contract.



PRESENTATION AND DISCLOSURE

Two key requirements apply to presentation in the financial statements;

- Items relating to unit-linked or separate account business must be shown distinct from other business, and
- All reinsurance items must be shown separately and not netted against the business being reinsured.

The ED proposes to present a margin-based approach in the statement of comprehensive income (income statement). Premiums and claims paid are accounted for as deposits received and repaid and thus these items go straight to the statement of financial position (balance sheet). As a minimum, the income statement requires the following line items to be presented:

Change in risk adjustment

Release in residual margin

Underwriting margin

Losses on contracts acquired in a portfolio transfer

Gains on reinsurance contracts

Losses at initial recognition of an insurance contract

Gains and Losses at Initial Recognition

Non incremental acquisition costs

Differences between actual and expected cashflows
Changes in estimates of cashflows and changes in discount rate

Impairment losses on reinsurance assets

Experience adjustments and change in estimates

Interest on insurance liabilities

For the short duration contract pre-claims liabilities, a more traditional presentation is required. The following entries are to be shown:

Premium revenue, i.e., the release in the pre-claims liability

Claims incurred

Expenses incurred

Amortization of incremental acquisition costs

Underwriting margin

Changes in additional liabilities for onerous contracts

In addition to the financial statements, the ED requires disclosures about the amount recognized in the statements and the nature and extent of risks from the insurance contracts. The following disclosures are required about amounts recognized in the statements:

- Reconciliation of opening to closing account balance of items such as assets, liabilities, risk adjustments, residual margins and reinsurance assets; and
- The methods and inputs used to develop the measurements.

The minimum disclosures for risks related to insurance contracts include:

- Exposure to risks and how they arise and changes in the reporting period;
- Risk management objectives, policies and processes and changes in the reporting period;
- Information about the regulatory framework the insurer operates under and the effect of this;

CONTINUED ON PAGE 8

- A sensitivity analysis of insurance risk factors;
- Information about exposure and credit worthiness of reinsurers;
- Description of how it manages liquidity risk along with a maturity analysis; and
- A sensitivity analysis of market risk factors.

TRANSITIONAL MEASUREMENT

On the date of transition to the new standard the ED proposes to exclude the residual margin from the insurance contract liability calculated for existing business. Additionally, any existing balances of deferred acquisition costs will be derecognized. The difference between the existing and new liability will represent an adjustment to retained earnings, but will not be recognized in profit and loss.

Companies will be permitted at transition to re-classify their assets to better match the accounting for insurance liabilities proposed in the ED.

COMPARISON WITH US GAAP

Current accounting under US GAAP for products issued by insurers is focused on the income statement, adjusting the recognition of certain revenues and expenses so that profits emerge in proportion to expected revenues. This is done by forcing certain adjustments to the bal-

ance sheet such as deferred acquisition cost assets and unearned revenue liabilities. The IASB's ED focuses instead on the balance sheet and lets income be the difference between two balance sheet amounts. Given the different focus, there is no reason to expect that earnings under CFV will have any relationship to earnings under current US GAAP accounting requirements.

There are similarities between CFV and the liability required under what used to be known as SFAS 60. At issue, best estimate cash flows are discounted and a margin for adverse deviation is added. There are also several important differences in calculating the liability:

- Cash flows are considered over a range of scenarios rather than a single best estimate scenario,
- The discount rate under CFV reflects the characteristics of the liability rather than the expected earned rate on the assets backing the liability. The discount rate under CFV will likely be lower than the expected earned rate on the assets,
- The provision for adverse deviation under CFV must be calculated using one of the methods specified in the ED. This could be higher or lower than the margins used in US GAAP,
- Assumptions and margins for adverse deviation under CFV are not locked in, and
- A residual margin is required under CFV that is not present in SFAS 60.

As a result of these differences, profits will emerge in different patterns than under SFAS 60. It is likely that the profits will be more volatile. Under SFAS 60 profits would emerge in proportion to premium and in proportion to the release of the provision for adverse deviation. With assets measured at amortized cost and absent any loss recognition issues, earnings under SFAS 60 would emerge in a reasonably steady manner. Under CFV, no assumptions will be locked in. Revised expectations about future cash flows and risk adjustments could occur at each valuation date, rather than waiting for a loss recognition event. Discount rates will move with the market which will encourage companies to classify their underlying assets such that they will be fair valued to match the exposure to risk-free rate volatility. However, as asset values will typically have additional spread risk that will not be reflected in the



liability values, additional income volatility will likely be realized.

For products accounted for under what used to be known as SFAS 97, the comparison is less clear and may well depend on the product design. The basic liability under SFAS 97 is the account value. An additional liability is established for front-end loads, sales inducements and non-level revenue streams. A DAC asset is capitalized and amortized in proportion of estimated gross profits. Under CFV the account value and the additional liabilities are not directly relevant to the liability calculation. They are only relevant to the extent they affect the expected future cash flows. At contract inception, it is quite likely that the initial liability under CFV will be higher than the liability net of DAC under SFAS 97 primarily due to the more restrictive definition of acquisition costs used in the net actuarial liability and the presence of the residual margin. After that point, the product structure, presence of

guarantees and revenue profile will determine how the profit differences emerge. The same volatility expected to emerge under CFV for products currently accounted for under SFAS 60 will exist for SFAS 97 products. The impact of experience variances were somewhat mitigated under SFAS 97 through the DAC amortization. As there is no DAC under CFV, this mitigation will not take place.

CONCLUSION

The ED marks a major step forward in the IASB's quest for an insurance accounting standard. The proposed measurement approach is significantly different from some of the accounting used today under US GAAP. While it remains to be seen how the FASB will choose to move forward on this issue, a large portion of the world-wide insurance industry may soon be using current fulfillment value to measure its insurance contracts. ■



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IASB/FASB Exposure Drafts on Insurance Products Primary Concerns Expressed by Life Insurers

By Laura J. Hay, John T. Dieck and Richard Browne

With the IASB release of an Exposure Draft (ED) on *Insurance Contracts* and the subsequent release of the FASB Discussion Paper (DP) *Preliminary Views on Insurance Contracts*, U.S. insurers are attempting to understand the implications of these documents for U.S. insurance products. In discussions with more than 100 insurance executives, KPMG has identified a number of top concerns of insurers. In addition, KPMG has performed a survey of insurers with regard to their views on some of the key issues relating to the IASB ED. In this article we discuss these top concerns of insurers, providing numerical examples for several of them, and indicate the relevant survey results with regard to these issues. While the survey results are broad across the industry, including responses from life, property casualty, and health insurers, as well as reinsurers, the focus of this article is on matters expressed by life insurers.

Top Concerns Expressed by U.S. Life Insurers

Many in the survey have expressed concerns with portions of many of the proposals in the ED. In this article we consider some of the concerns of these U.S. insurers.

MEASUREMENT MODEL

The four building block model for measuring the insurance liability under the IASB ED, where block 1 represents projected cash flows, block 2 represents discounting, and blocks 3 and 4 represent a risk and a residual margin, respectively, is generally acceptable to most insurers, particularly the purpose of the residual margin to eliminate any gain at issue. In the survey, 72 percent of respondents answered “Yes” to the question **“Do you agree that the residual margin should offset any gain at initial recognition of an insurance contract?”**

The FASB prefers a different approach than the IASB to margins in the measurement model. The FASB recommends a single composite margin while the IASB prefers the two separate margins. The composite margin is determined at inception of the contract so, as with the IASB model, there is no gain at issue. The difference in earnings patterns between the FASB and the IASB preferred approaches to margins can be significant depending on the product line. There were significant minority positions on both the IASB and FASB preferring the alternate model and both the IASB ED and FASB DP ask for feedback on constituent preferences.

In order to illustrate the measurement model, consider the following simple term insurance example:

Product	10-year term
Face	300,000
Premium	8,750
Incremental acquisition costs - Yr 1	5,000
Non-incremental acq. Costs - Yr 1	638
Maintenance expenses per annum	435

Note that this contract terminates at the end of the 10th year.

The graph on page 11 (top, right), shows the development of profit for the term example, both for the IASB preferred risk/residual margin approach and the FASB preferred composite margin approach. US GAAP results are shown for comparison.

According to the ED, for cash flows that are not closely linked to a specific asset portfolio, it is appropriate to

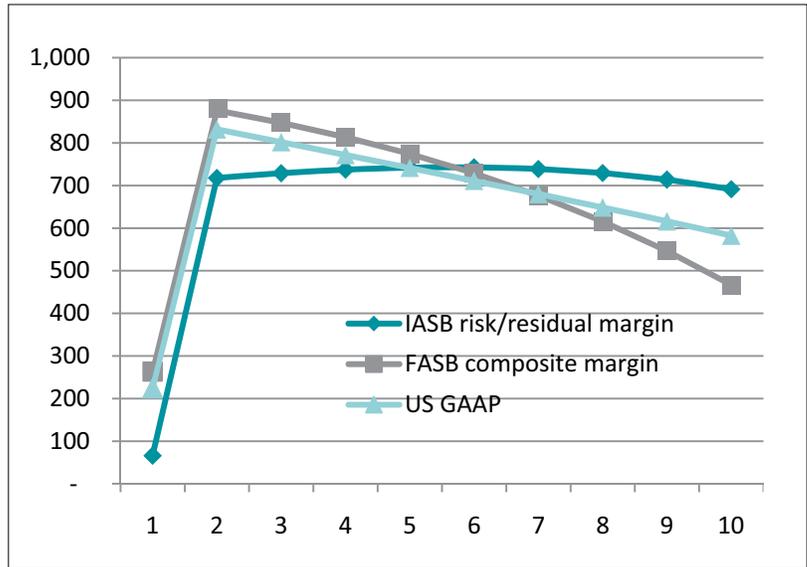
Many in the survey have expressed concerns with portions of many of the proposals in the ED.

