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Statutory Reserving for Fixed Indexed Annuities with Guaranteed Lifetime Withdrawal Benefits

By Kush Kotecha, Ben Yahr and James Collingwood

In recent years, insurers have introduced fixed indexed annuity (FIA) products with guaranteed lifetime withdrawal benefit (GLWB) riders. Often, these riders are designed to generate attractive levels of guaranteed income. Target customers are typically baby boomers who are concerned about retirement planning and who are seeking ways to protect their nest eggs while generating income in retirement. The base FIA contract offers the policyholder limited equity-market exposure with full downside protection. With the addition of a GLWB rider, the policy also provides guaranteed income for life. FIA writers typically offer a slightly richer GLWB for a little less than variable annuity writers because the account value of the base contract isn't as volatile.

With the popularity and sales of these products growing, companies are considering the statutory reserving requirements for these products. Currently, the applicable statutory reserving guidance for these products is Actuarial Guideline XXXIII (AG33), which requires that a company set a reserve for each policy equal to the greatest present value of guaranteed benefits the policyholder may elect, regardless of the likelihood the policyholder would choose that option. Consequently, reserves for these products should reflect the withdrawal scenario that results in the highest present value of cash flows, since AG33 in its current state forces the carrier to assume the policyholder will elect the option most valuable to the policyholder.

As companies have applied AG33 to products with a GLWB, they are finding that the GLWB feature results in higher reserves than anticipated. The higher reserves result from using the GLWB utilization scenario that results

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Chairperson's Corner

By Rob Frasca

Although the summer is normally a slow time for volunteer activities, the Financial Reporting Section Council has been busy throughout the summer months on several initiatives to benefit the Section members.

The first initiative relates to education opportunities for section members who reside outside of the United States. Until now, all webcasts sponsored by the Financial Reporting Section have been largely focused on a North American audience and scheduled in the middle of the U.S. workday. Webcast recordings have been available for those unable to participate live, but the lack of a local focus has made them less attractive to our members overseas. This fall, for the first time, the section is sponsoring a webcast specifically targeted to our members working in Asia. The webcast will provide an update on developments at the IASB related to IFRS for insurance accounting and will be presented by actuaries located in Asia with a special focus on considerations relevant to those practicing in that region. At the time of writing of this article, the time had tentatively been set for Tuesday, Sept. 18 at 12:00 noon Hong Kong time. Please check the SOA website for the final schedule and details on how to participate live. Thanks go to Council member Bill Sayre for coordinating this session.

Keeping with the international theme, the section council is looking for additional ways to keep Financial Reporting Section members apprised of developments related to financial reporting as applied around the world. This information is directly relevant for actuaries practicing in various countries. It can also be useful to actuaries working solely in their own domestic environments because it provides an indication of worldwide developments that may one day come to local shores. In the June 2012 issue of *The Financial Reporter,* editor Lisa Markus introduced a new feature by reprinting an article on Solvency II from *The Actuary* (UK) and the current issue features an article on developments related to statutory capital in Australia. The aim is to continue this practice regularly by printing in each issue an article written for financial reporting actuaries outside of North America. The section council is currently looking for a section member interested in assisting Lisa by taking on the role of international editor, responsible for sourcing an appropriate international article for each issue of *The Financial Reporter*. Anyone interested should contact Christy Cook, the Financial Reporting Section's SOA section specialist at *ccook@soa.org.*

Finally, the section council is looking to enhance the value of Financial Reporting Section membership by enabling access to technology tools that may be useful to financial reporting actuaries. Examples might include spreadsheets that support exhibits used in actuarial textbooks and checkers used by software firms to demonstrate calculations used in their valuation systems. This project has been initiated with a general call to software vendors and consulting firms willing to provide access to tools they make generally available in supporting their products. Academic actuaries and textbook publishers who have developed actuarial tools for educational purposes are being contacted as well. Any section members with financial reporting-related

calculators or other tools that they would be willing to share with their fellow actuaries are encouraged to contact our project leads for more details. Special thanks to council member Mark Yu *(mark.you@aig.com)* and friend of the council Michael McDermid *(michael_mcdermid@jhancock.com)* for spearheading this ambitious effort.

As we all return from our summer holidays and begin to see another year-end reporting season on the horizon, the Financial Reporting Section Council continues to look for additional ways to support our fellow members. We look forward to seeing these current initiatives through to completion and welcome all comments and additional ideas. ■

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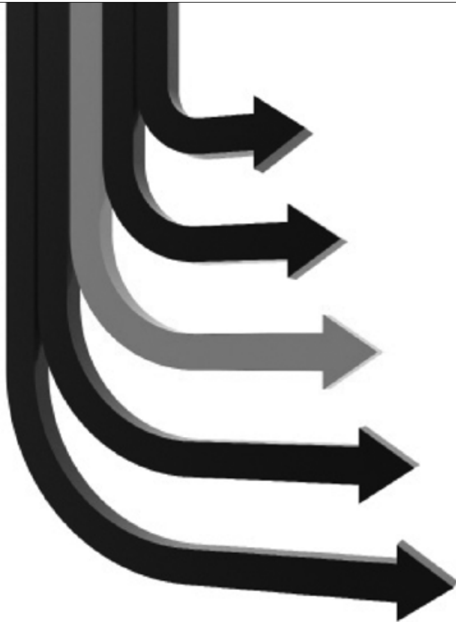

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in the highest preset value of cash flows. Although consistent with the requirements and intent of AG33, some companies believe that this worst-case utilization scenario produces reserves that are overly conservative and are based on unlikely policyholder behavior. These expectations have resulted from companies becoming accustomed to the more principle-based framework underlying Actuarial Guideline 43 (statutory reserving guidance for variable annuities and associated riders).

As a result, statutory reserve requirements for FIA products with a GLWB rider have captured the attention of both industry organizations and state regulators. The American Academy of Actuaries Annuity Reserves Working Group (ARWG) has taken up the issue from the industry's perspective, while the Life Actuarial Task Force of the NAIC has created the Fixed Annuity Subgroup to address the issue from a regulatory perspective. Discussions between these two groups have focused on three potential courses of action that would represent an interim solution until the introduction of principle-based reserving (PBR) for FIA products:

Table 1

GLWB Parameter	Product 1: High-Value GLWB	Product 2: Modest-Value GLWB
Rollup rate	7% compound	5% compound
Maximum years for roll-up	20 years	15 years
GLWB charge	0.50% of the benefit base	0.65% of the benefit base
Guaranteed withdrawal rates at sample ages		
50	3.5%	4.0%
55	4.0%	4.5%
60	4.5%	5.0%
65	5.5%	5.5%
70	5.5%	6.0%
75	6.0%	6.5%

1. **Current AG33:** Some have argued that the current standard should continue to be utilized, given that the standard already provides guidance on how to reserve for these products. Additionally, some have argued that while the current standard may be conservative in some respects (e.g., benefit utilization), it could be seen as not conservative in other respects (e.g., static interest rate environment is assumed).

