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OCI OK

By Tom Herget

The use of Other Comprehensive Income (OCI) is receiving its moment in the sun. It is being considered for housing some of the earnings volatility in the International Accounting Standards Board (IASB) current approach to measuring insurance contracts' performance.

The American Academy of Actuaries' Insurance Accounting Task Force¹ recently prepared a white paper to help IASB members understand just what could belong in OCI.²

Following are some of the concepts that were raised to help answer this question.

ACCOUNTING BASICS

Any accounting system has fundamental relationships between assets, liabilities and net worth. No matter what rules or principles exist for an accounting basis, the balance sheet item for net worth is the difference between assets and liabilities.

The income statement is a measure of performance for an accounting period. The change in net worth reflects the excess of income over expenses for the period. The change in net worth that results from this performance is called Comprehensive Income (CI).

CI comprises two components, Profit or Loss (PL) and Other Comprehensive Income (OCI). A search of accounting literature has not revealed principles for assigning elements to either PL or OCI. Items included in OCI are events that rule makers have decided should not be in PL. Some of the events may be characterized as unusual, non-recurring, or items outside the control of management.

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Once a contract has expired, earnings under any accounting basis will be the same. No matter what the IFRS, US GAAP, Estonian or whatever reserving rules are, the change in liabilities will be canceled once the policy obligation is extinguished. All the accruals sum to zero; the only thing left is cash.

At the point where the policy exits the company's inventory, the PL and CI must be equal. Thus, the last OCI entry reverses all the prior OCI entries so they sum to zero.

AUTHORITATIVE ACCOUNTING LITERATURE

Search results for information related to OCI in three popular accounting systems (US GAAP, IFRS and U.S. statutory) revealed:

US GAAP: A Sept. 30, 2010 letter from Ernst & Young, LLP states, "There are no clear underlying principles for the recognition of OCI items or for the reclassification of such items through net income."

IFRS: A June 2010 Ernst & Young, LLP industry newsletter reads, "A number of respondents to the exposure draft requested that the IASB also address the issue of the lack of clear underlying principles for the recognition of OCI items (as well as for the reclassification of such items to profit or loss) within IFRS."

U.S. Statutory: Instructions for preparing the U.S. statutory statement include a description of its OCI provision: "The purpose of the capital & surplus account is to delineate certain charges and credits not included in operations such as net capital gains and items pertaining to prior years. ..."

The conclusion is that under these three accounting bases, there is no articulation of comprehensive principles for recognizing items in OCI.

USES OF PROFIT OR LOSS

PL is used by company management, by authorities and by investors.

Company Management

All insurance products are developed using models of future cash flows. The models produce results that display returns to policyholders, employees/agents and to the company itself. The returns to the company itself are the PL. In pricing, the anticipated PL should be set neither too low (not enough return) nor too high (likely uncompetitive and unsalable). The actual PL as it emerges is compared to the expected PL to evaluate the success of the product. Under current accounting standards, it is rare, if at all, that items captured in OCI play a part in the product pricing process, since they are typically non-recurring items.

PL can also play an important role in the determination of executive and employee bonus and incentive compensation. This helps align management actions with shareholder interests. OCI may or may not be a component of incentive plans.

Finally, PL is used to trumpet performance results. Each quarter, in print and through earnings conference calls, PL is the focal point of performance discussions. OCI is usually mentioned and discussed separately in such communications.

Regulatory Authorities

Insurance regulators tend to look at balance sheet adequacy on a current basis before looking at income. However, a string of successive negative CI's would cause alarm.

Insurance taxation bodies have a keen interest in the PL as that serves as the basis for taxable income. In the United States, impacts of management-elected changes are often captured and re-spread into PL or OCI over a specified number of years, according to regulatory policy.

Investors

Generally, the item that attracts investors' attention most is the PL. That seems to be the basis on which management is judged. PL is the numerator of a common benchmark, earnings per share. When a share value is expressed as a multiple of earnings per share, it is the PL that is used as the benchmark although sometimes additional adjustments are made by an analyst.



RECOGNIZING EVENTS IN EITHER PL OR OCI

One could ask, should OCI even exist? A case can be made that it doesn't really matter how something gets to the bottom line.

If OCI should exist, performance impacts could be allocated to PL or OCI by either a blanket assignment or through principles.

Blanket Assignment

Authoritative literature could merely state what measures do not belong in PL and should run through OCI. This would involve subjective determinations and could be the result of convenience, simplicity or political compromises. Any accounting authority can make such a list; without principles, there would be no way to evaluate its propriety.

Principles

There are many viewpoints as to what can constitute regular or normal earnings (PL) in insurance, especially since there is so much unknown and so much variation around the unknown in insurance products and the investments and capital that support them.

Following are several possible principles. This presentation starts with a clean sheet of paper, incognizant of rule makers' existing preferences or pronouncements. There may be more than one right answer. Any answer may also not be practical. Also, it might be that no single principle is adequate; a combination may be needed. The purpose of this offering is to discuss different viewpoints.

Here are some possibilities and perspectives, offering advantages and disadvantages, on the following

candidates for principles that could be used to distinguish OCI from PL:

1. Warranted vs. unwarranted volatility;
2. Actions within vs. outside of management control;
3. Ordinary (usual) vs. extraordinary (unusual) events;
4. Regular results vs. those due to changes in methodologies or assumptions; and
5. Current year results vs. prior (or future) period adjustments.

1. Warranted vs. unwarranted volatility: The challenge is to develop a consensus viewpoint among participants as to what type of volatility would be considered unwarranted. There is a common perspective that volatility imposed by accounting conventions that doesn't reflect the underlying economics of the business can be viewed as unwarranted. This is called accounting mismatch.