FOOTNOTES

¹ The survey included responses of more than 100 insurance executives of U.S. insurance companies. Approximately 57 percent of respondents were employed by life and health companies, 32 percent from P&C companies and 11 percent from other organizations. The survey was conducted after the release of the IFRS ED, but prior to the release of the FASB DP.

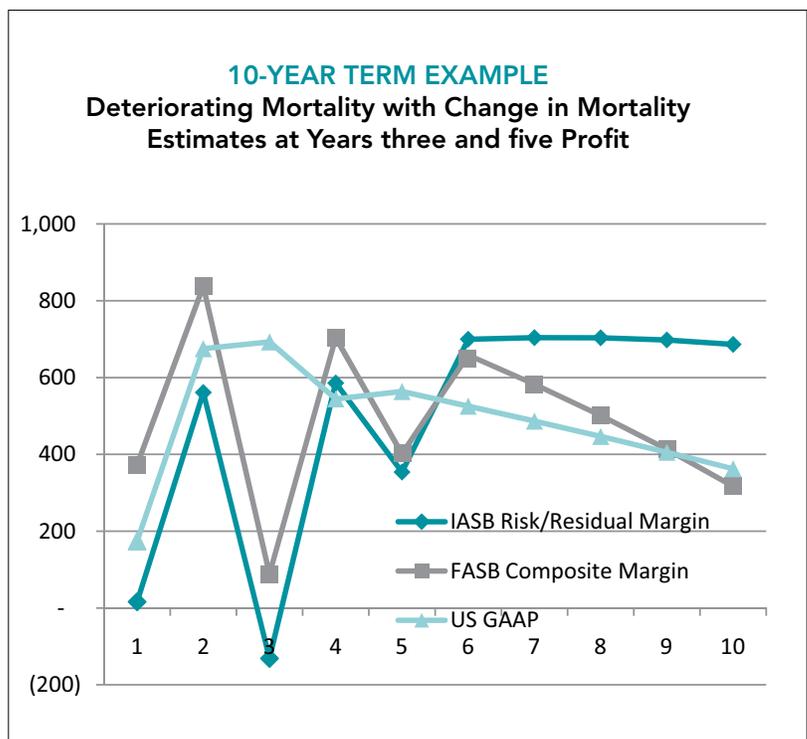
use a discount rate that is equal to the risk-free rate plus a liquidity premium. In this example we have used 4 percent for the discount rate. Discount rates are discussed more below.

The insurance liability in this example is equal to the present value of projected benefits, maintenance expenses and incremental acquisition costs less projected premiums, discounted at the appropriate discount rate. The liability is recalculated at each valuation date, based on current best-estimate projected cash flows and the current discount rate. In this example, we assume both the projected cash flows and the discount rate do not change over the life of the contracts. It should be noted that by including incremental acquisition costs in the liability cash flows, there is an offsetting decrease in liability when the incremental acquisition costs are paid. Any non-incremental acquisition costs are not included in the reserve cash flows and will reduce net income at the time they are incurred.



Also note that for our example we have assumed that the definition of deferrable acquisition costs under U.S. GAAP is the same as the definition of incremental acquisition costs under the proposed ED. This was done for simplicity. The treatment of acquisition costs is discussed more below.

As noted above, the building block measurement model preferred by both the IASB and FASB call for a revaluation of the reserves at each valuation date, based on then current assumptions. This revaluation of reserves when assumptions change can produce volatility in the results. This is illustrated by the following example, which is the same as the term example above, except that we have assumed deteriorating mortality for several years followed by projected mortality assumption changes at years three and five. (see graph to the right, bottom.)



So how do profits emerge under this new model? There are essentially five sources of profits and losses. The first three always occur—meaning even when actual is equal to expected. The last two occur when experience deviates from expected or when there are changes in estimates. They are:

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1. Release of margins—risk, residual (IASB preferred model) or composite (FASB preferred model),
2. Interest differences—the actual earned rate vs. the discount rate used,
3. Loss at inception—could be triggered by a loss at inception due to contract characteristics or perhaps non-incremental costs that are not included in the cash flows,
4. Experience fluctuations—where actual is not equal to expected, it flows through to the bottom line as it occurs, and
5. Changes in estimates—when there is a change in an assumption such as discount rate, the present value of that change flows through in the period in which the change is made; depending on the nature of assumptions being changed, the effect of changes in estimates may dwarf the other four sources of profit.

The ED has proposed an income statement presentation called the summarized margin approach that essentially breaks down the components of profit listed above. The summarized margin presentation more overtly shows these specific sources of profit. In our survey, we asked companies, “**Will the proposed margin presentation be useful to the users of an insurer’s financial statements?**” The responses were as follows:

Yes, no additional changes are necessary	4%
Yes, with some modification	43%
No, the ED does not capture the concept of margin appropriately	53%

It appears that the respondents are not comfortable with the ability of the summarized margin presentation to provide meaningful information.

As a final note on the measurement model, both the IASB and FASB boards agree that the measurement model be based on probability-weighted discounted cash flows. Most insurers in the United States have considerable experience with discounting cash flows on a stochastic basis for such products as variable annuities with guaranteed benefits. However, most do not usually consider stochastic scenarios when projecting the mor-

tality or morbidity elements in their insurance products. For such products as term insurance, where mortality is the main driver of cash flows, is it necessary to perform stochastic probability weighted scenario calculations? The ED does not require stochastic modeling, however, it does require that all information about the amount and timing of the cash flows needs to be considered. Some testing will probably be necessary.

MARGINS

Under the IASB preferred approach to measuring the insurance liability, there is a risk margin defined to be the maximum amount the insurer would rationally pay to be relieved of the risk that the fulfillment cash flows exceed those expected. While the ED specifies that one of three approaches be used to determine the risk margin (confidence level, CTE level or cost of capital), the ED does not provide any guidance as to the confidence levels or CTE levels that might be appropriate, nor does it give any details as to how a cost of capital calculation would be performed.

The survey asked the question, “**The ED limits the number of techniques that can be used for estimating the risk adjustment to confidence level, conditional tail expectation or cost of capital. Do you think that this is appropriate?**” The responses were as follows:

Yes, limiting choices improves consistency	46%
Limiting choice is OK, but need a few more	20%
No, we should be free to choose our techniques	24%

The FASB preferred approach proposes elimination of the risk margin altogether and the establishment of a single composite margin to force to zero the excess, if any, of the present value of inflows over the present value of outflows. This appears to be the more popular approach among U.S. insurers, probably for at least two reasons: (1) It is easier to implement, and (2) it will allow for better comparability between products and companies than the risk margin approach.

The popularity of the composite approach was confirmed in the survey. The following question was asked, “Do you support using a risk adjustment and a residual margin or do you prefer a single composite margin?” The responses were:

- Single composite margin 72%
- Risk adjustment and residual margin 19%
- I will propose another approach 7%

It should be noted that the IASB and the FASB preferred approaches to margins can produce the same gain at issue or the gains at issue may be different prior to consideration of margins. If, after the risk margin, there is a positive gain, the residual margin sets the gain to zero; in this case the composite margin would be equal to the sum of the risk margin and the residual margin, and both methods produce zero gain at inception. However, if after the risk margin is taken into account there is negative gain, no residual margin is set up and negative gain (loss) remains. In this case the composite approach produces no gain at inception, while the risk margin approach produces a loss.

The IASB ED specifies that after initial recognition, the risk margin is re-measured each period based on a current assessment of the maximum amount an insurer would rationally pay to be relieved of the risk that ultimate cash flows exceed expected.

The residual margin, however, is to be recognized in earnings over the coverage period only. The ED specifies it should be recognized in a “systematic manner on the basis of the passage of time” (with acknowledgment that an unusual pattern of benefits and claims may make another method more appropriate).

In the term insurance example, the risk adjustment margin is calculated using a factor applied to the present value of claims on the valuation date. This was used as a proxy for the results expected from the specified methods. The residual margin was run off as a percentage of expected claims at issue, noting that the coverage and claims periods are the same for this product, and that this method produced a recognition of the margin in earnings in a systematic manner based on the passage of time.

The IASB ED specifies that after initial recognition, the risk margin is re-measured each period ...

The initial residual margin, then, would be locked-in at inception and recognized in earnings in a systematic manner based on the passage of time. A number of insurers believe that as cash flow changes and changes in the risk margin occur, these changes should serve to reduce the residual margin rather than be reflected in earnings. In the survey the following question was asked, “**The ED proposes that future changes in cash flows and the risk margin are recognized in profit and loss. Do you believe these changes should reduce the residual margin locked in at inception?**” The responses were:

Yes 59% No 30% Not sure 11%

For the FASB composite margin approach, the initial margin is locked-in at inception and is recognized each period by a percentage that is equal to the inception to date allocated premium plus claims as a percent of the total premium plus claims over the life of the contract. The amount recognized in the current period is the calculated amount based on the formula less the amounts previously recognized. This formula based on the FASB DP differs from the formula in the IASB ED which only used current period allocated premiums plus claims in the numerator to develop the current period margin release. The FASB DP modified the formula so that at the end of the life of the portfolio all the composite margin will have been released. The total premium plus claims is redetermined each period reflecting actual history and changes in projections. As noted above, this approach has the appeal of simplicity of implementation.

