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Insurance Accounting as a Black Hole

By Henry Siegel

"Proposed insurance accounting changes akin to going from a 'black box' to a 'black hole'".
–One investor at a recent Morgan Stanley sponsored accounting roundtable.

This comment struck me as a very interesting analogy, but probably not in the way the person making it intended. It was probably meant to imply that the new insurance accounting was getting less understandable. To me, it meant exactly the opposite; that may be the result of having a physics grad student as a son.

It's true that you can't understand what's inside a black box. You can't see into it and, depending on how it's constructed, can't X-ray it or possibly even break it open. What's inside is truly unknowable except to the person who put something inside it.

A black hole, on the other hand, is generally understandable at a high level by anyone who's taken a college-level physics course (or seen one of the many sci-fi shows that distort their physics) and is rather well understood by experts in the field. There are mathematical equations that describe the behavior of black holes and their effects on the space and matter surrounding them. There are even photos of them. (Below, right)

It's my hope that the final insurance accounting standard, whatever it turns out to be, will have the same characteristics as the black hole. It will be easy to understand at a fairly high level by anyone who spends a little thought on it and can be completely understood by those who choose to become experts in the subject. Many of the latter will be actuaries, both preparers and those who work for investment companies, and that's good for our profession.

Of course, users will require extensive disclosures, a topic neither the International Accounting Standards Board (IASB) nor the Financial Accounting Standards Board (FASB) has tackled yet in detail. It will also require extensive retraining—a concern for preparers, users and auditors alike. In fact, I think recognition of this is a large part of the great unhappiness that the analysts at the Morgan Stanley roundtable evidenced. This retraining will take time and money, but my hope is that by the end of this decade we'll be wondering what all the fuss was about.

This quarter, both the FASB and the IASB worked quite diligently on the Insurance Contracts project although not always achieving agreement. There was an Insurance Working Group (IWG) meeting and several panels with analysts and preparers similar to the one cited above. Furthermore, the Securities and Exchange Commission (SEC) came out with a paper on one way that International Financial Reporting Standards (IFRS) could be incorporated into U.S. accounting requirements, thereby shedding light on their thinking on the subject and providing interested parties a chance to react.

As of this writing, it's clear that the June 30 target date the IASB had set for a final standard will not be met; it's not clear whether the next IASB due process document will be a final standard, a near-final standard, or another exposure draft. In any event, it's highly unlikely that anything will be out before the end of 2011, and there is increasing pressure for the IASB and FASB to issue new standards together, after appropriate field testing, probably in late 2012. With new leadership for the IASB taking charge July 1, there is much now up in the air.

Here, with the help of the "IASB Updates," are the key events of the quarter.

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APRIL MEETINGS

There were three separate joint board meetings during April as the boards attempted to finish as much as possible prior to June 30.

Top-Down Approaches to Discount Rates

Having tentatively decided back in February that an insurer could use either a "top-down" or a "bottom-up" approach to determine discount rates, the boards discussed the subject further. The discussion was largely in response to reactions from preparers who, based on Solvency II QIS 5 (Quantitative Impact Study 5) results, are greatly concerned about the volatility introduced into the financial statement by the current proposals. The boards' decisions didn't help too much. The boards tentatively decided that in applying the "top-down" approach:

a. Insurers must determine an appropriate yield curve on the basis of current market information using either the actual portfolio of assets the insurer holds or a reference portfolio (presumably a replicating portfolio) of assets.
b. If there are no observable market prices for some points on that yield curve, extrapolate or interpolate as appropriate.
c. The cash flows of the instruments must be adjusted so that they reflect the characteristics of the cash flows of the insurance contract liability. An insurer shall make both of the following adjustments:
    i. Type I, which adjust for differences between the timing of the cash flows to ensure that the assets in the portfolio selected as a starting point are matched with the duration of the liability cash flows, and
    ii. Type II, which adjust for risks inherent in the assets that are not inherent in the liability.
d. An insurer using a "top-down" approach need not make adjustments for remaining differences between the liquidity inherent in the liability cash flows and the liquidity inherent in the asset cash flows.

