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RESPECT

By Henry Siegel

Like many people, I've been working with the International Accounting Standards Board (IASB) for almost 10 years on its insurance contracts project and for the past several years with the Financial Accounting Standards Board (FASB) as well. In working with people on a project for that long, you learn a few things about them. If there's one thing I've learned about every board member and staff member that I've worked with it's that they are trying their best to devise the best standard they can. I'd also add that, without exception, the board members and staff are smart and hard-working. In many cases, very smart and very hard working!

So it upsets me when I hear a board member make comments that imply those of us in the industry are trying to get a standard which will allow us to manipulate our earnings or that our comments are not worth listening to. When I compare our experience with other industries, the number of accounting frauds in our industry I can remember are few and relatively long ago (e.g., Equity Funding). The companies I'm familiar with have a very serious attitude toward showing their earnings in a meaningful way. I remember clearly a situation where the chief financial officer (CFO) of our company, not an actuary, came to visit our chief actuary to ask if he could lower reserves on a block of pension contracts that had been set up based on an asset adequacy test in excess of statutory minimums. The conversation was short. "No," said the chief actuary. The CFO walked out, no further discussion. This was not the only time I've heard similar conversations.

I've even had them myself. I was asked once by a business unit CFO if he could raise an incurred but not reported (IBNR) reserve he had already journalized because he didn't need the earnings this year and wanted to release it the next year. Again, it was the same short conversation.

CONTINUED ON PAGE 6

My point in all of this is that the groups I participate in that comment on standards (at last count there were five) don't approach this from how can they manipulate results but what would be the best result for the industry, both users and preparers. I'm not always sure that all board members appreciate that.

In particular, actuaries have standards of practice that don't allow us to engage in earnings manipulation outside the boundaries allowed by accepted practice and that are an inevitable result of projecting future cash flows. The entire accounting standard being developed by the IASB and FASB depends on actuarial standards of practice for their success.

The IASB and FASB and their staffs need to develop a mutual respect with actuaries that will make this successful and not assume we have improper motivations. The International Actuarial Association (IAA) and the IASB recently signed a memorandum of understanding that was disappointing to me in that it did not include a recognition that actuaries can be relied upon to develop standards that would produce reliable projections. Nowhere did it say that accountants can rely on actuaries to produce acceptable experience assumptions.

This is regrettable.

SEPTEMBER MEETINGS

This quarter, neither board substantially discussed insurance contracts in July or August. In September, however, there were major issues discussed by the IASB and FASB.

Transition: Joint IASB/FASB Meeting

At the Insurance Working Group meeting in June, everyone agreed that transition was a key issue for the success of the project. The proposal in the original exposure draft would have resulted in life insurers showing negative earnings for many years, an unacceptable result. Accordingly, this was the subject of a detailed discussion by a joint meeting of the boards.

Measurement

The key issues on measurement are how to determine the remaining residual or single margin on contracts issued previously and how to determine the discount rate as of the date of issue for purposes of how much of the liability should be in OCI.

The discussion of the single/residual margin considered several alternatives, based on conversations with preparers and users. The possibility of measuring it based on fair value as of the earliest date of presentation was considered and strongly supported by several board members. However, the majority of the board recognized that determining the fair value would involve at least as much guesswork as estimating the margin based on the fulfillment method.

Therefore, the boards tentatively decided that when an insurer first applies the new insurance contracts standard, the insurer shall do the following.

1. At the beginning of the earliest period presented,
   a. Measure the present value of the fulfillment cash flows using current estimates at the date of transition (i.e., as of the earliest period presented, which could be as much as three years prior to the current date), and
   b. Account for the acquisition costs in accordance with their existing tentative decisions for acquisition costs and derecognize any existing balances of deferred acquisition costs.
2. Determine the single or residual margin at the beginning of the earliest period presented, as follows.
   a. Determine the margin through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so.
   b. If it is impracticable to determine the cumulative effect of applying that change in accounting principle retrospectively to all prior periods, the insurer is required to apply the new policy to all contracts issued after the start of the earliest period for which retrospective is practicable (i.e., apply retrospectively as far back as is practicable).

c. For contracts issued in earlier periods for which retrospective application would normally be considered impracticable because it would require significant estimates that are not based solely on objective information, an insurer shall estimate what the margin would have been if the insurer had been able to apply the new standard retrospectively. In such cases, an insurer need not undertake exhaustive efforts to obtain objective information but shall take into account all objective information that is reasonably available.

d. If it is impracticable to apply the new accounting policies retrospectively for other reasons, an insurer shall apply the general requirements of ASC Topic 250-10/IAS 8 that are relevant to situations in which there are limitations on retrospective application (i.e., measure the margin by reference to the carrying value before transition).

The boards asked the staff to consider developing a constraint, or set of constraints, on the estimated amount of the single or residual margin. In addition, the FASB asked the staff to explore a practical expedient that might allow insurers to determine the margin based on the definition of portfolios during the retrospective period.

This first request shows the lack of confidence the boards have in actuaries to do a responsible job of estimating the proper value. If we had a better relationship between accountants and actuaries, such a request would not be necessary; the boards would simply rely on actuaries to derive an acceptable estimate. They could simply state that the estimate must be based on Actuarial Standards of Practice adopted by the IAA and this would be sufficient.