DISCOUNT RATES

Perhaps the greatest concerns of U.S. insurers are related to the discount rate to be used to discount cash flows in determining the reserves. The FASB discussion paper indicates that if the cash flows of an insurance contract

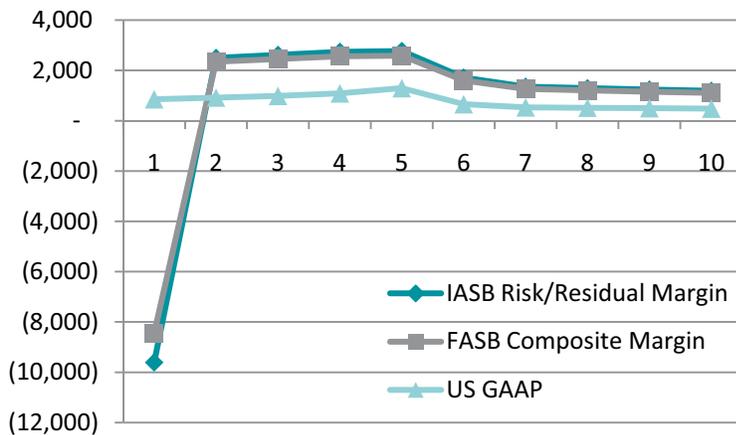
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do not depend on the performance of specific assets, then the discount rate should equal the risk-free rate, adjusted for liquidity risk. Presumably this means that if certain cash flows depend on the performance of specific assets, then the discount rate applied to those cash flows would depend on that performance, otherwise the appropriate discount rate is based on the risk-free rate plus a liquidity premium.

Many U.S. insurers have products that are fund-based, with interest credited to the funds based on general account returns. These products include deferred annuities and universal life. Some parties have asked whether the general account portfolios backing these products could be considered specific assets under the ED? It should be noted that many U.S. deferred annuities may be classified as insurance under the ED because of the presence of the waiver of surrender penalties upon death and lifetime annuitization options.

Consider the following example:

Product	SPDA
Deposit	100,000
Incremental acquisition costs	5,000
Guaranteed interest	5% years 1-3, 1.5% thereafter
Surrender charge (% deposit)	5-5-5-3-1
Expected earned rate	7%
Expected credited rate	5.5%
Risk-free rate plus liquidity premium	4.5%



We assume the product is held for 10 years and then surrendered.

It should be noted that there are questions regarding whether such contracts as this require unbundling of the contract into an investment component and an insurance component. In this section we have assumed the contract is not unbundled; that is, it is entirely an insurance contract. Unbundling is considered in the next section.

The risk margin is determined using a cost of capital method, assuming that required capital is a fixed percent of the account balance.

The chart below, left, shows the emergence of profit when the discount rate is equal to 4.5 percent, the assumed risk-free rate adjusted for liquidity. The large strain at issue is characteristic of these kinds of products when the discount rate is less than the credited rate.

If a final standard allowed that the discount rate should be linked to the performance of the general account assets supporting the product, then a discount rate such as the credited rate, or the expected asset earned rate might be appropriate. Please note that for the proposals as written, considering using the earned rate would likely be a highly controversial choice. The following chart shows the emergence of profit when the credited rate of 5.5 percent is used as the discount rate. The first year strain is reduced substantially. (see Chart on page 15, top, right)

If the expected earned rate is used for the discount rate, then the profit pattern more closely resembles that of US GAAP. (See chart on page 15, bottom, right).

Another issue related to discount rates is the expected volatility that will result if the risk-free rate plus liquidity adjustment based discount rate is used. This can be especially pronounced under long-term contracts, such as certain annuities, long-term care and long-term disability. As an example, with our SPDA product we assume a discount rate of 4.5 percent for three years, followed by a drop to 3.5 percent. The chart on page 16 (top, left) shows the emergence of profit under this scenario.

Still another issue of concern to U.S. insurers related to discount rates is how to determine the appropriate liquidity premium to use for a discount rate equal to the risk-free rate adjusted for liquidity. The ED provides very limited guidance about the liquidity premium and many are discussing this issue now.

UNBUNDLING

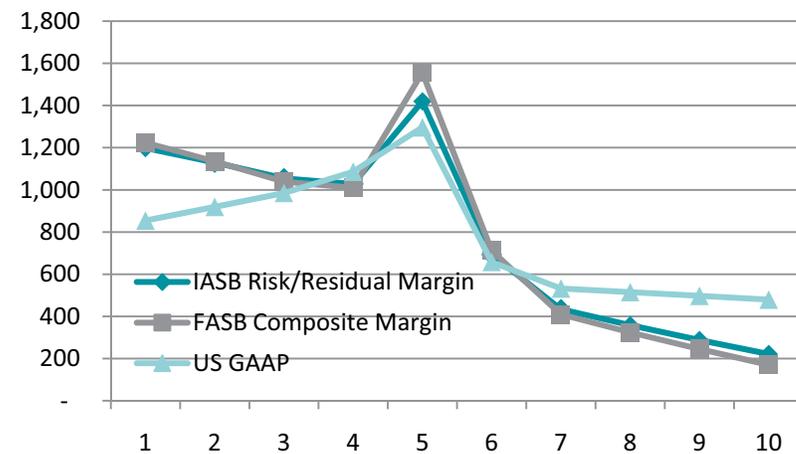
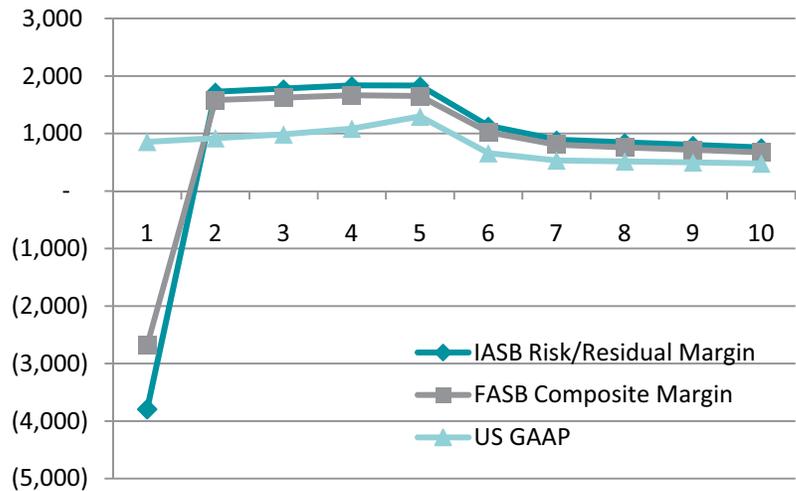
Unbundling refers to the bifurcation of a contract into a component that is treated as an investment contract, generally accounted for as a financial instrument, and a component that is treated as an insurance contract. Specifically, the IASB ED indicates that unbundling should occur when the contract contains an investment component with an account balance that:

1. Has an account balance that is credited with an explicit return, and
2. The crediting rate is based on the performance of the underlying investments and must pass on all investment returns (a minimum rate guarantee may exist).

With regard to condition 2, the ED specifically identifies unit-linked contracts, index-linked contracts and universal life contracts. The guidance on unbundling account balance components is included in an example rather than the unbundling principle which is based on the concept of “closely related.”

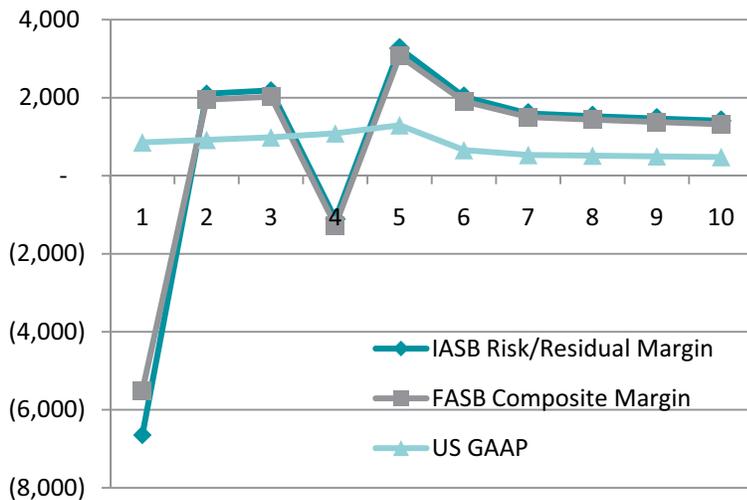
It is not clear as to exactly which products commonly sold in the United States this might apply, with all the versions of deferred fixed and variable annuities and universal life type contracts. For example, on fixed-spread product where the crediting rate is based in part on the actual returns of a portfolio of general account assets, but the crediting rate is also discretionary, depending on such other factors as competitiveness and desire to preserve business, is unbundling to be done?

In order to see how unbundling might be done, we have modified our original SPDA example to unbundle the contract into an investment and an insurance compo-



nent. Insurance benefits in this example are equal to the surrender charges waived on death. If the model had included annuitization benefits, these would also be considered insurance benefits. We have allocated the deposit and the acquisition costs to the insurance and investment components at 5 percent and 95 percent, respectively (the ED doesn’t provide guidance on how or if acquisition costs are to be allocated to the different components).

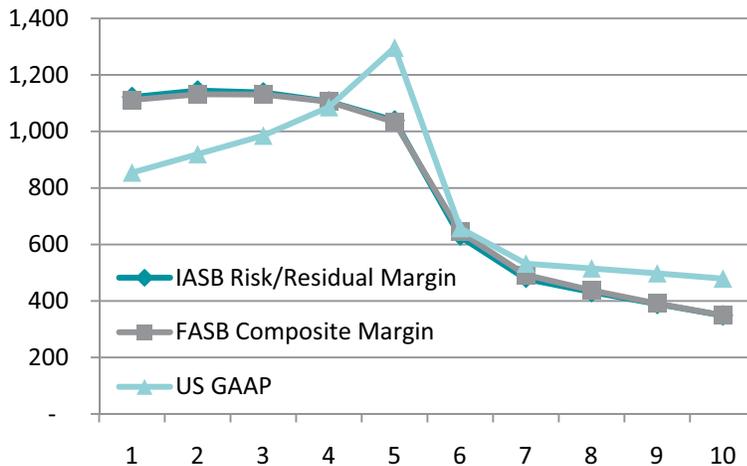
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The investment component in our example is valued using the amortized cost method, by determining the discount rate at inception under which the present value of expected amounts released on surrender and death equate to the entry value of the contract. The entry value is equal to the allocated deposit less the allocated acquisition costs.