A Modified Approach for Short-Term Policies

The boards discussed the modified approach for short-term policies, which is another highly controversial subject, particularly for P&C insurers. The approach proposes that a different approach should be used for the accounting in the pre-claims period for contracts, typically of short duration, that meet specified criteria. In particular, the boards discussed what those criteria might be and whether that different approach was a proxy for the building-block approach or a separate model.

The boards tentatively decided that:

a. They would later consider (thereby postponing discussion of the key issue) whether the pre-claims obligation should reflect the time value of money, based on their tentative decision in the Revenue Recognition project on reflecting the time value of money.
b. The insurer should reduce the measurement of the pre-claims obligations over the coverage period as follows:
    i. on the basis of time, but
    ii. on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.
c. An insurer should perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre-claims period.

In addition, the IASB tentatively decided that an insurer should deduct from the pre-claims obligation measurement the acquisition costs that would be included in the measurement of the insurance contract liability under the building-block approach. Nine of the 13 IASB members present supported this approach. The FASB did not vote on this issue.

MAY MEETINGS

Topping the record in April, there were four separate meetings on insurance in May, including one that spread over into June.

May 4

This discussion of unbundling, like many before and to follow, was confused by the question of whether it affected the measurement of the liability or only the presentation. By the end of the quarter, this was still unclear.

Unbundling

The boards discussed whether non-insurance goods and services should be unbundled from an insurance contract in accordance with the principles for identifying separate performance obligations in the Revenue Recognition project. The boards tentatively decided they should be subject to further discussion.

The boards tentatively decided that an insurer should unbundle explicit account balances (e.g., for unit-linked and variable contracts) that are credited with an explicit return that is based on the account balance, again using criteria based on those being developed in the Revenue Recognition project. An insurer would not unbundle implicit account balances. All IASB members and a majority of FASB members supported these decisions.

In addition, the IASB tentatively decided that an insurer would account for an unbundled explicit account balance in accordance with the relevant requirements for Financial Instruments in IFRS, subject to future decisions on allocation.

May 11–12

Measurement of Policyholder Participation

The boards considered how to apply the principle that an insurance contract is measured using the expected present value of the fulfillment cash flows when those cash flows result from contractual participation features.

The IASB made the following tentative decisions.

a. The measurement of the fulfillment cash flows relating to the policyholder's participation should be based on the measurement in the IFRS financial statements of the underlying items in which the policyholder participates. Such items could be assets and liabilities, the performance of an underlying pool of insurance contracts or the performance of the entity.
b. An insurer should reflect, using a current measurement basis, any asymmetric risk sharing between insurer and policyholder in the contractually linked items arising from a minimum guarantee.
c. An insurer should present changes in the insurance contract liability in the statement of comprehensive income consistently with the presentation of changes in the linked items (i.e., in profit or loss, or in other comprehensive income (OCI)).
d. The same measurement approach should apply to both unit-linked and participating contracts.

Nine members of the IASB voted in favor of this decision, four voted against, and one abstained.

The FASB tentatively decided that the measurement of the liability should reflect the expected present value of the cash flows, discounted at current rates, using the contractual measurement basis for the underlying items in which the policyholder participates. The majority of FASB members supported this decision.

There will be further discussion of this subject since the types of contracts considered did not include those issued in the United States and other jurisdiction where the board has full discretion over how much to pay.

May 16—Insurance Working Group Meeting

The meeting was well attended by 10 IASB and three FASB members, respectively. In addition, Hans Hoogervoorst, the incoming IASB chairman, attended for the morning session and also was the only IASB board-level representative at the dinner that followed. One comment he made was that there seemed to be considerable unanimity among the preparers and users in the sessions he attended and that was a sign that resolution could be reached. Of course, this ignored that the IASB doesn't agree with this unanimity.

There were four agenda topics discussed and two additional topics that came up that turned out to be the most controversial.