Determining the Discount Rate

The boards tentatively decided that, for those periods for which it would be impracticable to determine the discount rate that would reflect the characteristics of the liability, insurers shall determine the discount rate as follows.

a. Calculate the discount rate in accordance with the standard for a minimum of three years and, if possible, determine an observable rate that approximates the calculated rates. If there is not an observable rate that approximates the calculated rate, then determine the spread between the calculated rate and an observable rate.

b. Use the same observable reference point to determine the rate (plus or minus the spread determined in (a) if applicable) to be applied at the contract inception for contracts that were issued in the retrospective period.

c. Apply the yield curve corresponding to that rate to the expected cash flows for contracts recognized in the retrospective period to determine the single or residual margin at contract inception.

d. Use the rate from the reference yield curve reflecting the duration of the liability for recognizing interest expense on the liability.

e. Recognize in other comprehensive income the cumulative effect of the difference between that rate and the discount rate determined at the transition date.

Transition Disclosures

The boards tentatively decided that insurers shall make the disclosures required by ASC

CONTINUED ON **PAGE 8**

Topic 250-10/IAS 8. In addition, insurers shall make the following, more specific, disclosures:

a. If full retrospective application is impracticable, the earliest practicable date to which the insurer applied the guidance retrospectively;

b. The method used to estimate the expected remaining residual or single margin for insurance contracts issued before that earliest practicable date, including the extent to which the insurer has used information that is objective, and separately, the extent to which the insurer has used information that is not objective, in determining the margin; and

The IASB decided that it would not explore further disclosures about the effect of regulation on reported equity in the insurance contracts project.

c. The method and assumptions used in determining the initial discount rate during the retrospective period.

The boards also tentatively decided that an insurer need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it first applies the new guidance. Furthermore, if it is impracticable, when an insurer first applies the guidance, to prepare information about the claims development that occurred before the beginning of the earliest period for which the insurer presents full comparable information, it shall disclose that fact. (This decision confirms the proposal in the IASB's exposure draft.)

IASB-Only Meeting

Residual Margin: Accretion of Interest

The IASB tentatively decided that, consistent with the proposals in the original exposure draft (ED):

- An insurer should accrete interest on the residual margin, and
- The rate used for the accretion of interest should be the discount rate of the liability determined at initial recognition, i.e., a locked-in rate.

Disclosures

The IASB tentatively agreed with the disclosure package as set out by the staff in Agenda Paper 16F "Disclosures: Overview and Proposed Drafting," including requirements that insurers should:

a. Disclose gains or losses arising on contract modifications, commutation or derecognition;

b. Provide reconciliations between the opening and closing carrying amounts of insurance contract liabilities and insurance contract assets, including information about the carrying amounts of onerous contract liabilities recognized in the precoverage period; the expected present value of fulfillment cash flows, the risk adjustment and the residual margin; and

c. Disclose amounts payable on demand in a way that highlights the relationship between such amounts and the carrying amount of the related contracts.

The IASB tentatively decided not to add more guidance on the level of disaggregation of the reconciliation of carrying amounts beyond the requirements to (a) consider the level of detail necessary to satisfy the disclosure objective, and (b) to aggregate or disaggregate data so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.

The IASB tentatively decided to delete the specific disclosure proposed in paragraph 89 of the ED about contracts for which uncertainty about the amount and timing of claims payments is not typically fully resolved within one year.

The IASB decided that it would not explore further disclosures about the effect of regulation on reported equity in the insurance contracts project.

Review Draft or Re-expose

This was a very important discussion from the perspective of the industry. A decision not to re-expose would have meant a final standard would be available much sooner.

Although the deliberations on the insurance contracts project are not yet complete, given the stage of the deliberations and the desire to provide greater certainty to the market, the IASB discussed whether the IASB should proceed to an international financial reporting standard (IFRS) as its next step, perhaps with a review draft being made publicly available, or publish a revised exposure draft. The IASB discussed the progress that has been made on the insurance contracts project, and acknowledged the length of time that has been devoted to the project and the importance of issuing a final standard in a timely fashion. The IASB discussed the substantive nature of the changes made since the ED and the importance of evaluating each change within the context of the overall model. The IASB also considered the importance of obtaining constituents' input on targeted areas and of adjusting the model, if necessary, as a result of that input. On balance, the IASB decided to publish a revised exposure draft of the proposals on accounting for insurance contracts but to seek feedback only on the following issues:

1. The requirement that the cash flows used to measure participating contracts should be based on the cash flows used to account for the underlying items (mirroring approach);

2. The requirement to present premiums in the statement of comprehensive income, which has two consequential decisions:

   i. The part of the premium that relates to investment components is excluded from the premium presented in the statement of comprehensive income, and
   ii. The premiums are allocated in the statement of comprehensive income on an earned basis (to be discussed at a future meeting);

3. The requirement to use the residual margin to offset changes in estimates of future cash flows (unlocking);

4. The requirement to present in other comprehensive income changes in the discount rate used to measure the insurance contract liability; and

5. The proposed transition requirements, including the tentative decisions made at the September meeting as well as those that will be made at future meetings.

While the IASB noted that the exposure draft would include the full text of the proposed standard, it would also be necessary to clearly inform stakeholders that, after re-exposure, the IASB does not intend to revisit aspects of the proposed standard other than those targeted areas set out above.

The American Academy of Actuaries and the IAA will both comment on the exposure drafts the boards produce. I hope the boards will pay attention because, as we know:

Insurance accounting is too important to be left to the accountants!

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