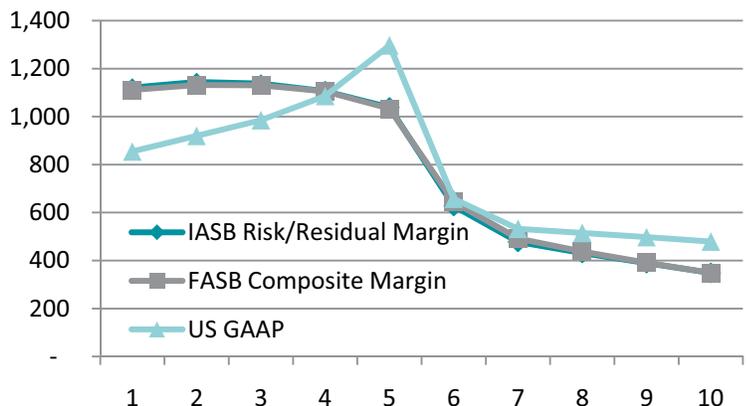
The insurance component is valued using the building block approach, using a discount rate of 4.5 percent, consistent with our original SPDA example. The risk margin is calculated using a simplified approach, equal to 10 percent of the present value of expected claims (waived surrender charges).

Other assumptions for this example are generally the same as our original example. The chart to the left (middle) shows the emergence of profit.



Note the scale on this graph is different than the scale on the earlier SPDA examples. In the unbundling case, the strain at issue is eliminated and the results are much more consistent with US GAAP. This is because the investment component is valued under a method that is forced to be zero at inception, the amortized cost method, and because the insurance component is a small part of the total contract.

In addition, for this example, when we look at the impact of changes in the discount rate, the volatility is much less than when the contract is not unbundled. (See chart to the left, bottom.)



In this case a discount rate of 4.5 percent for three years followed by a rate of 3.5 percent is used. The profits are relatively insensitive to changes in the discount rate because it impacts only the insurance component which is such a small portion of the total contract.

The authors do not maintain that the above unbundling example is necessarily appropriate under the IASB ED or the FASB DP. For example, there may be different methods to consider in determining how to approach allocations for unbundling purposes. We have merely presented it as one possible approach to illustrate the possible impacts of unbundling.

The survey question, **“Do you think it is appropriate to unbundle some of the components of an insurance contract?”** elicited the following responses:

- Yes, it is appropriate 7%
- Yes, but with some clarification as to how to unbundle 51%
- Unbundle embedded derivatives that are not closely related, but that’s it 24%
- No, contracts within the scope of the insurance standard should be valued as insurance contracts in their entirety. 17%

The confusion over exactly how unbundling is to be done is evident from the additional survey question, **“Do you believe the proposed criteria for when unbundling is required are appropriate?”** The responses were:

- Yes, the criteria are appropriate 13%
- No, there is not enough guidance for consistent application 81%
- No, I would recommend an alternative 6%

ACQUISITION COSTS

Companies appear to be generally pleased with the approach of including incremental acquisition costs in the measurement building blocks. Note that the residual/composite margin is effectively reduced by the incremental acquisition costs; however, since the residual/composite margin is floored at zero any acquisition costs not recognized due to the floor will reduce net income as incurred.

Some insurers, though, are concerned with the tightness of the definition of incremental acquisition costs as compared to US GAAP definitions. There is also concern over inconsistencies between the ED definition of incremental acquisition costs and expenses deferrable under the new EITF 09-G, which could mean double implementation of expense accounting changes.

In the survey, the following question about the impact of the ED with respect to incremental acquisition costs was asked, **“Do You Believe That The ED’s Accounting Treatment For Incremental And Non-Incremental Costs Will Impact Your Product Features, Reinsurance Or Cost Structures The Most?”** The responses were:

- Cost structures 33%
- Product features 6%
- Reinsurance program 3%
- All equally 28%
- No significant impact 30%

TRANSITION

The ED does not allow for a risk margin to be established for existing business. This has the impact that future profits that would have been generated had a residual margin existed now become part of equity at adoption rather than being released over time in the future. Many insurers do not feel this is appropriate.

Of course, for existing business the risk margin may need to be determined at historical points in time. The complications of doing this for blocks of very old business should be evident. On the other hand, many insurers have developed techniques for estimating historic cash flows when performing such exercises as converting to US GAAP.

OTHER CONCERNS

Disclosures

There are significant concerns about the sensitivity of information that may need to be disclosed. There are also concerns about the necessary time it will take to assemble the required disclosure information.

Our survey question, **“Do you think that the proposed insurance model or the required disclosures gives away company information?”** The responses were as follows:

Yes 54% No 28% Not sure 18%

To the question, **“When considering the proposed presentation requirements, including footnote disclosure, do you believe your systems already capture the necessary information that needs to be redirected to meet the requirements or is there information that is simply not captured today?”** The answers were:

- It’s captured, we just need to figure how to use it 9%
- We will be redesigning front-end systems to capture this info 69%
- Not sure 21%



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Performance Management

Most insurers felt that Key Performance Indicators (KPI) will need to be changed to accommodate the new environment. **“The proposed insurance standard will drastically change the presentation of the financial statements. These changes will potentially eliminate or change key performance indicators. Is this the case for your company?”**

Yes 89% No 4% Not sure 7%

One area of special concern seems to be how to explain the increased volatility in results, both internally and externally, to analysts in particular.

Resources

With the possible need to redesign front-end systems, actuarial systems, and reporting formats, there will clearly be demands on resources. In particular, all of these activities will involve the input from actuaries. In our survey we asked the participants how they plan to respond to these demands on actuarial resources at this point. **“It is expected that the ED will create an actuarial resource shortage.**

How do you expect to modify your current actuarial resource pool?”

- Redeploy existing resources more effectively 37%
- Expand our actuarial resource pool 32%
- Outsource certain actuarial activities 21%
- No change necessary 10%

Final Note

In this article we have presented some of the major concerns expressed by life insurers regarding the IASB ED and the FASB DP that have emerged at this time. We expect that, as insurance companies continue to examine the implication of these documents on their business portfolios, other concerns and issues will surface.

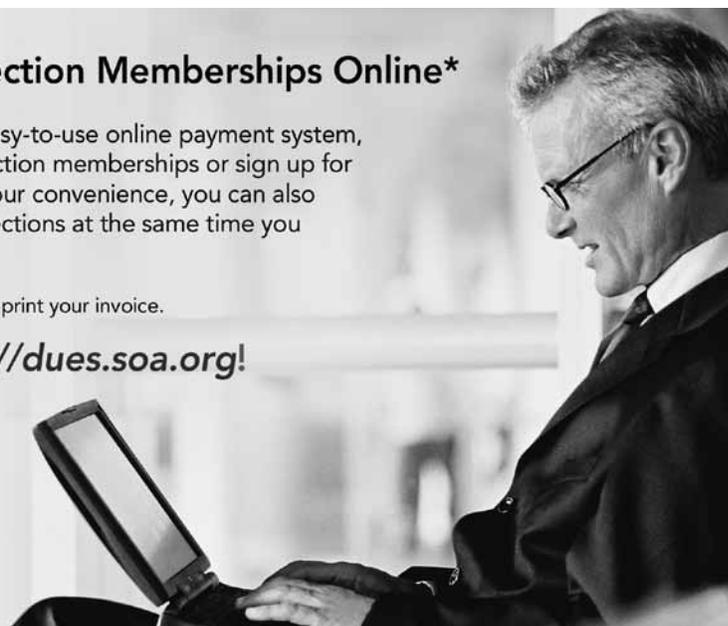
The deadline for providing comment on the IASB ED was Nov. 30, 2010 and on the FASB DP is Dec. 15, 2010. We hope companies have performed some of the analysis necessary to understand the implications of these documents on their own insurance products and have expressed their concerns by commenting. If not, it is time to start assessing the implications of the new accounting models for insurance products. ■

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PBA Corner

By Karen Rudolph

At publication time for this issue, the VM-20 impact testing will be well underway. Regulators have identified several key objectives for the testing. Discussion of the impact study project was a part of the NAIC's August 2010 meeting agenda in Seattle. Ideally, the NAIC would like to engage approximately 25 participating companies, each covering approximately three new business products. The impact study results for these companies and products are intended to address the following items:

- Quantify the impact of VM-20 methods on life insurance products sold in the United States and more generally on the broader U.S. life insurance industry,
- Assess the effectiveness of the exclusion tests,
- Assess the effectiveness of the Net Premium Reserve methodology as a floor for the minimum reserve,
- Assess the effectiveness of the Economic Scenario Generator in exposing economic risks,
- VM-20 treatment of reinsurance,
- An understanding of the range of approaches used to establish prudent estimate assumptions,
- An understanding of whether model granularity affects the minimum reserve,
- The number of economic scenarios and how the number chosen impacts the minimum reserve,
- Assessing how companies utilize sensitivity testing in evaluating balance sheet risks,
- Assess the effectiveness of the reporting and documentation requirements of VM-31,
- Determine regulatory benchmarks or metrics that could be used to measure a company's compliance with the principle-based reserve requirements of the valuation manual,
- Assess the degree of difficulty in implementing the proposed new methodologies, accounting for staff and computer resource considerations,
- Identify areas where refinements to the methodology are necessary in order to improve the risk measurement functionality of the methodology, and
- Identify areas where further clarification of the proposed methodology or processes are needed in order to facilitate a smooth implementation.

This is a very tall order particularly given the time constraints. The NAIC would like work on the study completed and ready for their consideration by March 31, 2011 with the report to be presented during the Summer 2011 National Meeting in Philadelphia. The objectives list includes assessing the effectiveness of several key aspects of VM-20 which may require the participants to make more than one pass at different calculation types. Results will also need to include comparable calculations of current minimum reserve standards in order to determine impact.