2. **Modifications to the AG33**: Potential modifications to the AG33 framework have been discussed, with a focus on areas that companies have identified as particularly conservative. Specifically, modifications to utilization and lapse assumptions have been proposed to reflect that not all policyholders will persist indefinitely and elect their benefit at the most optimal time. As such, a reserve calculation tool was developed by the ARWG to illustrate the impact of allowing for utilization and lapses in determining the present value of benefits for the GLWB benefit under a modified AG33 approach.

3. **PBR AG43-like:** Noting that these products are similar to variable annuity products with guaranteed living benefits, the ARWG has also proposed using an AG43 approach to the Fixed Annuity Subgroup. The use of an AG43-like approach could be implemented via minor wording changes in AG33, which would allow companies to use this type of approach.

Discussions about what approach to take as an interim step until the introduction of PBR for fixed-deferred annuity products are ongoing, with both the ARWG and Fixed Annuity Subgroup reviewing the current AG33 standard and considering these potential courses of action.

CASE STUDY

We developed a case study to analyze the potential reserve impact of the interim solutions currently being discussed. We analyzed six issue ages ranging from age 45 to age 70 for two sample product designs represent-

ing a "high-value" and "modest-value" GLWB under each of the interim solutions. The GLWB features are shown in Table 1 (pg. 4).

Since the methodology for a modified AG33 approach and an AG43-like approach have not been finalized, we implemented these approaches as follows:

For our analysis, we calculated reserves using the following three approaches:

1. Current AG33: reserves based on the GLWB utilization scenario that produces the greatest present value of benefits.

2. Modified AG33: reserves based on the weighted-average of a range of GLWB utilization scenarios.

3. AG43-like: reserves being the greater of (i) the Standard Scenario Amount and (ii) the CTE 70 Amount using best estimate GLWB utilization rates.

The weighted-average utilization rates in the modified AG33 reserve calculation were based on the GLWB utilization used in the CTE 70 calculation. GLWB utilization rates varied by age, with the majority of the policies starting withdrawals between ages 65 and 70.

Table 2 compares the reserve in excess of the cash surrender value for the three approaches.

Under the "high-value" GLWB design, the present value of the GLWB under the AG33 approaches exceeded the cash surrender value for the younger issue ages. Under a "modest-value" GLWB design, the present value of the GLWB under the AG33 approaches is less than the cash surrender value. For both designs in our case study, the AG43-like approach is driven by the CTE 70 and tends to produce lower reserves than the AG 33 approaches.

The benefit design of the GLWB rider will determine whether the benefit stream resulting from the GLWB wins under the AG33 framework. In general, higher roll-up rates, longer deferral periods and higher guaranteed withdrawal rates will result in a greater likelihood that the AG33 approaches lead to reserves in excess of the cash surrender value.

Table 2: Excess reserve at issue as a % of CSV

Issue Age	Product 1: High-Value GLWB			Product 2: Modest-Value GLWB		
	AG33	AG33 Mod	AG 43-like	AG 33	AG 33 Mod	AG 43-like
45	41%	6%	0%	0%	0%	0%
50	21%	4%	0%	0%	0%	0%
55	10%	0%	0%	0%	0%	0%
60	0%	0%	0%	0%	0%	0%
65	0%	0%	0%	0%	0%	0%
70	0%	0%	0%	0%	0%	0%

While the above table may look benign at first blush, the potential excess reserve strain for Product 1, the high-value GLWB, is significant. If a company selling Product 1 received 10 percent of the premium from younger policyholders (e.g., age 50 or younger), the initial reserve it establishes may be 2 percent to 4 percent greater than the initial cash surrender value for the entire block. To put this in perspective, a company may hold approximately 6 percent of reserves as capital to support an FIA product. As such, an extra 2 percent in reserves would translate to a 33 percent increase in capital strain.

Because pricing exercises typically approximate AG33 reserves instead of applying the same rigor used in valuation, some companies were surprised at the additional reserve strain that was generated when the valuation department developed the actual statutory reserves. They were particularly surprised by the large statutory reserves generated in the AG33 calculation from situations the companies believed very unlikely to occur. As companies learn that the AG33 reserves are much higher than their pricing expectations, they are approaching their states of domicile to request alterna-

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tive valuation options, such as an AG43-like approach. In addition, these companies are revisiting and altering specific product features and limitations to minimize the impact of AG33 on future business.

LOOKING AHEAD

As noted above, the potential modifications being discussed are being considered as interim solutions until PBR for fixed deferred annuities is implemented. The ARWG is currently working on assisting the Life Actuarial Task Force with the development of VM-22 for fixed deferred annuities. While progress has been made on developing this long-term solution, companies are interested in exploring the use of alternative approaches like those discussed above in the interim. However, given the progress to date, it seems unlikely that a widely accepted interim solution will be in place by year-end 2012.

As a result, we expect to see companies with large blocks of this type of business explore the feasibility of obtaining a permitted practice from their state of domicile to allow them to use a modified calculation approach (such as an AG43-like approach). Companies heading down this path will likely leverage the work products of the ARWG and the discussions with the Life Actuarial Task Force. In addition, they will want to reference other companies that have successfully obtained permission from their states of domicile in recent years to utilize a modified approach.

In addition to addressing the reserve strain on in-force policies, companies are re-pricing their current products and/or modifying their current product designs. For example, firms have lowered the rate at which the GLWB benefit-base rolls up, shortened the length of the benefit-base roll-up period, increased the minimum issue age for GLWB benefits and/or redefined death-benefit provisions, all with an eye toward reducing reserves calculated under AG33 in its current form. Companies will likely continue to investigate product design modifications that can be implemented to reduce reserve strain under the current framework.

In summary, there is no one-size-fits-all solution for companies looking for statutory-reserve relief. We expect solutions to be company-specific. Therefore, any insurer with a meaningful in-force block of FIAs with GLWBs or looking to enter the market will need to remain watchful of new developments as they emerge.

The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP. ■

Convergence Once Again

By Henry Siegel

con·verge

1. a. **To tend toward or approach an intersecting point**
   b. **To come together from different directions; meet**
2. **To tend toward or achieve union or a common conclusion or result**
3. **Mathematics: To approach a limit.**

Source: *www.thefreedictionary.com*

Since the FASB joined the Insurance Contract Project, making it a joint project with the IASB, the goal has always been to develop a converged standard. There has never, however, been agreement on what "converged" means in an accounting context.

Some have said it means that the two boards would adopt identical standards. Others have said that the standards just needed to be close, without defining how close was close enough. It was therefore inevitable that there would be disagreement on whether or not a converged standard could be or had been achieved.