Participating Contracts

The discussion at the IWG was lively. After I pointed out that the definition of par contracts included in the paper for the meeting did not apply to most U.S. par contracts, it was quickly acknowledged and not discussed further.

The remaining discussions centered on whether the board's paper worked for the unit-linked and 90/10[1]

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contracts that are prevalent in Europe and elsewhere. The Working Group agreed that it generally worked for unit-linked contracts (including U.S. variable contracts) but the Europeans had problems with how it worked for 90/10 contracts, particularly how to handle things like own stock, home office real estate and other items that cannot be held at market value. (These are not normally problems for U.S. variable contracts.) Staff agreed they need a paper to cover U.S.-type contracts and FASB staff will be drafting one.

Convergence
The industry representatives next started a vigorous discussion of the need for the IASB and FASB to reach agreement on the standard. Several IWG members recommended that the IASB should wait for FASB to catch up before issuing a final standard. There was little opposition expressed.

While it seemed very doubtful at the time that the IASB will wait for FASB, more recent developments suggest that this is not impossible.

Use of OCI for Changes in Liabilities Due to Changes in Discount Rate
The industry representatives repeated their desire to be able to use OCI for changes in both market value of assets and the parallel changes in liability values due to changes in the discount rate. The IASB staff tried to make the case that identifying the assets backing insurance liabilities was impossible, but I pointed out that we already do it for Loss Recognition testing and other purposes. Essentially all of the preparers at the table, and several of the users, agreed that OCI for both assets and liabilities provided a good result. IASB staff was unconvinced.

Unbundling
Essentially, there was agreement among Working Group members that with the exception of situations where there was a clear lack of interrelation, there would be very little unbundling. As I noted previously, one of the problems is that several of the analysts at the table asked for more unbundling, when what they really meant was more disclosure, more gains by source analysis and just more information in general. In the end, several IASB members were not happy with the consensus that there should be very little unbundling.

Modified Approach for Short-Term Contracts
P&C industry representatives argued for no discounting in the calculation (essentially keeping the Unearned Premium Reserves as in U.S. GAAP).

Discount Rates
The final hour was billed as a report on the boards' discussion on discount rates. It turned out to be something very different.

IASB staff reported that they had thought about the issue and they now believe that there should be one yield curve used for discounting for each currency. Keep in mind that the discount rate is supported to be a risk-free rate plus an illiquidity adjustment.[2] It's difficult to know how to have a single yield curve when Euro-denominated policies are issued in countries with very different risk-free rates.

Also, this represented a surprising clarification to the IASB's position. It was thought, for instance, that the illiquidity adjustment would be different for single premium immediate annuities and universal life contracts because the former have no withdrawal benefit; this new staff position would require the same discount rate for both, with an adjustment for the different liquidity in either the risk margin or cash flows. Furthermore, this position does nothing to alleviate the industry's concerns about the volatility this will introduce into the income statement.

IWG members and observers (and some board members I spoke with) left the meeting confused about how this is supposed to work.

May 17–18
Assets Backing Insurance Liabilities
The board tentatively decided not to change the requirements for presenting gains and losses on assets held to back insurance contract liabilities. The board noted that this decision was based on the assumption that changes in the carrying amount of the insurance contract liability are not presented in OCI. If that were to change, as the industry has been urging via the HUB Group, the treatment of assets backing insurance contract liabilities might need to be revisited. This would be one way to allow assets and liabilities to be treated consistently

despite the IASB's unwillingness to reopen IFRS 9 on Financial Instruments.

Risk Adjustments

The IASB and FASB continued their discussion on Insurance Contracts by considering how risk should be reflected in the measurement of an insurance contract liability. The IASB tentatively decided that the measurement of an insurance contract should contain an explicit adjustment for risk. The FASB tentatively decided that:

a. An insurance contract measurement model should use a single margin approach that recognizes profit as the insurer satisfies its performance obligation to stand ready to compensate the policyholder in the event of an occurrence of a specified uncertain future event that adversely affects that policyholder.
b. An insurer satisfies its performance obligation as it is released from exposure to risk as evidenced by a reduction in the variability of cash outflows.
c. An insurer should not remeasure or recalibrate the single margin to recapture previously recognized margin.

