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By Jim Milholland

Jim Milholland, FSA, MAAA, is a retired partner from Ernst & Young, LLP. He can be reached at actuary@milholland.com.

How many discount rates does it take to value a liability? "Too many" is the response of the actuarial profession, which has suggestions for improving the overly complex requirements of the International Accounting Standards Board (IASB) in its proposed new accounting standard for insurance contracts. These suggestions and other activities to get ready for the new standard were the main topics of discussion of financial reporting actuaries at the meeting of the International Actuarial Association (IAA) in Washington, D.C. in April. Also of interest to financial reporting actuaries are the activities of the IAA in support of the International Association of Insurance Supervisors (IAIS), which has a tight deadline to develop proposals for capital requirements for insurers.

SIMPLIFYING THE PROPOSAL

(Fair warning—the following paragraphs presume a working knowledge of the IASB's June 2013 revised Exposure Draft Insurance Contracts (the ED).) One of the major concerns found in comment letters to the ED was the complexity of the proposed requirements, especially as they relate to participating contracts. The specific concerns were about:

- Multiple models, depending on the nature of the participation feature. Linked contracts would be in effect unbundled by an approach called "mirroring," but other participating contracts would use a discounted cash flow model.
- Multiple discount rates because of different rates, over time, for the contractual service margin (CSM) and for cash flows. Furthermore, cash flows in some models would be separated into:
  - Those that had asset dependency,
  - Those that did not, and
  - Those that relate to options not otherwise separated (e.g., embedded derivatives) all with potentially different discount rates.

At a session of the Insurance Accounting Committee (IAC), a member of the German Actuarial Association (DAV) presented its suggestion for simplification and improvement of the proposals. The DAV recommends:

- That the IASB adopt a single model—the discounted cash flow model—for all contracts that use the building blocks, and
- That there should be no distinction among the discount rate used for cash flows or the CSM.

The DAV provided Excel files with numerical examples covering different types of contracts. They are available for interested parties. [*https://aktuar.de/unsere-themen/rechnungslegung/*]

Another source of concern with the ED is the mandated used of other comprehensive income (OCI) for the difference in the value of the liabilities using a fixed rate and the value using a current rate. The purpose of the use of OCI is to match the treatment of supporting assets. If the insurer measures assets at fair value through OCI (FVOCI), the investment income is the amortized-cost basis income, but the assets are at fair value on the balance sheet. The difference between the fair value and the cost basis of the assets is in OCI. The corresponding treatment for insurance liabilities is to measure them at a fixed rate, the rate analogous to the amortized cost basis for investments, for the purpose of determining the interest expense in profit or loss, and then to measure them again at current rates for the balance sheet. The difference in the two measurements would be in OCI.

The required use of OCI was not well received when the ED was published. Nearly all commenters on the ED saw that use of OCI is more appropriate for some situations than others; i.e., it works well when investments are measured at FVOCI, but not as well when assets are measured at fair value through profit or loss (FVPL) or when the insurer has hedging instruments that are measured at FVPL. In response to many comment letters requesting optional use of OCI, the IASB in its re-deliberations has tentatively decided that the effect of changes in discount rates should be either through profit or loss (P&L) or through OCI, at the option of the company, for portfolios of contracts.

The DAV believes that the measurement of liabilities should coincide with the accounting for the assets in

order to reflect the characteristic link between assets and liabilities for participating contracts. In this sense, the OCI issue has to be considered together with a fully unlocked CSM in the following ways:

1. To avoid accounting mismatches, the use of OCI for insurance liabilities should follow the accounting for the assets. If the insurer measures assets at FVOCI, it would use the amortized cost-basis rate to determine the interest expense for P&L, and it would use the current rate to measure the liabilities for the balance sheet. The difference between the two measurements would be in OCI. If the insurer measures assets at fair value through profit or loss (FVPL), the liability discount rate would be the current rate both for the interest expense in profit or loss and for the balance sheet. If the insurer has a mix of assets with different treatment or if it changes its investment approach over time, the discounting of liabilities would use blended rates. This suggestion leads to a blended rate for discounted cash flows, if the insurer measures some supporting assets at FVOCI and others at FVPL.