It was nonetheless a surprise to some when FASB Chair Leslie Seidman publicly acknowledged on June 5 what anyone following the project already knew; the two boards had not reached agreement on several important issues, and a converged standard was unlikely to emerge. Given that recognition, she further stated, the FASB was going to take a step back and discuss how to proceed on the project. What she definitely did not say, however, was that the FASB was considering abandoning the project, and indeed, the two boards continue to work together on the remaining outstanding issues.

It was another surprise, and definitely not part of the agenda, when on June 25, at the opening of a meeting of the IASB's Insurance Working Group (IWG), Burkhard Keese of Allianz, a member of the IWG, strongly raised the need for a converged standard. I immediately supported this comment as did other industry representatives. In doing so, we asked both boards to go back and review again the issues that they had not agreed upon, and consider whether they are really so important that compromise was impossible.

Table 1 identifies the four major issues that the boards have not agreed upon (other minor issues exist as well). In my view, none of these issues should be prohibitive to convergence. In fact, the ACLI has recently published a study that arrived at this same conclusion for the first and third issues. So let's briefly (there are many more arguments on both sides of each issue) review each of these items.

Table 1: Major Outstanding Disagreements Between IASB and FASB

Issue	FASB's view	IASB's view
Measurement and presentation of premiums in excess of present value of expected cash flows	For contracts accounted for under the building block approach record as single margin	For contracts accounted for under the building block approach split between measurement of explicit risk adjustment and residual margin
Unlocking the single/residual margin for changes in cash flow assumptions	Adjust only amortization of single margin	Unlock the residual margin for favorable and unfavorable changes
Acquisition costs: Agreed to include costs directly attributable to obtaining insurance contracts	Limit to costs of successfully acquiring contracts within a portfolio Note: this is consistent with US GAAP	Include both successful and unsuccessful costs of acquiring portfolio
Investment contracts with discretionary participation features (DPF)	Do not explicitly scope into the insurance contracts standard	Specifically scope into insurance contracts standard Currently scoped into IFRS 4

Should there be one margin or two? I'm sure we could live with either alternative. I prefer adoption of a single margin because it is simpler to implement and understand and because I suspect calculating the risk margin will add to rather than reduce the "black box" complaints of users. On the other hand, I can see that having an explicit risk margin could be helpful and we could simply treat it as another item in the cash flow calculations. Earnings would be mostly unaffected whichever alternative is chosen.

Should acquisition costs include only costs for successful efforts? Well yes, those already using US GAAP would prefer including only successful efforts. But the ACLI concluded that the difference is small (around 10 percent), and if we had to return to includ-

CONTINUED ON **PAGE 8**

ing the total, we could. Is this something worth going to war over? It may be difficult for the FASB to compromise on, but I don't think the issue should be a deal breaker for either side.

Should unlocking of the residual margin be allowed? This is probably the most challenging issue to resolve. The industry points out that having the ability to unlock the residual margin will reduce volatility in earnings. This is true, but it wouldn't be the end of the world if the residual margin wasn't unlocked either. The entire industry is going to provide more details about their earnings in the financial statement notes; the effects of assumption changes is going to be a disclosure many firms will make in any event.

Should investment contracts with DPF's be scoped into the insurance standard? This issue hardly seems worth arguing about. The result is largely the same under either alternative; although some differences do exist (e.g., should there be an account value floor?).

So we have a situation, familiar to all who have negotiated an M&A transaction, where there is a list of outstanding differences and the two sides need to sit down together and reach a deal. Most of the dispute is over philosophical issues that should be the subject of compromise. This is the message the industry gave to the board members and staff at the IWG meeting. It remains to be seen if the boards will continue to be adamant in their positions.

The remainder of this paper describes the results of the joint board meetings during the quarter.

APRIL JOINT BOARD MEETING

The IASB and FASB continued their discussions on insurance contracts by considering reinsurance, as well as issues related to policy loans and contract modifications (including riders). They also held an education session on the single margin approach tentatively adopted by the FASB. This was one instance where the boards made a serious effort to move towards a converged result.

> The entire industry is going to provide more details about their earnings in the financial statement notes. …

Reinsurance

The boards tentatively decided that:

- For retroactive reinsurance contracts, the residual or single margin included in the cedant's reinsurance recoverable and the reinsurer's insurance contract liability should be amortized over the remaining settlement period in the same manner as the release of the corresponding direct single/residual margin (i.e., in line with the pattern of services for the IASB or release from risk for the FASB).
- An insurer should treat cash flows resulting from contractual features affecting the amount of ceded premiums and commissions that are contingent on claims or benefits experience (often referred to as "loss sensitive features") as part of the claims and benefits cash flows (rather than as part of the premiums) if they are not accounted for as investment components. An insurer should treat any premium adjustments that are not loss-sensitive in the same way as other changes in estimates of premiums arising from the contract.
    - Any features that provide cedants with a unilateral right (but not an obligation) to pay a premium and reinstate a reinsurance contract should not be considered to be loss sensitive features for the purpose of applying this guidance.

Measurement of the Contract

Both boards tentatively decided that both the cedant and the reinsurer should evaluate whether to account for the reinsurance contract using the building block approach (BBA) or the premium allocation approach (PAA) in the same manner in which an insurer should evaluate a direct insurance contract.

Of course, as noted, the two boards have different ways at arriving at this determination.

The FASB also concluded that reinsurance contracts that reinsure both insurance contracts measured using the building block approach and insurance contracts measured using the premium allocation approach, should be separated based on the underlying contract measurement model, with each component being accounted for using the same approach used to account for the underlying direct insurance contracts.

Policy Loans and Contract Modifications (Including Riders)

The boards tentatively decided that in applying the general decisions on unbundling and disaggregation, policy loans should be considered in determining the amount of the investment component to which they relate.

The boards also tentatively decided that:

- An insurer should account for contract modifications (i.e., riders) that are part of the insurance contract at inception as part of the contractual terms of the contract. Thus the general decisions on unbundling and disaggregation should apply to riders.
- An insurer should de-recognize an existing contract and recognize a new contract (under the applicable guidance for the new contract) if it amends the contract in a way that would have resulted in a different assessment of either of the following items had the amended terms been in place at the inception of the contract:
  - whether the contract is within the scope of the insurance contract standard; or
  - whether to use the premium allocation approach or the building block approach to account for the insurance contract.

This can be considered the equivalent of SOP 05-1 of US GAAP. It remains to be seen if this is a material improvement; it certainly couldn't make things worse.

In addition, the IASB tentatively decided that an insurer shall de-recognize an existing contract and recognize a new contract if it amends the contract in a way that would have resulted in the contract being included in a different portfolio than the one in which it was included in at initial recognition. The FASB plans to consider in the future which additional circumstances will result in de-recognition and whether there needs to be application guidance.