The IASB and FASB will continue to explore whether the two approaches could be made comparable through disclosures.

May 31–June 2

Reinsurance

The IASB and FASB finally had a substantive discussion of accounting for reinsurance. They tentatively decided:

1. If a reinsurance contract does not transfer significant insurance risk because the assuming company is not exposed to a loss, the reinsurance contract is nevertheless deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts is assumed by the reinsurer. A loss is defined as an excess of the present value of the cash outflows over the present value of the premiums. This dealt with an important clarification requested by commentators on the Exposure Draft (ED).
2. An insurer should assess the significance of insurance risk at the individual contract level. Contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent that are entered into with the same or a related party, should be considered a single contract for the purpose of determining risk transfer.
3. A cedant should not recognize a reinsurance asset until the underlying contract is recognized, unless the amount paid under the reinsurance contract reflects aggregate losses of the portfolio of underlying contracts covered by the reinsurance contract. If the reinsurance coverage is based on aggregate losses, the cedant should recognize a reinsurance asset when the reinsurance contract coverage period begins. An onerous contract liability should be recognized if management becomes aware in the pre-coverage period that the reinsurance contract has become onerous. All members of the IASB and the FASB supported this decision.
4. The ceded portion of the risk adjustment should represent the risk being removed through the use of reinsurance.
5. If the present value of the fulfillment cash flows (including the risk adjustment under the IASB's tentative decisions) for the reinsurance contract is:
   a. Less than zero and the coverage provided by the reinsurance contract is for future events, the cedant should establish that amount as part of the reinsurance recoverable, representing a prepaid reinsurance premium and should recognize the cost over the coverage period of the underlying insurance contracts.
   b. Less than zero and the coverage provided by the reinsurance contract is for past events, the cedant should recognize the loss immediately.
   c. Greater than zero, the cedant should recognize a reinsurance residual or composite margin.
6. The cedant should estimate the present value of the fulfillment cash flows for the reinsurance contract, including the ceded premium, and without reference to the residual/composite margin on the underlying contracts. This should be done in the same manner as the corresponding part of the present value of the fulfillment cash flows for the underlying insurance contract or contracts, after remeasuring the underlying insurance contracts on

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The IASB discussed whether changes in the discount rate should be recognized as an adjustment to the residual margin or in profit or loss in the period of the change, to the extent that these changes create an accounting mismatch. No decision was made.

initial recognition of the reinsurance contract.

7. When considering nonperformance by the reinsurer:
   a. The cedant would apply the impairment model for Financial Instruments when determining the recoverability of the reinsurance asset.
   b. The assessment of risk of nonperformance by the reinsurer should consider all facts and circumstances, including collateral.
   c. Losses from disputes should be reflected in the measurement of the recoverable when there is an indication that on the basis of current information and events, the cedant may be unable to collect amounts due according to the contractual terms of the reinsurance contract.

All members of the IASB and the FASB supported these decisions.

JUNE MEETINGS

Whether to Unlock the Residual Margin

The IASB tentatively decided that the residual margin should not be locked in at inception. Eight IASB members supported and seven members opposed this decision. The FASB has already tentatively decided to propose a single-margin approach. However, the FASB also indicated that if it were to adopt an approach that includes both a risk adjustment and a residual margin, they would not favor unlocking a residual margin.

How to Unlock the Residual Margin

The IASB tentatively decided that an insurer should:

a. Adjust the residual margin for favorable and unfavorable changes in the estimates of future cash flows used to measure the insurance liability. Experience adjustments would be recognized in profit or loss. Eleven IASB members supported this decision and four opposed it.
b. Not limit increases in the residual margin. Twelve IASB members supported and three opposed this decision.
c. Recognize changes in the risk adjustment in profit or loss in the period of the change. Nine IASB members supported and six opposed this decision.
d. Make any adjustments to the residual margin prospectively. Ten IASB members supported and five members opposed this decision.