Meanwhile, Life and Health Actuarial Task Force work on VM-20 has slowed considerably and the version posted on http://www.naic.org/committees_lhatf.htm and dated Aug. 13, 2010 is considered the version to be used for the impact study exercise.

RECENT VM-20 CHANGES

The LHATF work leading up to the Summer 2010 National Meeting in Seattle included the following changes to VM-20 requirements:

- Section 2 Minimum Reserve has been re-written so that the exclusion tests are optional, not mandatory and to recognize a deferred premium asset element in the net premium methodology. The minimum reserve is the aggregate net premium reserve plus the excess, if any, of the greater of the aggregate deterministic reserve and the stochastic reserve over the difference between the aggregate net premium reserve and any deferred premium asset held on account of the policies. Section 2 continues by defining the structure of the minimum reserve if the stochastic reserve exclusion or deterministic exclusion tests are passed. Section 2 also defines principle-based valuation reserves as deterministic or stochastic reserves that are either required or calculated for a policy. This is important in terms of VM-31 reporting requirements for business subject to a principle-based reserve valuation.
- Section 3 Net Premium Reserve now includes an Applicability section defining the net premium reserve as the Section 3 methodology (ACLI's proposal) for term insurance and universal life with



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CONTINUED ON PAGE 20

secondary guarantee (ULSG) longer than five years, and the current formulaic minimums (located in VM-A and VM-C) for all other products. Lapse rates allowed for determining net premium reserves for fund-based ULSG policies was reduced from its original range of 1.5 percent – 3.0 percent to a range of 0.5 percent – 1.0 percent, where the assumption used depends on the policy's funding level for the secondary guarantee.

In light of the timing delay introduced by the impact study, the sunset date on Actuarial Guideline 38, Section 8C has been extended to Dec. 31, 2013.

- Section 6 Stochastic and Deterministic Exclusion Tests was revised to reflect a definitional change (from “seriatim” reserve to “adjusted deterministic” reserve) and a change to the safe harbor ratio. What was a 4.0 percent stochastic exclusion test threshold has been increased to 4.5 percent. The increase accommodates a change to the denominator of the ratio. The denominator no longer includes expenses or reinsurance expense allowances. Treatment of these items, in particular reinsurance expense allowances, was seen as potentially inconsistent within the industry and so was removed from the ratio.
- Section 7 Cash Flow Models now includes two alternatives for determining cash flows from reinvestment assets. Alternative 1 is the method that has historically been in VM-20 and is a function of the corresponding U.S. Treasury rate plus a fixed-basis-point spread. Alternative 2 uses gross investment income from reinvestment assets less asset default costs and investment expenses. Regulators expect both alternatives be tested in the impact study exercise in an effort to evaluate differences in these two approaches. It is expected the operative version of VM-20 will use only one of the two alternatives. Section 7 also reflects the regulators' current thinking with regard to the economic scenario generator.

Rather than prescribing the interest scenarios, regulators have re-written Section 7 to refer to a prescribed economic scenario generator with prescribed parameters. The generator will provide returns for several different investment categories. The actuary will use judgment in mapping each proxy fund to the prescribed fund returns. The requirements continue to allow for use of scenario reduction techniques assuming the stated requirements for such techniques are met.

- Section 9 Assumptions have been revised for mortality assumption development. Significant changes include: Allowing the company to use a method other than the Underwriting Criteria Scoring (UCS) system for determining the appropriate industry mortality table, as long as the method is actuarially sound; if using the UCS system, the company is allowed to adjust the resulting table up or down 2 tables. Generally, the process for establishing the valuation mortality assumption is more clearly spelled out. Specific mortality margin methods have also been added to VM-20. The margin is prescribed, and has a random fluctuation risk component and a company variation risk component. An Appendix 3 has been added to support the mortality margin requirements.

OTHER VALUATION MANUAL AND REGULATORY CHANGES

VM-00 has also been re-exposed with several changes. One change that impacts actual implementation is the reduction in transition time from five years to three years. This means that once the Valuation Manual becomes operative, for policies otherwise subject to VM-20 requirements, a company has the option of electing to establish reserves according to VM-A and VM-C for three years after the operative date rather than the original five years. For companies having taken a wait-and-see position, this change shortens the time during which they can prepare for the principle-based methodology.

In light of the timing delay introduced by the impact study, the sunset date on Actuarial Guideline 38, Section 8C has been extended to Dec. 31, 2013. Policies issued Jan. 1, 2011 to Dec. 31, 2013 can make

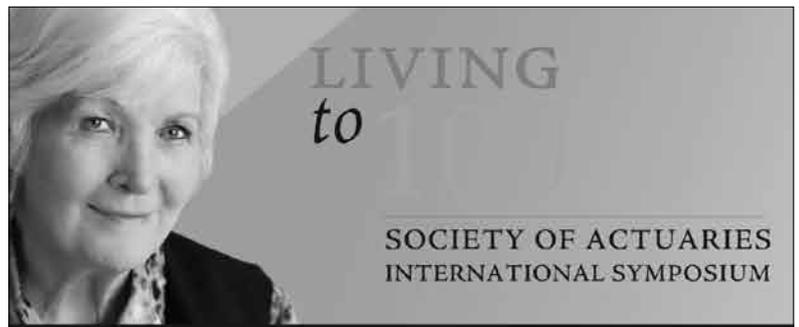
use of the provisions allowed in section 8C of this actuarial guideline whereas without such extension, they would have reverted back to section 8B.

C3 PHASE III

This project remains in the exposure stage and has not had substantive discussion of late. The Academy's C3 Working Group continues to function, meeting less frequently however. Progress on the project is in a holding pattern pending other activity related to the VM-20 impact study and potential revisions to VACARVM based on the Oliver-Wyman report. C3 Phase III does not have an official operative date at present.

PRACTICE NOTES

In December 2009, a public policy practice note on C3 Phase III joined the practice note for C3 Phase II and Actuarial Guideline XLIII on the Academy website. Work has just begun on developing a practice note for application of VM-20 Requirements for Principle-Based Reserve for Life Products. Experiences drawn from the NAIC impact study should provide relevant content for the practice note. ■



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Actuaries
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Report on the International Actuarial Association

By Jim Milholland



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One can learn how difficult it is to develop an accounting standard by joining a group of actuaries trying to write a comment letter on a proposed standard. The actuaries must first try to reach a common understanding of what the proposal says, and then try to reach agreement on what the standard should say.

At a special meeting of the Insurance Accounting Committee of the IAA in Toronto on September 27 – 29, actuaries discussed the IASB's exposure draft Insurance Contracts (the ED). The discussions were lively and progress was made toward a comment letter, but the meeting ended with much left to do before the submission deadline of November 30.

ACTUARIES ARE SUPPORTIVE, BUT CRITICAL

While the global actuarial response is still a work in progress, discussions show that actuaries support issuance of a principled standard and agree with the direction of the IASB in the ED. They also advocate an unfettered role for the actuary to interpret and apply the principles, for example, without constraints or limitations on the methods for calculating risk margin. In other respects, actuarial support of specific aspects of the ED varies widely.

BUILDING BLOCKS

Actuaries agree that the now-familiar building blocks provide an appropriate basis for the measurement of liabilities, at least for long duration contracts. At the same time, actuaries disagree about many aspects of each building block. They do not even agree on how many building blocks there should be; i.e., whether the margin has one or two parts.

Building Block 1

Building Block 1 is the current, unbiased estimate of future cash flows. The ED refers to them as the cash flows that fulfill the obligations of the contract, which leads many observers to label the measurement attribute as a fulfillment value. After nearly 10 years of debate, the IASB has finally agreed with actuaries that future premiums on recurring premium products must be included in the cash flows and that discretionary par-

ticipation features must also be included. The IASB has also concluded that certain expenses should be included in cash flows and draws the line at incremental acquisition costs and direct maintenance costs. Because acquisition costs are included in expected cash flows, the margin is calibrated to the present value of premiums less acquisition costs. So, while there is no deferred acquisition cost asset, there is relief from strain at least to the extent of incremental acquisition costs.

Most actuaries find the consideration of only incremental costs to be too limiting and believe that the cash flows should include all acquisition costs or at least those that are incremental to a portfolio of contracts. A portfolio perspective allows, for example, acquisition costs of direct marketers to be reflected in the same way as commissions for agent-sold contracts.

Building Block 2

Building Block 2 is the adjustment for the time value of money, which of course refers to discounting the estimated future cash flows. No actuary disputes the need to discount long duration contracts, but the discount rate itself is a subject of much debate. The ED proposes that contracts for which cash flows depend wholly or partly on the performance of specific assets should reflect that dependency in the measurement of the liabilities. These contracts presumably include variable contracts, participating contracts and perhaps universal-life contracts. The ED does not explain how the dependence is reflected, but it does make reference to the use of replicating portfolios.

For contracts without a dependence on performance of specific assets, the discount rate is consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, which the ED concludes is a risk-free rate plus an adjustment for liquidity.

Actuaries find the guidance for setting discount rates lacking in clarity. There is concern about the references to replicating portfolios and to market-observable prices. If market consistency is introduced, the measurement objective begins to take on characteristics of an exit value, a measurement attribute that the IASB



has previously considered and has rejected. There is also concern that a different approach for contracts that do or do not have a dependence on performance of specific assets may lead to abuse. Insurers can add minor participation features that suffice to establish dependence and hence permit use of a different, typically higher, discount rate than otherwise. Actuaries are not convinced that a rate that reflects the characteristics of insurance contracts is necessarily the risk-free rate plus an adjustment for liquidity. After lengthy discussions and expressions of concern about the proposed guidance, consensus on what to recommend to the Board remains elusive.