- When an insurer makes a substantial modification to an insurance contract, the gain or loss on extinguishment of the original contract should be determined by measuring the existing insurance contract using the current entity-specific price that the insurer would hypothetically charge the policyholder for a contract equivalent to the newly recognized insurance contract.

- Insurers should account for non-substantial modifications as follows:

  - If the modification eliminates the insurer's obligation to provide some of the benefits that the contract would previously have required, the insurer shall de-recognize that portion of its obligation (including any related portion of the residual/single margin).

  - If the modification entitles the policyholder to further benefits, the insurer shall treat the modification as if the amendment was a new standalone contract (i.e., the margin is determined in the same way as for a new standalone contract with no effect on the measurement of the original contract).

Reinsurers and cedants shall present any gains or losses on commutations as a net adjustment to claims or benefits and shall not gross up both the premiums and claims, or benefits in recognizing the transaction on the statement of comprehensive income.

MAY JOINT BOARD MEETING

The IASB and FASB continued their discussions on insurance contracts by considering the separation of investment components from the insurance contract. In addition, the IASB considered its previous decisions on risk adjustment and residual margin.

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... an insurer should present in OCI changes in the insurance liability arising from changes in the discount rate. ...

Separation of Investment Components from the Insurance Contract (Unbundling)

The boards tentatively decided that if the investment component is distinct, an insurer shall unbundle the investment component and apply the applicable IFRSs or US GAAP in accounting for the investment component.

The boards tentatively decided that an investment component is distinct if the investment component and the insurance component are not highly interrelated.

Indicators that an investment component is highly interrelated with an insurance component are:

- a lack of possibility for one of the components to lapse or mature without the other component also lapsing or maturing;
- if the products are not sold in the same market or jurisdiction; or
- if the value of the insurance component depends on the value of the investment component or if the value of the investment component depends on the value of the insurance component.

An insurer shall account for investment components that are not distinct from the insurance contract together with the insurance component under the insurance contracts standard. Most observers feel that the unbundling required by these criteria will be relatively infrequent.

The boards also confirmed their previous tentative decisions regarding separation from insurance contracts, as follows:

- Embedded derivatives: unbundled when the embedded derivative is not closely related (for the IASB) or clearly and closely related (for the FASB) to the insurance component.
- Non-insurance goods and services: unbundled when the performance obligation to provide the goods or services is distinct, as previously defined by the boards.
- Investment components: exclude from the premium presented in the statement of comprehensive income an amount for an investment component as previously defined by the boards.

The boards also tentatively decided that insurers should be prohibited from applying revenue recognition or financial instrument standards to components of an insurance contract when unbundling is not required.

Risk Adjustment and Residual Margin - IASB Only

Following its education session in April, the IASB again reviewed its previous decisions on the risk adjustment and residual margin and decided to confirm them, namely:

- that the measurement of an insurance contract should include an updated, explicit risk adjustment; and
- that changes in estimates of future cash flows should be offset in the residual margin. The IASB also decided that it would not explore whether other changes in estimates should be offset in the residual margin.

This became one of the issues that Chairman Seidman was referring to in her June 5 comments, since FASB decided not to offset those changes in the single margin.

Use of Other Comprehensive Income (OCI)

The boards tentatively decided that an insurer should:

1. present in OCI changes in the insurance liability arising from changes in the discount rate;
2. not present in OCI changes in the insurance liability arising from changes in interest sensitive cash flow assumptions such as lapses; and
3. present interest accrual in interest expense using the discount rate locked in at inception of the insurance contract.

The boards also tentatively decided:

1. that the discount rate locked in at inception of the

insurance contract would be applied to changes in expected cash flows; and

2. not to include a loss recognition test in their proposed requirements.

The boards will consider at a future meeting how the above decisions will apply to participating insurance contracts, including the interaction with previous tentative decisions for participating insurance contracts.

Acquisition Costs in the Building Block Approach
The IASB tentatively confirmed that an insurer should include acquisition costs in the cash flows used to determine the margin (and hence the insurance contract liability), rather than account for them as a separate deferred acquisition cost asset.

The FASB tentatively decided against an approach that would require an insurer to expense the acquisition costs and recognize income equal to, and offsetting, those costs when the acquisition costs are incurred.

JUNE JOINT BOARD MEETING

The IASB and FASB continued their discussions on insurance contracts by exploring a method of measuring earned premiums for presentation in the statement of comprehensive income and considering how to attribute cash flows to the unbundled components of bundled insurance contracts, in order to measure those unbundled components.

Method of Measuring Earned Premiums
The boards discussed an approach to derive a measurement of earned premiums. The boards agreed to explore further the usefulness of the information and the extent of any operational difficulties. No decisions were made at this meeting.

Unbundled Components
The boards tentatively decided that:

1. an insurer should attribute cash flows to an investment component and to an embedded derivative on a stand-alone basis. This means that an insurer would measure an investment component or embedded derivative as if it had issued that item as a separate contract. The insurer would thus not include the effect of any cross-subsidies or discounts/supplements in the investment component.
2. after excluding the cash flows related to unbundled investment components and embedded derivatives:
   a. the amount of consideration and discounts/supplements should be attributed to the insurance component and/or service component in accordance with proposals in paragraphs 70-80 of the exposure draft *Revenue from Contracts with Customers*; and

   b. cash outflows (including expenses and acquisition costs) that relate directly to one component should be attributed to that component. Cash outflows related to more than one component should be allocated to those components on a rational and consistent basis, reflecting the costs that the insurer would expect to incur if it issued that component as a separate contract. Once cash outflows are attributed to components, the insurer would account for those costs in accordance with the recognition and measurement requirements that apply to that component.

This item will probably not be a major problem for life insurers since the amount of unbundling will be relatively rare. It basically says that if you do unbundle, value the investment component based on how you would separately value it, rather than doing some allocation of costs.

Both boards are now aiming to release their next exposure document at the end of this year. We will see how each of them approaches the problem of convergence. There are many major issues on which the boards agree. Hopefully, they will find a way to come close enough on the others to declare success. This is another situation showing why

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

Revenue Recognition, Part 2: Earned Premiums and Experience Deviations

By Jim Milholland

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The most recent discussions of the International Accounting Standards Board (IASB) and of the Financial Accounting Standards Board (FASB) confirm their interest in the approach to revenue recognition that was presented in the article "Presentation of Comprehensive Income takes Center Stage," in the June 2012 *Financial Reporter*. In papers written by the IASB and FASB staff, the approach is called the "earned premium" approach. This paper explains what is meant by earned premium. It then explores what happens under this approach when experience is different from expected. As was the case in the previous article, it must be emphasized that the IASB and the FASB have not made decisions about revenue recognition and that the approach described here may or may not appear in the final standards. Also as before, although the IASB tentatively made some decisions that differ from those made by the FASB, the concepts in these papers apply to reporting comprehensive income under either set of decisions. In particular, although the examples do not consider the IASB's risk adjustment, the concepts apply equally well when the measurement of the liability includes a risk adjustment and a residual margin.