The IASB discussed whether changes in the discount rate should be recognized as an adjustment to the residual margin or in profit or loss in the period of the change, to the extent that these changes create an accounting mismatch. No decision was made.

The FASB did not vote on how to unlock the residual margin.

Allocation Methods for the Residual Margin

The IASB tentatively decided that:

a. the residual margin should not be negative, and
b. insurers should allocate the residual margin over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the contract.

Acquisition Costs

The boards tentatively decided that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the direct costs that the insurer will incur in acquiring the contracts in the portfolio. The costs should exclude indirect costs such as software dedicated to contract acquisition, equipment maintenance and depreciation, agent and sales staff recruiting and training, administration, rent and occupancy, utilities, other general overhead and advertising.

In addition, the IASB tentatively decided that no distinction should be made between successful acquisition efforts and unsuccessful efforts, while the FASB reiterated its decision in ASU 2010-26 (EITF 09-G) that the acquisition costs included in the cash flows of insurance contracts will be limited to those costs related to successful acquisition efforts. The FASB's position was subsequently endorsed in a private meeting the American Council of Life Insurers had with the chief accountant of the SEC.

Presentation of the Statement of Comprehensive Income

The boards indicated a preference for the presentation model outlined in Example 2 in Appendix A of Agenda Paper 3A /FASB Memo No. 70A. The example presents the underwriting results of contracts measured under the building-block approach separately from contracts measured using the modified approach and includes volume information as follows:

1. Underwriting Margin
    a) Building-block approach underwriting margin reflecting:
        i. Change in/release of:
            1. Risk adjustment (IASB)
            2. Residual margin (IASB)
            3. Composite margin (FASB)
        ii. Experience adjustment related to the current period disaggregated as:
            1. Premium due
            2. Claims incurred
            3. Expenses incurred
            4. Expected net changes in the liability for the period
        iii. Changes in assumptions
        iv. Gains and losses at initial recognition
    b) Modified approach underwriting margin reflecting:
        i. Change in/release of
            1. Risk adjustment (IASB)
            2. Composite margin (FASB—if applicable)
        ii. Premium revenue (based on the release of the pre-claims obligation grossed up for amortization of acquisition costs)
        iii. Claims incurred
        iv. Expenses incurred
        v. Amortization of acquisition costs included in the pre-claims obligation
        vi. Experience adjustments related to the current period
        vii. Changes in assumptions
        viii. Changes in additional liabilities for onerous contracts
2. Investment performance:
    a) Investment income
    b) Interest accreted on the expected net cash flows
    c) Changes in discount rate

The boards discussed whether they would require all insurers to present each of the above line items in all cases on the statement of comprehensive income, rather than in the notes. No decision was made.

THE SEC PAPER

On May 26, the SEC issued a paper titled "*Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers—Exploring a Possible Method of Incorporation.*"[3] In brief, the paper suggested that one method for adopting IFRS would be what has been called the "condorsement" method. Under this approach, the FASB would work to try to make U.S. GAAP and IFRS become the same over a period of time, perhaps five years. In the end, if differences remain, that would be acceptable. Future IFRSs would be reviewed as they are promulgated and perhaps included into U.S. GAAP.

While only a suggestion of one possible approach—the SEC is considering others—this paper received considerable comment within the industry. This is largely because the IASB and FASB have been having difficulty agreeing on several important standards including Insurance Contracts and Financial Instruments.

All things considered, both boards and staff deserve commendation for the progress they made this quarter. There is hope that the major issues will be resolved by September, although without any meetings in August, this will be a challenge.

Always remember:
Insurance accounting is too important to be left to the accountants! ■

END NOTES

1 Contracts where the shareholders may receive no more than 10 percent of the earnings on participating portfolio. This is common outside the United States (with some countries having 80/20 or 70/30 splits) and in the United States in some jurisdictions for par contracts sold by stock companies.

2 Remember that the discount rate is always the risk-free rate plus an illiquidity adjustment. The top-down or bottom-up approach is only how to calculate it. The target is the same.

3 *http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-paper-052611.pdf*