Building Block 3

Building Block 3 is the adjustment for risk, previously referred to as the risk margin. The ED states the risk adjustment is the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected. The combination of fulfillment cash flows with an adjustment that is characterized as a price for risk makes the measurement attribute ambiguous. It becomes a hybrid that is quasi market consistent. Every actuary at the meeting objected to the measurement objective for risk adjustments. A small team of actuaries is developing an alternative measurement objective for discussion at the regular committee meeting in Vienna in October.

The ED permits three, but only three, approaches to calculating a risk adjustment. They are a confidence level, a conditional tail expectation, or a cost of capital. Actuaries object to limitations on the permitted methods. They believe that actuaries are best suited to select the method that is most appropriate for the purpose. Limiting the methods may result in estimates that are less reliable than those that would be produced by methods that are proscribed.

GAIN AT ISSUE

The discussion of risk adjustments leads to the topic of gain at issue. The ED makes clear that there can be no gain at issue. If the sum of the present value of fulfillment cash flows plus the risk adjustment at inception is less than zero, the amount needed to bring the sum to zero is captured as a residual margin. This amount, the residual margin, is sometimes referred to as a fourth building block. There can be a loss at issue. If the discounted cash flows plus the risk adjustment exceed the present value of premiums, the liability is recognized as calculated with no residual margin. A residual margin is amortized systematically over the life of the contract but, unlike the risk adjustment, it is not re-measured except to reflect greater-than expected contract terminations.

In the ED, the IASB asks respondents to comment on a possible alternative approach to risk adjustments and residual margins. The alternative is to have a composite margin that is the amount by which the present value of the fulfillment cash flows is less than zero at inception of the contract. In other words, building block 3 would be a single composite margin that prevents gain at issue and does not purport to be a measure of risk. It provides for adverse development to the extent of the margin in the premium.

Actuaries favor risk and residual margins to a composite margin, but, by a small majority, would really rather have no constraints on gain at issue. Some actuaries find that the residual or composite margin is an arbitrary deferral of profit and that it is difficult to characterize. They also note that the residual or composite margin appears to provide for those cash flows that are not reflected in Building Block 1. They would prefer

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that Building Block 1 directly reflect these cash flows. Explicit consideration of all cash flows assures that the release of the amount in the liability that provides for the cost coincides with the incurral of the costs.

As noted, the ED states that the residual or composite margin is not re-measured. It notes that the residual or composite margin would buffer the effects of changes in assumptions if it were recalibrated when the present value of future cash flows is re-measured. The ED asks respondents to comment on this possibility. Actuaries at the meeting were evenly split between those who believed that the effects of a change in assumptions should be buffered. They also slightly preferred that, if there is buffering, then it should offset only changes in demographic assumptions, not changes in financial assumptions.

UNBUNDLING

The IASB seeks comparability of accounting for insurance contracts with significant savings components to accounting for financial instruments that are not insurance. The ED proposes that financial components of insurance contracts that are not closely related to the insurance component be separated, or unbundled, from the insurance contract for measurement and presentation. The term “closely related” is defined in connection with separation of embedded derivatives from host contracts, leaving the reader to surmise that it means that the financial component is separated from the insurance contract when it can be measured without reference to the insurance contract. The ED gives an example of a contract with financial components that must be unbundled. The example is quite obviously a variable contract although it is not named as such. The ED also refers to universal-life insurance in a context that implies that the Board intends for those contracts to be unbundled.

Actuaries are divided on the application of the proposed guidance on unbundling. Some believe that it clearly requires unbundling of universal-life type contracts while others are equally certain that it does not. Few actuaries are convinced of the benefits of unbundling, however, and the comment letter will say that unbundling should occur only when the insurance component is incidental to a financial instrument or when the combination of an insurance feature with a financial instrument does not have commercial substance.

PRESENTATION

The ED proposes presentation in the statement of profit or loss that highlights:

- the underwriting margin (i.e., changes in the risk adjustment and release of the residual margin), and
- experience adjustments (i.e., differences between actual cash flows and previous estimates) and changes in estimates (i.e., changes in current estimates of cash flows and discount rates).

This presentation is referred to as the summarized margin approach because it recognizes the release of the margin in a way that allows direct comparison to the deviations in cash flow from expectations. It does not recognize in profit or loss the actual amounts of incremental acquisition costs, benefits or direct expenses. Notwithstanding the departure from current practices, most actuaries are comfortable with the proposed presentation, in large part because the amounts not recognized in the statement of profit or loss are disclosed in the notes to the financial statements.

SHORT DURATION CONTRACTS

The Board acknowledges that the use of building blocks may be impractical for short duration contracts, especially those for which the estimation of cash flows and risk adjustments is problematic in the pre-claims period. The ED would require a modified approach to measurement of liabilities for contracts that have a coverage period that is approximately 12 months. The modified approach is similar to the unearned premium but with added complications to allow for some recognition of the time value of money. There is also a deferred acquisition cost that is recognized as a reduction in the liability. The presentation in the

Actuaries are divided on the application of the proposed guidance on unbundling.

statement of profit or loss includes earned premium as revenue and benefits and direct costs as expenses. This presentation recognizes many of the items that are missing from the summarized margin approach, such as the amounts of claims, incremental acquisition costs and direct expenses.

Actuaries appreciate that the Board was willing to accommodate short duration products but find the modified approach more complicated than current practices. They hope to persuade the Board to permit, but not require, measurement and presentation similar

to current US GAAP practices. They are not concerned about the contrasting presentation approaches.

CONCLUSION

By the time this report is published, the comment letter from the IAA will have been submitted to the IASB. It can be accessed at the IAA website www.actuaries.org. Actuaries are encouraged to read the letter to see how the IAA commented in the end. ■

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FASB/IASB Financial Instruments Joint Project

By Leonard J. Reback



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The Financial Accounting Standards Board (FASB), which sets accounting standards under US GAAP, and the International Accounting Standards Board (IASB), which sets accounting standards under IFRS, are engaged in a joint project to update the accounting standards for financial instruments. Although insurance contracts are scoped out of this project (and are covered by a separate joint project), the financial instruments project will impact actuaries in a number of ways. Investment contracts that do not meet the US GAAP or IFRS definition of insurance are subject to financial instruments accounting, even if they are regulated as insurance contracts. Under current US GAAP, investment contracts generally include most fixed annuities, GICs, term certain payout annuities and deposit reinsurance contracts.¹ The financial instruments standard will also impact the valuation and presentation of embedded derivatives that are bifurcated from insurance contracts. It will also impact the valuation and presentation of account balances and other financial instrument components that would be unbundled from insurance contracts based on current tentative decisions under the joint insurance contracts project. The financial instruments project will also impact the accounting for many of the invested assets used to back insurance contracts.

PROJECT SCOPE

Although this is a joint project, FASB and IASB have taken different approaches to developing their respective standards. And although the goal is to ultimately have a single high-quality financial instruments accounting standard across both jurisdictions, each board has reached some different tentative decisions to date.

The IASB has been developing its new standard in stages:

1. Classification and measurement,
2. Amortized cost and impairment, and
3. Hedging.

The IASB has already released a new standard in late 2009, IFRS 9, which covers classification and measurement of financial assets. It released exposure drafts in 2010 requesting feedback on some tentative decisions it made regarding classification and measurement of financial liabilities and amortized cost and impairment. It has not yet released any exposure drafts covering decisions on hedging.

FASB is attempting to develop a comprehensive new financial instruments standard in a single step. It released an exposure draft in May 2010, with a comment deadline of September 30, covering its tentative decisions on all aspects of financial instrument accounting.

CLASSIFICATION AND MEASUREMENT

Although the boards have reached different decisions to date on classification and measurement, there are similarities between the two approaches. Both boards would have two main measurement categories, one which uses fair value with all changes in fair value flowing through net income, and one in which amor-

FOOTNOTES

¹ The current insurance contracts project may result in a change to the definition of an insurance contract and so, for example, fixed deferred annuities might be defined as insurance contracts rather than investment contracts under the revised standard. However, the account balance may have to be "unbundled" and treated as a financial instrument, even under the revised insurance contracts standard.



tized cost would be used to determine net income. Both boards would use criteria related to the nature of the instrument's cash flows and the business model to determine which measurement category is used, although the criteria are not identical between the two boards. Each board has developed additional measurement categories for special situations. And each board would permit a fair value option, at least for situations where it reduces an accounting mismatch.

Under the IASB classification and measurement approach for financial assets, financial assets would be measured either at fair value or at amortized cost. The classification would be consistent for both net income and the balance sheet.² Financial assets would be held at fair value, with all changes in fair value flowing through net income, unless they meet both of the following criteria:

- Contractual cash flows are solely payments of principal and interest, and
- The business model is to hold the asset to collect contractual cash flows.

Financial assets that meet both criteria would be held at amortized cost. However, for financial assets that meet the criteria to be held at amortized cost, a fair value option would be available if using fair value would mitigate or eliminate an accounting mismatch.³ Financial assets that would be required to be held at fair value include equities, standalone derivatives and many assets that contain an embedded derivative. Lower tranches of structured securities, such as mortgage backed securities and CDOs may also need to be held at fair value, since some of the cash flows could be considered compensation for accepting prepayment or default risk of the higher tranches, and thus not strictly principal or interest.

IASB's tentative decisions on classification and measurement for financial liabilities is that most liabilities should be at amortized cost, with embedded derivatives that are not closely related to the host contract bifurcated and held at fair value. Standalone derivatives and liabilities held for trading would be at fair value in their entirety. A fair value option would be available for financial liabilities. However, for financial liabilities for which fair value option is elected, changes in fair

FASB is attempting to develop a comprehensive new financial instruments standard in a single step.

value due to changes in own credit would be shown in other comprehensive income rather than in net income. This would include changes in fair value due to both changes in credit standing and changes in the market price of credit.