EARNED PREMIUMS

The revenue, or earned premium, for an accounting period is the amount that the liability provides for expected claims and expenses for the period. Referring back to the June article, Table 1 below is Table 9 from that article, with the addition of a total column. The table shows the progression of the liability for a portfolio of 20-year endowment contracts when the experience is the same as expected. The example ignores acquisition costs.

The term "repayments" refers to cash surrenders and maturities, in keeping with the terminology adopted by the staff in discussions about contracts with investment components. The terminology may be prejudicial to the debate about whether the amounts should be included in revenue and expenses or whether they should be treated like deposits. This debate is discussed further below.

Table 1 demonstrates what is already well known, namely that the amounts that contribute to building the liability, premiums and interest credited to the liabil-

Table 1: Movement in the Liability

Year	1	2	3	4	5	10	15	 20	Total
Beginning liability	0	27,883	54,107	78,772	101,994	198,951	268,904	318,033	0
plus premium	31,000	27,890	26,483	25,144	23,870	18,370	14,069	10,689	375,103
plus interest credited	1,080	2,338	3,597	4,784	5,905	10,607	14,029	16,420	203,347
minus expenses	500	450	427	406	385	296	227	172	6,050
minus insurance benefits	339	396	467	505	540	556	464	-0	8,761
minus margin released	324	344	403	437	470	527	517	153	8,895
minus repayments	3,034	2,814	4,119	5,358	6,537	11,595	15,637	344,817	554,744
Ending liability	27,883	54,107	78,772	101,994	123,836	214,953	280,158	-0	-0

ity, are equal in the end to the amounts that are taken from the liability to provide for benefits and expenses (assuming actual experience equals expected). Thus the use of expected benefits and expenses as revenue can be seen as a way to allocate the contributions to accounting periods.

This perspective has certain appeal to accountants. In the premium allocation approach for short duration contracts, the premium will be allocated to the accounting periods during the coverage term in relation to the expected pattern of incurred claims. If claims are expected to occur more or less uniformly over the period of coverage, revenue each period is a ratable part of the premium. If claims have a distinct pattern, say they are weather-related and skewed to certain parts of a calendar year, then the premium is allocated according to the expected pattern of claims. Therefore more premiums are earned in the months in which claims are typically heaviest. For contracts using the building blocks approach, the earned premium approach results in allocating the contributions in a pattern that corresponds to the pattern of expected benefits and expenses. It is broadly conceptually consistent with revenue recognition for contracts that use the premium allocation approach.

The other appeal is that the earned premium approach is broadly consistent with the concepts found in the emerging general accounting standard *Revenue from Contracts with Customers (*RCC). The central idea in the exposure draft of RCC is that the consideration from the customer is recognized as revenue when the reporting entity satisfies its performance obligation to the customer. When the performance takes place over time, revenue is recognized over time in relation to the proportion of the value of the asset transferred or the service provided, to the total to be transferred or provided. The service provided by an insurance contract is the coverage, and the expected claims and expenses are the measure of the relative value transferred in that period. The pre-claims liability is akin to a performance obligation as that term is used in RCC.

Of course the amount allocated is not just premiums, but the sum of premiums collected and interest credited to the liability. That amount is hereinafter referred to as the total contribution. The name "earned premium" may be a misnomer. Perhaps, it should be labeled "compensation for insurance coverage," with an explanatory note that the compensation comprises both premiums and interest credited to insurance liabilities. If the investment component is excluded from the presentation in the statement of comprehensive income, then the note should say the compensation comprises the part of premiums and interest credited to insurance liabilities that are used to provide for insurance coverage and excludes the part that relates to the investment component.

INCLUDING OR EXCLUDING THE INVESTMENT COMPONENT

The IASB and the FASB have tentatively decided that the elements attributable to the investment component should be excluded from the amounts presented in comprehensive income. This disaggregation for presentation in the statement of comprehensive income applies even though the contract is not unbundled for measurement purposes. In the boards' view, cash values, endowments and perhaps even dividends are not insurance features as they do not represent significant additional benefits to the policyholder on the occurrence of an insured event. These amounts are repayments of a portion of the policyholder's contributions. To see the totality of premiums and amounts paid to policyholders, users of financial statements will have to refer either to the reconciliation of the ending liabilities to the beginning liabilities in the financial statement notes or other disclosures outside the financial statements.

The boards' decision is not popular with many actuaries. They believe that the contract features do not need to be unbundled for separate measurement nor disaggregated for presentation since they are integral to providing insurance. Some actuaries argue that life insurance cash values, for example, are better characterized as unearned revenue than as a deposit, because if the contract is not terminated the cash value will be used to settle the performance obligation (i.e., pay claims).

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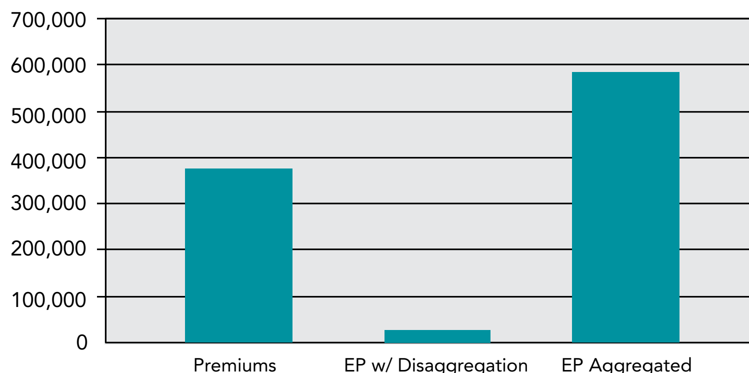
Actuaries are also concerned that investors want to see premiums and other volume information, and this format may be difficult for investors to understand.

Total Revenue Reported Over Contract Life



The final decision is obviously very important to the amount of revenue reported. The chart above shows the amount of revenue reported over the life of the contracts under the earned premium approach (EP) with and without disaggregation of the investment component. The amount of premiums collected from the policyholders is also shown as a benchmark figure.

The relationships in the chart are influenced by the fact that the contracts are endowment policies. If the investment component is not separated, nearly 60 percent of the revenue is reported in the final year when the contracts mature and the endowments are paid.

WHEN EXPERIENCE DIFFERS FROM EXPECTED

The example in Table 1 shows how revenue is recognized when experience is the same as expected. Experience almost always differs, and insurers make changes in the estimates of future cash flows. How can differences be handled so that the amount of revenue that is reported is a proper reflection of the amounts that compensate for the insurance benefits? One answer that seems the most conceptually consistent is illustrated in the following example.