One example of unwarranted volatility would be the component of CI created by the fact that assets and liabilities are measured at discount rates that are determined on an inconsistent basis. Another possibility is the fact that one side of the balance sheet may be unlocked (e.g., at fair value) while the other side may be locked-in (e.g., at amortized cost).

Advantages:

- Accounting mismatch is objective and it is relatively easy to identify.

Disadvantages:

- It might involve two perpetual independent valuations at reporting time (companies are already doing this with available for sale securities and shadow DAC, shadow VOBA calculations).

2. Actions within vs. outside management control: This is also a challenge to define. Conceptually, management is responsible for every action and inaction of its company. Further, the purpose of insurance is to deal with risks (for the most part) outside of the policyholders' control.

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Possible examples of items outside of management's control would be introduction of a new catastrophe model that now dictates more capital is needed. Another candidate would be the use of market interest rates in determining the value of liabilities. A third possibility would be the introduction of legislation that is disruptive to the current business plan. Some people maintain investment results are outside of management's control.

Advantages:

- This helps measure management performance by removing items that are beyond their control.

Disadvantages:

- Management is responsible for everything; why exempt certain items?
- It may be difficult to ascertain what is or is not within management's control.
- There might be a bias in classifying favorable events to be within management's control and unfavorable ones outside of their control, thus inviting manipulation.

3. Ordinary (usual) vs. extraordinary (unusual) results: Here again, defining extraordinary will be a challenge. To an individual, the arrival of a hurricane may be a life-changing extraordinary event. But to an insurer, this would be a regular component of day-to-day business. A major catastrophe, for which benefits are payable under the terms of a contract is not an extraordinary, external event. Nor would major medical or technological breakthroughs that dramatically reduce the cost of existing coverage be considered an extraordinary event. For this purpose, a determining criterion might be whether there is a provision for such events in the pricing of the product.

Possible considerations for extraordinary events might be a court case that establishes retroactive liabilities in contracts where no such exposure was anticipated (asbestos). Another possibility is the collapse of a counterparty (a reinsurer or a hedge provider), the value of whose promises is now dramatically diminished. Additional candidates are the transfer of a large loss

portfolio and the acquisition or sale of a block of business or company.

Advantages:

- This helps provide a better trend line of normal operations.
- This may help management make difficult decisions if there is a separate place in CI to report their impacts.

Disadvantages:

- It is difficult, and getting more difficult, to define the dividing line between the ordinary and the extraordinary.
- There may be a tendency to classify adverse events as extraordinary and favorable events as ordinary, thus inviting manipulation.

4. Regular results vs. those due to changes in methodologies or assumptions: Insurers will frequently review methodologies in light of emerging developments and environments. Companies will often introduce new models or upgrade existing ones. These can be perceived as presenting a better indication of the future. Use of new methodologies can be viewed as a refinement rather than a correction.

Often, assumptions need to be changed. If an event occurs during the current period that dictates a prior assumption is no longer valid, the assumption should be changed. OCI could be used to report the impact of the assumption change. However, applying outdated, prior assumptions to the current period's inventory is a meaningless, if not incorrect, determination.

Advantages:

- This helps provide a better secular performance trend line.
- It may help management make difficult decisions if there is a separate place in CI to report their impacts.

Disadvantages:

- Since insurers should be changing their evaluation of the future regularly, why classify activities as extraordinary when they are part of normal operations?

- To measure the impact of the assumption change, the company would need to quantify by using old assumptions at a new date or new (but premature) assumptions at the old date. Neither would reflect a valid representation of the balance sheet at that time.

5. Current year results vs. prior (or future) period adjustments: Assumptions need to be changed periodically. Sometimes what had appeared to be an aberration is confirmed as a trend. This is a normal situation for the evaluation of mortality and sometimes voluntary terminations. Introduction of a new assumption is appropriate. With the benefit of hindsight, one could say that the change should have been implemented several periods earlier. One use of OCI would be to report the prior period effects in OCI and only the current period in PL.

In the same way, changing an assumption brings into the current year, adjustments to the results of all future years. Using OCI to remove these effects from the current year PL would also improve the usefulness of PL.

Sometimes, a mistake may have been made. Thousands of keystrokes are used to generate an image of a liability or an asset. When these human errors are detected, their impact could be recorded in OCI.

Advantages:

- Items that have prior period impacts can usually be clearly identified as well as quantified.
- This helps provide a better trend line of normal operations.
- This eliminates opportunities for management to manage earnings.

Disadvantages:

- This might become painful for management to constantly address.
- Pointing one's eyes towards a mistake in a prior report might become a source of litigation.
- Changes in estimates could be used to manipulate the emergence of profit through PL; e.g., an insurance liability could be strengthened through OCI in order to improve future PL.

CONCLUSION

Since OCI concepts are being considered as a solution to reducing volatility in the insurance contracts IFRS, it would be a very appropriate time for the accounting industry to consider articulating the principles behind distinguishing between elements of PL and OCI. If the accounting industry desires to provide lists of what should be included in OCI, professionals can submit possible lists. If the accounting industry prefers to develop principles behind what belongs in OCI vs. PL, the actuarial profession would be willing and able to assist, expanding on (or adding to) the five candidates presented. Personally, this author feels that addressing the warranted versus unwarranted volatility (which reveals the accounting mismatch) offers the most information to the user. It is possible that some combination of the above principles offers the most valuable information to a user. The quantification of the impacts of unusual or extraordinary events could always be made in disclosures and not necessarily be assigned to OCI. ■



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ENDNOTES

¹ The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

² http://www.actuary.org/pdf/finreport/OCI_response_111219.pdf