2. The DAV also suggest that the effects of changes in discount rates for rates that are estimates should be treated like other changes in estimates; namely, they should be offset by a change in the CSM. The rates that are estimates are those that are not supported by returns stemming from covering assets, i.e., rates resulting from reinvestments (in particular but not limited to those beyond the term of the investment portfolio).

The DAV believes that, in combination, these suggestions would lead to a consistent accounting of assets and liabilities in the P&L and balance sheet.

It is apparent that the suggestions of the DAV, especially the use of a single model, are a net simplification, but they do create some complications of their own. Projecting blended discount rates may be tricky and probably would need actuarial guidance. It is also necessary to settle on a growth rate and a discount rate for variable or unit-linked contracts.

The suggestions were well received by the members of the IAC, but the committee has not endorsed the suggestions. Several members commented that they were pleased to see the proactive leadership of the DAV. Undoubtedly the suggestions will influence the thinking of the IAC as it moves forward. Although there may not be a formal request by the IASB, the IAC and its members are in regular contact with IASB members and staff.

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PREPARING FOR THE NEW STANDARD

Perhaps the major activity of the IAC (actually of the Education and Practice Subcommittee) for the foreseeable future will be publishing educational notes on the new insurance standard. These are referred to as International Actuarial Notes, or IANs. The committee has no fewer than 25 IANS slated for publication, although the exact number will depend on how some topics are grouped; i.e., some may be combined. Most of these, about 12, are updates of IANs on International Financial Reporting Standard (IFRS) 4 to reflect changes resulting from the new standard. Changes may be minor, as in the case of the IAN on product classification, since the proposed new standard is only a little different from IFRS 4 on this topic. In fact the committee hopes to have four IANs drafted and ready for review at the next IAA meeting in September.

As has been mentioned in these reports, the IAA has two publications available for purchase that are must reading for actuaries planning for the new accounting standard. The IAA has a third work in process that will likewise be valuable for financial reporting actuaries. A short description of each follows.

Stochastic Modeling—Theory and Reality from an Actuarial Perspective was published in 2010. Not limited to considerations for IFRS, it will nonetheless be helpful to actuaries who will use stochastic modeling to get mean expected cash flows for the first building block.

Discount Rates in Financial Reporting: A Practical Guide was published last year. Also not limited to IFRS, it is a valuable primer on the construction of discount rates.

A monograph on the adjustment for risk is slated for publication shortly after the IASB adopts the new insurance standard. The monograph is intended to help the actuary bridge the accounting guidance to standard actuarial practices.

CAPITAL REQUIREMENTS

The IAIS is field-testing an approach for measuring capital adequacy for the 10 global systemically important insurers (G-SIIs). This is the so-called Basic Capital Requirement (BCR), which should be finalized in 2014 and likely implemented in 2015. There is a longer-range project to develop an international capital standard (ICS) for broader implementation (i.e., not limited to G-SIIs). The efforts by the IAIS are in response to a request from the Financial Security Board (FSB). The FSB wants a capital requirement for insurance companies that would parallel capital requirements for banks.

The IAA is supporting the IAIS by providing advice and counsel on the development of BCR and ICS. The IAA's support was a topic of discussion of the Collaborative Technical Committee (CTC), which is a group of actuaries from several committees that meet to discuss issues in common. Capital requirements touch on regulatory and ERM topics, to say the least. They can also touch on accounting requirements, particularly if the measurement of available capital is defined and quantified in terms that imply a certain measurement of liabilities. The current thinking is that margins in liabilities are part of capital, so what is needed is a current, unbiased estimate of liabilities, sans margins, sometimes referred to as a best estimate or a central estimate. The stated objective would seem to be met by the proposed measurement of liabilities emerging in IFRS on insurance contracts, with removal of CSM and the adjustment for risk. Members of the CTC agreed that it would be regrettable if capital testing required yet another measurement of liabilities, different from the measurement of liabilities used for insurance regulators for shareholders. On the other hand, the IAIS is not able to wait for the IASB to complete its work and will have to declare itself soon. The next few months should reveal if financial reporting actuaries will have yet another measurement of liabilities. Regardless, the IAA may develop an International Standard of Practice related to the actuary's involvement with BCR or ICS. ■