Returning to the example of the 20-year endowment contracts, suppose that there are fewer deaths in the fourth year. The amount of benefits paid is less, but because there are a greater number of contracts, the liability at the end of the fourth year is greater than the projected year-end liability at the beginning of that year. The difference in the liability is a result of the fact that, even without a change in the underlying assumptions, the mortality rates and surrender rates, the amounts of expected future cash inflows (premiums) from the fifth year on is greater than had been expected, but the cash outflows will be greater than had been expected. These differences are legitimately considered a change in estimate.

Suppose further that the number of lapses is less than expected. The amount of repayments in the fourth year is less than expected, but there will be more contracts remaining in force to terminate by death or cancellation at a later date. The effect on the liability is a change in estimate using the same logic for the effects of a difference in mortality.

But what about the current period difference between the actual and the expected amounts of repayments? Arguably, keeping with the concept that the cash value is akin to a deposit, there should be no income effect from a policyholder deciding to keep his policy rather than to surrender it, or to surrender his policy rather than to keep it. This point of view is used in the following analysis.

Using the example of the 20-year endowment contract, the effects of differences in experience from assumptions can be illustrated by comparing three calculations.

- **Original -** The first is the example where experience is the same as expected.
- **Revised -** The second is the example where the liability is calculated at the start under the original assumptions, but it is revised at the end of the year for the effects of the difference in experience from the assumptions.
- **Hindsight -** The third is calculated as if the actuary knew from the outset what the experience would be in the fourth year. This calculation serves as a benchmark to compare what the insurer would have reported had it known in advance what the experience would be to what it actually reports if it starts with one set of assumptions and has to change midstream.

Table 2 displays the fourth year mortality rates, Qx, and the fourth year cancellation rates, Wx, underlying the original calculation and the revised calculation.

Table 2: Original vs. Revised Inputs

Change occurs in year four		
	Original	**Revised**
Qx	0.00072	0.00036
Wx	0.05	0.03

As noted, the revised calculation has the original assumption at the beginning of year four, but cash flows and decrements during the fourth year are based on the revised inputs, which represents the situation when experience deviates from assumptions.

The progression in the liability is shown in Table 3. For these purposes, it is necessary to show the progression in the present value of the cash flows apart from the progression of the margin.

The revised calculation starts the same as the original, but the revised calculation has adjustments to the value of future cash flows and to the margin at the end of the fourth year. The adjustment to cash flows brings the liability in line with the hindsight calculation. The revised calculation and the hindsight calculation are both prospective valuations of the same future expected cash flows from the end of year four forward, after factoring in that there have been lower than expected numbers of deaths and cancellations as compared to the original calculation.

Similarly the revised margin starts the same as the original, but at the end of the fourth year is adjusted for the effect of differences in mortality and lapses. This adjustment does not bring the margin into line

Table 3:	**Progression in the Liability Yr. 4**		
Movement in discounted cash flows	**Original**	**Revised**	**Hindsight**
Beginning value	70,947	70,947	70,589
plus premium	25,144	25,144	25,144
plus interest credited	4,784	4,784	4,766
minus expenses	406	406	406
minus insurance benefits	505	505	253
minus repayments	5,358	5,358	3,209
PVCFs before change in estimate	94,606	94,606	96,633
change in estimate	0	2,026	0
Ending value	94,606	96,633	96,633
Margin			
Beginning margin	7,825	7,825	8,081
margin released	437	437	224
adjustment for change in estimate	0	-2,026	0
difference in repayments	0	2,150	0
Ending margin	7,388	7,511	7,857
Total Liability	**101,994**	**104,144**	**104,489**

CONTINUED ON **PAGE 16**

with the hindsight calculation. The margin absorbs the difference between actual and expected mortality. The margin is not a prospective calculation and hence, with the adjustments, it is not the same as if the actuary had anticipated the lower lapses and mortality in the fourth year from the outset of the contracts.

The revised margin is also adjusted for the difference in repayments, i.e., the difference between the amounts actually paid for cancellations and the amounts originally expected to be paid. Without this adjustment, the margin and total liability would be much more different from the hindsight calculation than they are.

It is insightful to see how performance compares under the three calculations.

Table 4: Comparison of Comprehensive Income for Years 4, 5 and In Total

	Year 4				
Comprehensive Income	Original	Revised	Hindsight	Rev. - Orig.	Hind. - Rev.
Revenue	1,348	1,348	882	0	-465
Investment income	5,299	5,299	5,299	0	0
Benefits	505	253	253	-253	0
Interest credited	4,784	4,784	4,766	0	-18
Expenses	406	406	406	0	0
Net income	952	1,204	757	253	-447

	Year 5				
Comprehensive Income	Original	Revised	Hindsight	Rev. - Orig.	Hind. - Rev.
Revenue	1,395	1,423	1,445	28	22
Investment income	6,445	6,590	6,590	145	0
Benefits	540	551	551	12	0
Interest credited	5,905	6,031	6,031	126	0
Expenses	385	393	393	8	0
Net income	1,011	1,038	1,060	27	22

	Total				
Comprehensive Income	Original	Revised	Hindsight	Rev. - Orig.	Hind.- Rev.
Revenue	23,706	24,072	24,005	366	-67
Investment income	218,054	222,601	222,601	4,547	0
Benefits	8,761	8,659	8,659	-101	0
Interest credited	203,347	207,450	207,383	4,103	-67
Expenses	6,050	6,141	6,141	91	0
Net income	23,602	24,423	24,423	821	-0

The revenue in each case is taken from the progression of the liability. It is the sum of the expected benefits and expenses and the margin released. Investment income is interest on invested assets and cash flows. Profits are not distributed, so the asset base, which is cumulative cash flows, exceeds the liability by the amount of retained profit and the remaining margin. The interest credited is from the progression of the liability, which is the unwind of the cash flow discounting. The margin is amortized without interest, for simplicity.

Benefits are the actual amounts and so differ from the progression of the liability in the fourth year for the revised and hindsight calculations. Repayments are not shown, in keeping with disaggregation, but in the fourth year they are different from the expected amount in the progression of the liability.

In year four, the revised calculation differs from the original only by the difference between actual and expected death claims. The hindsight calculation differs from the revised calculation by the amount of revenue. This difference in revenue is a reflection of the fact that the hindsight calculation anticipates the lower amount of death claims in year four and hence releases less into revenue.

In year five, the revised calculation and the hindsight calculations reflect that there are more contracts than anticipated in the original calculation. The revised calculation has the same cash flows as the hindsight calculation throughout (not just year five). The difference in revenue is a consequence of adjusting the margin (in the revised calculation) midstream, at the end of year four, rather than knowing in advance (in the hindsight calculation) what the pattern of benefits would have been.

Total comprehensive income is of course the same between the revised and the hindsight calculations, as they use the same cash flows. The change in the present value of future cash flows at the end of year four makes the revised value the same as for the hindsight calculation, but the corresponding adjustment to the margin does not result in the same revised margin as in the hindsight calculation. Hence the revised calculation has different timing and amounts of revenue recognized throughout the 20-year life of the contracts. The total difference in revenue of 67 is equal to the difference in the interest credited in the first four years, i.e., before the date of the adjustment.