FASB's tentative decisions on classification and measurement are different. For the most part, FASB's approach makes no distinction between assets and liabilities, and most financial assets and liabilities would be on the balance sheet at fair value. The default measurement approach for both financial assets and financial liabilities is fair value with all changes in fair value through net income (FV-NI). For financial liabilities using FV-NI, the impact of own credit is included in net income. However, the portion of the own credit impact related to a change in credit standing (but not the portion related to changes in the price of credit) would be displayed separately.

Financial assets and liabilities that meet certain criteria would be eligible, but not required, to have qualifying changes in fair value flow through other comprehensive income rather than net income (FV-OCI), similar to how available for sale securities are accounted for

FOOTNOTES

² There is one exception which is probably of little or no relevance to actuaries. Equity investments held for strategic purposes would be at fair value on the balance sheet, but an election could be made so that all changes in fair value—including any realized gain when the investment is sold—flow through other comprehensive income.

³ This may be the case for financial assets backing insurance contracts if insurance contracts are measured using the approach described in the IASB Insurance Contracts exposure draft. Although the proposed measurement of insurance contracts is not fair value, it is a current value that will likely be more similar to fair value than to amortized cost for most long-term contracts. Therefore, holding the assets backing the insurance contract at fair value, rather than amortized cost, may mitigate, though not eliminate, the accounting mismatch resulting from different measurement criteria of insurance contract liabilities and financial assets.

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today. The change in amortized cost, including interest earned and impairment losses, would flow through net income and other changes in fair value would flow through other comprehensive income. The criteria for being eligible for FV-OCI are similar, but not identical, to the IASB criteria for amortized cost. All the following must be met to qualify for FV-OCI:

1. There is a principal amount that will be contractually repaid to the investor at maturity, subject to an original issue discount or premium,
2. The contractual terms identify any additional amounts to be paid by the creditor,
3. The instrument cannot be contractually repaid or settled such that the investor will not recover substantially all of its investment, other than by the investor's own choice,
4. There is no embedded derivative that would be bifurcated under FAS 133 (i.e., it is not a hybrid instrument), and
5. The business strategy is to collect or pay the contractual cash flows, rather than sell the asset or settle the liability.

Some types of contracts, such as equity investments, derivatives and hybrid contracts are unlikely to meet the criteria for FV-OCI, and thus would be required to be held at FV-NI.

FASB does propose two alternative models for special situations. An entity could elect to hold a liability at amortized cost if it meets the criteria for FV-OCI, but only if doing so would reduce an accounting mismatch. This is unlikely to apply to many insurance company liabilities, since most insurance company liabilities

are backed primarily by financial assets. Since amortized cost is not available for financial assets at all, it is unlikely that using amortized cost for a liability backed primarily by financial assets would reduce an accounting mismatch. However, amortized cost may be applicable to a financial liability backed primarily by real estate.

FASB developed another special measurement model for "core deposit liabilities." This model was developed primarily for bank deposits, but may also be applicable to insurance company retained asset accounts. It is applicable to "deposits without a stated maturity that management considers to be a stable source of funds."

One impact of these classification and measurement decisions is that none of the approaches being proposed by either board is entirely consistent with the measurement approach used in the joint insurance contracts project for long duration insurance contracts. The current fulfillment value approach used in the insurance contracts project is not entirely consistent with either amortized cost or fair value (whether FV-NI or FV-OCI). In particular, the determination of the discount rate is different. Thus, any of the measurement approaches under consideration for financial instruments is likely to generate significant artificial accounting volatility when used for assets backing insurance contracts that are measured at current fulfillment value.

There will be other, perhaps surprising, impacts of applying the classification and measurement approaches under consideration. Using the FASB decisions in the financial instruments project and the current US GAAP definition of insurance contracts could lead to the following impacts:

1. Modco or funds withheld deposit reinsurance contracts with a DIG B-36 embedded derivative would be held at FV-NI due to the embedded derivative;
2. Other deposit reinsurance treaties, such as those with returns partially dependent on capital market returns could be at FV-NI;
3. Investment contracts such as SPDAs, GICs and term certain payout annuities would be at FV-OCI, or in some cases FV-NI; and

There will be other, perhaps surprising, impacts of applying the classification and measurement approaches under consideration.

4. Policy loans, if treated as a separate financial instrument, would likely be at FV-OCI.

Under the IASB tentative decisions, some of the FV-OCI items mentioned above may qualify for amortized cost. And the insurance contracts project may define some of these items as insurance contracts rather than financial instruments, although the account balance may still need to be unbundled as a financial instrument.

IMPAIRMENT AND AMORTIZED COST

For financial assets using amortized cost or FV-OCI, including deposit reinsurance receivable assets, credit impairments and reversals of previously recognized credit impairments would need to be reflected in current net income. Both FASB and IASB are proposing updates to the method for calculating an impairment loss. Each board has reached different tentative decisions, but there are similarities. Both boards would include expected future credit losses rather than credit losses incurred to date in the current period impairment amount. And both boards would permit reversals of previously recognized impairment amounts if projected future credit losses decrease.

Under the FASB approach, assets would be evaluated for credit impairment each reporting period. Some assets, particularly those for which there is a known incurred credit impairment, would be evaluated individually for impairment. Other assets would be pooled, and each pool would be evaluated for an aggregate credit impairment. When evaluating credit impairments, only events that have actually occurred and current economic conditions could be taken into account. Essentially, current economic conditions as of the end of the reporting period would be assumed to persist forever, with no future improvement or deterioration. Any amounts that the entity does not expect to collect relative to contractual amounts or expectations when the asset was purchased would be recognized as an impairment.

IASB developed a new amortized cost model for financial instruments in order to deal with impairments.



Although impairments are not relevant to financial liabilities, this amortized cost model would apply to financial liabilities as well as assets. Under this amortized cost model, an effective yield would be determined at inception of the contract. The effective yield would equate the present value of future cash flows, including any future expected impairment losses, to the transaction price of the instrument. The transaction price would be adjusted for transaction costs. For fixed rate financial instruments, this effective yield would be locked in as the discount rate for the instrument. For instruments with an indexed interest rate, the spread over risk-free rates would be locked in, and future discount rates would be equal to the current risk-free rate plus the locked-in spread. Each period, the expected cash flows would be discounted at the resulting discount rate. Unlike many amortized cost models, the expected cash flows would be updated each period to reflect any additional expected future impairment losses, reversals of previously recognized impairment losses, and changes to any other assumptions (such as surrender rates on GIC).

HEDGING AND OTHER IMPACTS

FASB's exposure draft proposes a number of changes to hedge accounting. Most importantly, hedge accounting would be permitted if the hedge was expected to be

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“reasonably effective,” replacing the current “highly effective” requirement. Demonstrating “reasonably effective” is likely to be more qualitative and less quantitative than the current requirement. The proposed rules would prohibit de-designating a hedging relationship. It is not clear to what extent the proposed rules would impact hedging of insurance risks. There is no proposed change to the definition of a “hedged item,” which currently makes it difficult for risks within insurance contracts to qualify as a hedged item. However, depending on accounting interpretations, the change from “highly effective” to “reasonably effective” might make it easier for risks within insurance contracts to qualify as hedged items.

The first criterion is similar, although more stringent, to existing criteria. However, the second criterion is new. That criterion would be met if, for example, the joint venture was in the same type of business as the investor, or if the joint venture was a supplier to the investor or a distributor of the investor’s products. It is unclear if, say, a real estate joint venture would be considered to have operations that are related to an insurance company’s consolidated operations. If not, the investment in a real estate joint venture would be considered a financial asset, and as an equity asset would be accounted for at fair value with all changes through net income (FV-NI). This is very different from current accounting for most real estate joint ventures.

In short, there are many developments underway in both US GAAP and IFRS.

IASB has not yet released any exposure drafts on hedge accounting. An exposure draft is expected in the second quarter of 2011.

Another aspect the FASB exposure draft may affect is accounting for insurance company joint venture income. Currently, joint ventures use equity method accounting, rather than financial instrument accounting, as long as certain minimal criteria are met. Under the FASB proposal, joint ventures would be treated as financial instruments unless:

1. The investor has significant influence over the investee, and
2. Operations of the investee are related to the investor’s consolidated operations.

The FASB exposure draft also includes some additional disclosure requirements. In particular, a “measurement uncertainty analysis” would be required for most financial instruments measured at fair value that use level three inputs (i.e., unobservable inputs). Since many investment contracts issued by insurance companies are valued using unobservable inputs, this additional analysis would likely be required for many insurance company liabilities.

In short, there are many developments underway in both US GAAP and IFRS. One of the most important developments is the joint insurance contracts project. However, some of the other projects will have substantial effects on insurance companies. This joint financial instruments project certainly will. ■

Solvency II Equivalence: Implications For The U.S. Insurance Market

by Kush Kotecha and David Payne

In late 2012, Solvency II, the new solvency regime for all EU insurers, will introduce a risk-based, forward-looking approach that will alter the way insurers are supervised. This will lead to a more efficient, competitive and innovative global insurance market.

While much of the discussion around Solvency II focuses on the capital calculation, it will require wide-scale changes to a company's overall risk culture and risk management processes, necessitating a bridge between quantitative risk measures and business decisions. Additionally, although the standards are being developed in the EU for EU insurers, the new solvency regime will have ramifications for insurance companies worldwide.

In July 2010, the Commission of European Insurance and Occupational Pension Supervisors (CEIOPS) issued Consultation Paper 81 (CP81) outlining its draft advice to the European Commission (EC) on Solvency II equivalence assessments for third-country (i.e., non-EU) supervisory regimes. After receiving feedback from the industry, CEIOPS issued its final advice in August 2010 which incorporated resolutions on the comments received.

In the final advice, CEIOPS provided guidance to the EC regarding which third-country supervisory regimes should be included in the first wave of equivalence assessments. They were charged by the EC to first identify the third-country jurisdictions where it would be most desirable to have an early determination on equivalency, before the introduction of Solvency II, based on their importance to the European insurance marketplace. CEIOPS then recommended which of the jurisdictions identified should be assessed in the first wave, after looking into the current state and proposed developments in the regulatory framework of each.