It is worth repeating that the total revenue in the revised calculation is much closer to the hindsight calculation than it would have been if the difference in the actual and expected amounts of repayments had been taken into comprehensive income in year four rather than offset by an adjustment to the margin. This observation supports the rationale that the difference in repayments should not affect net income.

SUMMARY

The analyses show that the approach to reporting comprehensive income described in the previous article can be made to work when the experience is different from the original assumptions. It will be interesting to follow the discussions of the IASB and the FASB to see if they settle on the approach described here. ■

PBA Corner

By Karen Rudolph

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During the last week of June 2012, the Life Actuarial Task Force (LATF) of the National Association of Insurance Commissioners (NAIC) exposed for comment the complete Valuation Manual. This is the first time the Valuation Manual has been exposed for comment in its entirety. This manual includes minimum reserve requirements for products subject to principle-based valuation requirements and for products not subject to such requirements. The Valuation Manual establishes the minimum reserve and related requirements for jurisdictions where the Standard Valuation Law (SVL) as amended in 2009, or similar legislation, has been enacted and the Valuation Manual is operative.

The Valuation Manual is composed of five sections and several appendices as outlined below:

SECTION I: INTRODUCTION

This is an introductory section covering general concepts underlying the reserve requirements in the Valuation Manual. Look to this section to find the goals of the Valuation Manual, the operative date, the process for updating the manual and information regarding principle-based reserve feedback loops.

SECTION II: RESERVE REQUIREMENTS

This section provides the requirements by type of product. For example, variable annuity products should refer to VM-21 for minimum reserves, while fixed annuity products refer to Appendix A (VM-A) and Appendix C (VM-C). Riders and supplemental benefits are covered in Section II as well. Detail calculation concepts are not included in this section.

SECTION III: ACTUARIAL OPINION AND REPORT REQUIREMENTS

This section summarizes the requirements for the actuarial opinion and memorandum and the principle-based reserves report.

SECTION IV: EXPERIENCE REPORTING REQUIREMENTS

Experience reporting requirements are found in VM-50 while the particular formats and instructions are found in VM-51.

SECTION V: VALUATION MANUAL MINIMUM STANDARDS

- Definitions (VM-01);
- Minimum nonforfeiture mortality and interest for policies subject to principle-based reserving (VM-02);
- The Standard Valuation Law as amended in 2009 (VM-05);
- Minimum reserve requirements for various products types and methods (life products: VM-20, variable annuities: VM-21, health insurance: VM-25, credit life and disability: VM-26);
- Actuarial opinion and memorandum requirements (VM-30);
- Reporting and documentation requirements for business subject to a principle-based reserve valuation (VM-31); and
- Experience reporting requirements (VM-50).

APPENDICES

- VM-Appendix A, which lists the specific minimum reserve requirements for policies issued on and after the Valuation Manual operative date, unless otherwise provided for in the Valuation Manual. This appendix includes APPM A-200 through A-830.
- VM-Appendix C, which includes the actuarial guidelines currently found in Appendix C of the Accounting Practices and Procedures Manual.
- VM-Appendix G, covering corporate governance requirements for principle-based reserves.
- VM-Appendix M, which includes a listing of mortality tables and corresponding sources.

The Valuation Manual is located at *http://www.naic.org/committees_a_latf.htm* under Exposure Drafts. It is expected that regulators will continue to refine the requirements in the life products section, VM-20, after adoption by the NAIC and prior to the Valuation Manual operative date.

Valuation Manual Updating

Once operative, changes to the Valuation Manual will be effected according to a process specified in VM-00. If an interested party, working group, or task force would like to recommend a change to the requirements in the Valuation Manual, the first step is to submit an amendment proposal form (APF) to LATF. The APF will be placed on the Pending List. Prior to each NAIC National Meeting, the Pending List will be updated. If LATF chooses to address an issue, the APF is moved to the Active List. Issues that are determined as not applicable or rejected by LATF are moved to the Rejected List. A Disposition List tracks the conclusions of LATF on each submitted APF. An issue can move from the Pending List to the Disposition List in one or more National Meetings.

Items on the Active List that become proposed changes to the Valuation Manual and are adopted by a simple majority of LATF will be exposed for comment through the NAIC's website. After some coordination with SAPWG,[1] the changes will be forwarded to the appropriate parent committees or task forces prior to consideration of NAIC adoption by the Executive Committee and Plenary. Changes to the Valuation Manual require adoption by the NAIC by an affirmative vote of at least three-fourths of the members of NAIC voting, but not less than a majority of the total membership, where such members represent jurisdictions totaling more than three-fourths of the relevant direct premiums written.

Valuation Mortality Requirements in VM-20

The valuation mortality requirements in VM-20 continued to change right up to the date of LATF's adoption of the Valuation Manual. The methodology for developing a mortality assumption for the modeled reserves[2] is consistent with the methodology proposed by the American Academy of Actuaries (the Academy) Life Reserves Working Group, but the parameters for margins and for grade-in to industry mortality rates were modified significantly by LATF. For a comprehensive understanding of the requirements, the reader is encouraged to review Section 9.C of VM-20 in the Valuation Manual. The process is summarized below, in steps.

i. Determine the mortality segments. Each segment consists of policies for which the company expects the mortality experience to be different than it is for other policies. Male preferred nontobacco risks, for example, would be one mortality segment.

ii. Determine the company experience for each mortality segment. Section 9.C lists more than one source of data that must be considered. The most obvious source is experience associated with the policies in the segment. The next source is experience associated with other books of business within the company and using similar underwriting. The last source, if applicable, is experience data from one or more mortality pools in which these policies participate under a reinsurance treaty.[3]

   The experience study upon which the company bases its assumption must be performed at least once every three years, and include at least three exposure years but not more than seven exposure years. Mortality improvement may be included from the central point of the exposure period to the valuation date but not beyond. The company's experience rates for the mortality segment cannot be lower than the mortality rates the company expects to emerge. This condition should be discussed and documented in the PBR actuarial report.

iii. For each mortality segment, determine the applicable industry mortality table. Currently, the 2008 VBT in all its forms (primary, limited underwriting and relative risk) serves as the industry table. This determination may be made using the underwriting criteria scoring

CONTINUED ON PAGE 20

tool (UCS) or any actuarially sound method, providing the company documents the analysis performed to demonstrate the applicability of the chosen method and reasons why the results using the UCS may not be suitable.

iv. Over the entire exposure period of the company's experience study, determine a single level of credibility. If the credibility level is less than 20 percent, the company cannot use any of its own mortality experience.