GUIDELINES FOR EQUIVALENCE

Under the Solvency II framework, regulatory regimes for third-party countries will be assessed on three levels of equivalence:

- Reinsurance considerations: treatment of third-country reinsurance, specifically the need to collateralize reinsurance arrangements with assets within the European Economic Area,

- Group solvency calculation: ability to use local regulatory capital amounts in the Solvency II capital calculation, and
- Group supervision: reliance on third-country for group supervision, i.e., European supervisors need only consider individual entities within their jurisdictions on a stand-alone basis.

Based on its analysis, CEIOPS identified Switzerland, Bermuda and the United States as the most important jurisdictions to the insurance markets within the EU at all three levels.

However, CEIOPS highlighted a number of concerns with regard to the U.S. regulatory regime that would hinder any assessment of equivalence:

- The lack of a single, central regulator,
- The absence of any group supervisory framework, and
- Professional secrecy issues centered around the inability of CEIOPS to exchange information with the National Association of Insurance Commissioners (NAIC) because the NAIC does not act as a supervisory authority.

Ultimately, CEIOPS recommended that only the regulatory regimes of Bermuda and Switzerland be further examined for compliance with equivalence.

U.S. EQUIVALENCE

The position of the United States with respect to equivalency remains uncertain. In the initial Consultation Paper, CEIOPS recommended that the United States not be considered for equivalency at any level in the first wave. The NAIC responded, arguing that the United States should be included, pointing specifically to the mandates of the current Solvency Modernization Initiative. In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed by Congress on July 21, 2010, established the Federal Insurance Office (FIO) within the Department of the Treasury which, in theory, would also facilitate stronger group supervision.



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In its final advice, CEIOPS acknowledged the NAIC's response and deferred the decision to the EC. It stated that it, "stands ready to undertake an assessment of the U.S. supervisory regime" with respect to reinsurance considerations and group solvency calculation. Group supervision is not included within the scope of this advice and, therefore, the recommendation is that it not be considered.

WHAT DOES THIS MEAN FOR U.S. INSURERS?

Adoption of Solvency II will continue to move forward, but whether the United States will be deemed equivalent at implementation is still under consideration and remains uncertain. The implications of not achieving equivalence will depend on the domicile of the parent company.

Parent domiciled in the United States with European subsidiary

Any European subsidiary will need to calculate its stand-alone capital requirement using the Solvency II methodology regardless of the final decision on equivalency. However, the issue of equivalency may have an impact on the corporate structure and ultimate supervision of the subsidiary. Non-equivalence for the United States may increase the likelihood of supervisors mandating such an action for U.S. groups, bringing with it increased regulatory burden and restructuring costs.

Reform and Consumer Protection Act, passed by Congress on July 21, 2010, established the Federal Insurance Office (FIO) within the Department of the Treasury which, in theory, would also facilitate stronger group supervision.

In its final advice, CEIOPS acknowledged the NAIC's response and deferred the decision to the EC. It stated that it, "stands ready to undertake an assessment of the U.S. supervisory regime" with respect to reinsurance considerations and group solvency calculation. Group supervision is not included within the scope of this advice and, therefore, the recommendation is that it not be considered.

European supervisors have the power to require the establishment of a European insurance holding company to create a sub-group consisting of all entities domiciled in Europe. A lead European supervisor would then regulate this newly created sub-group and enforce a solvency capital requirement calculation for the group.

However, there may be benefits to establishing a European holding company for many multinational groups regardless of equivalence. Such a restructuring to form a group of related entities could create the opportunity to work with a unified group of supervisors with a single point of view, rather than having to deal with individual supervisors separately. It may also bring the potential for diversification benefits across European operations, thus reducing the overall group capital requirement.

Certain U.S. companies have already begun to create a European holding company in anticipation of the new regime to take advantage of these benefits.

Parent domiciled in Europe with U.S. subsidiary

The U.S. subsidiary will still hold risk-based capital (RBC) in accordance with U.S. regulations. However, equivalency affects the aggregation of the capital requirements at the group level.

Equivalence for the United States would mean that the RBC calculation could be consolidated directly into the Solvency II assessment of the aggregated group capital requirement. However, if equivalence is not granted this would not be possible. Rather, a Solvency II-based calculation will have to be performed on the U.S. business. Depending on the underlying risk profile of the products, performing the Solvency II calculation could lead to a significant increase in the capital requirement.

Various U.S. companies are therefore participating in the current Quantitative Impact Study (QIS5) to investigate the difference between the RBC calcu-

lation and the Solvency II standard formula, and the impact of using each.

Impact on reinsurance

Non-equivalence with regard to reinsurance means that European supervisors have the power to require U.S. companies to post collateral in relation to any reinsurance (intra-group or external) of an EU entity. This would substantially increase the cost of writing such business and could make EU reinsurers more attractive to customers.

CONCLUSION

The question of Solvency II equivalence will have a significant impact on the broader U.S. insurance indus-

try and will result in a number of implications for U.S. companies, particularly with respect to capital requirements, group structuring and reinsurance business.

Solvency II equivalence can also present new opportunities to U.S. companies. For example, certain products may become more attractive if U.S. entities can benefit from a competitive advantage over European companies due to differences in capital requirements. Effective planning can result in a competitive edge in the future by allowing companies to optimize their capital allocation under the new regime.

U.S. companies should be investigating all potential impacts to their organizations now so that they can be ready for these impending changes. ■

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Who Knows What Tomorrow Will Bring?

by Henry Siegel



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Every financial actuary has gone through it—that period of three to 14 months known as the business planning process. An important part of that process is identifying what changes to expect in the upcoming period. As a service to the planning actuary I will discuss several possible developments on the financial front, each of which could have important implications for a company’s business plan.

1. Will there be a new International Financial Reporting Standard (IFRS) on Insurance Contracts by June, 2011?

The International Accounting Standards Board (IASB) wants very much to have a standard by June, as a kind of going away present for Chairman Sir David Tweedie and two other retiring board members. Unfortunately, they will receive well more than 100 comment letters on the Exposure Draft (ED) they published in July, many of which will be extensive and will include major concerns from industry, regulators and analysts. Many of those comments will require extensive revisions to the ED and that will take time. Furthermore, the Financial Accounting Standards Board (FASB) expects to re-engage the IASB on the subject starting in January.

All of which should lead us to say no, there won’t be a new standard for a while. But somehow, I suspect that we will indeed have a standard by June, or at least a final vote on one. We should not underestimate the determination of the IASB to be done with insurance for a while. So I think there will be an IFRS in June.

2. So, if the IASB will have a standard, what will the FASB do?

There’s a lot of pressure on the FASB to converge with the IASB. Depending on what the comment letters say, I suspect that FASB will go along with the IASB although with perhaps some significant differences such as whether there’s two margins or one.

3. If there is a new standard, what does that mean for me in planning?

Well, to start with, installing the new insurance standard will be expensive. It will take significant manpower and time.

The greatest cause for this will be the transition requirement. The ED has a ridiculous provision eliminating any residual margin on policies in force. This would essentially make many life insurers unprofitable for the foreseeable future. The solution appears to be a complete retrospective calculation of residual margins starting with contract inception for the entire block of policies in force. The best comparison is it might cost as much as a demutualization with respect to actuarial resources. This is not a trivial project and so should be started as soon as the details of the new standard are known.

4. Will we have convergence between US GAAP and IFRS on financial instruments?

The IASB and FASB have both issued new standards for measuring financial instruments. The FASB calls for fair value on everything; the IASB allows amortized books for most bonds and similar investments. It hasn’t looked promising for the two groups to get together.

But recently, things have changed. The banking regulators in the United States have sent a strongly worded comment letter to FASB urging them to converge with the IASB. Furthermore, the FASB recently published a report on outreach to analysts that clearly shows that fair value is not their preferred measurement basis in all situations. My guess, therefore, is that we will have convergence on financial instruments during 2011.

5. So if we get all these standards in 2011, when will they be effective?

My guess is they won’t be effective before 2015. This doesn’t mean, however, that you can wait for a while to start collecting data. You’ll need to produce at least one, possibly two years of past financial statements and that means two or possibly three back balance sheets. In short, if you need to produce

a 2015 financial statement you will need a balance sheet at least as of Dec. 31, 2013 and possibly as of 2012. And that's not very far off at all.

I hope everyone has a great holiday and remember:

Insurance accounting is too important to leave to the accountants! ■

6. What will the SEC do about convergence in 2011?

The SEC has promised to reexamine convergence in general in 2011. They could decide to allow domestic companies to use IFRS for filing. For insurance companies, however, it will be largely irrelevant if I'm right about insurance contracts and financial instruments. So I don't really care what the SEC does on this.

7. Will the NAIC make any changes to solvency regulation as a result of the Solvency Modernization Initiative (SMI) project?

The SMI project is a very wide-ranging project encompassing all (or almost all) aspects of solvency regulation. There are at least six work groups all of which seem to have different permutations of I, A or S in their acronym. Those work groups have also reached out to existing committees for input.

The areas of review include not only minimum surplus requirements and accounting standards, but such new ideas as Own Risk and Solvency Assessment as well. There's even a high level NAIC committee studying whether the NAIC should adopt IFRS for statutory purposes.

Initial discussions suggest, however, that the NAIC is unlikely to significantly modify RBC to be more like the Solvency II proposals. It's also unlikely that the NAIC will adopt IFRS for statutory accounting, particularly for reserves. However, since statutory accounting starts with GAAP, if the FASB converges with IFRS it will, again, not matter. This could lead to another significant NAIC project to redo codification starting with IFRS.

I don't expect the NAIC to do anything major during 2011, but everyone should keep a close eye on SMI. It could lead to important changes in future years.

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