v. Increase the mortality rates by a margin. The margin tables are prescribed in VM-20 and are different between that used for company experience versus industry rates. Both are expressed as percentage increases that vary by attained age. The margin used for company experience depends upon the single level of credibility determined in item iv. above. Lower levels of credibility require higher percentage increases. Although the Academy's original recommendation for percentage increases went lower than 5 percent at some attained ages, the final margin tables are floored such that no percentage increase is less than 5 percent.

vi. The final step in the process is to determine the prudent estimate mortality assumption. The company experience rates with margin are used for policy durations in which there exists sufficient company experience data. This is determined for a mortality segment by identifying the last policy duration with 50 or more claims over the exposure period.[4] This last policy duration cannot be longer than the maximum, or cap, found in the VM-20 table. The company must begin grading to industry rates following the sufficient data period. A company with low credibility must begin grading no more than one year after the sufficient data period ends. A company with high credibility must begin grading no more than four years after the sufficient data period ends. Once grading has begun, the company then has four years to linearly grade to 100 percent of the industry rates with margin. All policies must be at 100 percent of the industry rates with margin by the later of attained age 100 or 15 years after underwriting.

The final step in the process is to determine the prudent estimate mortality assumption.

Net Premium Reserve Methodology

In reaction to the results of the Impact Study, LATF requested the American Council of Life Insurers (ACLI) to recommend an alternative formula for the net premium reserve (NPR) for Universal Life products with secondary guarantees (ULSG). The ACLI enlisted member companies to help determine a method that ideally would minimize tax inefficiencies by following the economics of the policy while at the same time provide a reasonable statutory floor. Several alternatives were considered and, in the end, the following method was advanced:

$$NPR^{ulsg} = Min\left[\frac{ASG_{x+t}}{FFSG_{x+t}}, 1\right] \cdot NSP_{x+t} - E_{x+t}$$

where

ASG_{x+t} = actual secondary guarantee at the valuation date (e.g., the shadow account, for products utilizing a shadow account);

$FFSG_{x+t}$ = fully funded secondary guarantee at the valuation date (e.g., the fully funded shadow account, for products utilizing a shadow account);

NSP_{x+t} = net single premium at the valuation date, using mortality, lapse, and interest as prescribed in VM-20 Section 3; and

E_{x+t} = Expense allowance for ULSG products as defined in Section 3.

The final NPR for any ULSG product is the larger of the NPR described above and the NPR as calculated for a similar policy without the secondary guarantee and floored at the greater of the policy's cash surrender value and cost of insurance charges to the next processing date. ■

END NOTES

[1] Statutory Accounting Principles Working Group

[2] Deterministic Reserve and Stochastic Reserve

[3] If applicable mortality experience data is not available or limited, the company may choose to use an industry table as representative of its expected experience.

[4] The company may use a more aggregate basis in determining the sufficient data period if the mortality experience is based on a more aggregate level and then subdivided into segments.

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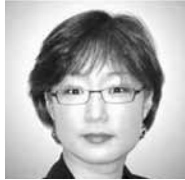
An ORSA Summary Report and ORSA Model Act Update

By Seong-min Eom and David S. Sherwood



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The National Association of Insurance Commissioners (NAIC) is forging ahead with development of the Own Risk and Solvency Assessment (ORSA), which will bring major changes in the way U.S. insurers conduct and report risk management. The ORSA Guidance Manual, adopted at NAIC's spring 2012 meeting, and draft ORSA Model Act provide the purpose, scope, and requirements for the initiative to improve insurance companies' ability to manage risk.

The commissioners hope that the final ORSA Model Act will be ready for implementation by state governments by Jan. 1, 2015.

Under the new rules, all insurers and their insurance "groups" over a certain size must conduct the ORSA. Regulators want insurers to implement risk management governance into all key areas of their operations, and to integrate their risk and capital control processes effectively. The rules also demand improved reporting to provide senior management with a better understanding of the risk profile in key areas.

ORSA GUIDANCE MANUAL

The ORSA Guidance Manual provides the purpose of the ORSA and guidelines for insurers to develop the ORSA Summary Report, outlining a comprehensive risk management framework that will enable insurers to:

- Manage risks and capital with forward-looking perspectives;
- Implement risk management and control processes appropriate for the insurer's business nature, objectives and complexity;
- Integrate risk management with capital actions to support the business strategy and planning; and
- Coordinate company-level risk management with group-level considerations.

The ORSA process encourages insurers to develop continuous, forward-looking assessments of company- and group-level risks, as well as an assessment of potential risks the insurer can face based on the insurer's business plan under either normal or stress scenarios. It can also link the insurer's risk assessment and capital views to the insurer's and the insurance group's financial solvency. Comprehensive documentation of the risk management framework, processes, and governance is a necessary element of ORSA.

The ORSA Guidance Manual directs that the ORSA Summary Report include, at a minimum, the following three components:

- Section 1 – Description of the insurer's Risk Management Framework;
- Section 2 – Insurer's Assessment of Risk Exposure; and
- Section 3 – Group Risk Capital and Prospective Solvency Assessment.

In addition to the ORSA Summary Report, insurers should maintain more in-depth risk management documentation and backup materials that support the submission to the commissioner. The regulator may request additional information to examine the insurer's risk management processes in detail. It is not clear yet if the ORSA Summary Report submission and review process will be coordinated so that the report need be filed only with the lead state regulator. Otherwise, the report filing and subsequent dialogue between the insurer and regulators could become unmanageable.

Section 1 – Description of the insurer's Risk Management Framework

According to the ORSA Guidance Manual, Section 1 of the ORSA Summary Report should address the following topics in the risk management framework:

- Risk Culture and Governance;
- Risk Identification and Prioritization;
- Risk Appetite, Tolerance, and Limits;
- Risk Management and Controls; and
- Risk Reporting and Communication.

This information can provide a better understanding of the insurer's overall risk management culture and the integration of risk management within the business operations. Still, insurers should have the group/company risk management policies and procedures in place because regulators can ask for supplementary materials. Regulators will evaluate the suitability of the key principles based on the particular insurer's risks.

Section 2 – Insurer's Assessment of Risk Exposure
Section 2 of the ORSA Summary Report should describe the insurer's primary risk assessment in both normal and stressed environments. The material risks that were identified and categorized in Section 1 are measured using either quantitative or qualitative methods. The risks should be quantified in a manner consistent with how business is managed on a group, legal entity, or other level. The ORSA Guidance Manual suggests including the likelihood and impact on financial statements and cash flows when measuring the risks. It also suggests assessing the stress impact on risk capital and available capital. The insurers should show the model validation including the factors considered and model calibration involved in the risk assessment. Due to the uniqueness of each insurer's risk profile, regulators won't provide a standard set of stress scenarios to test the risk exposure of the insurers. However, regulators may provide as inputs a set of stress factors for insurers to apply in the stress testing. These inputs into the risk assessment and capital model may create additional administrative burdens for insurers.

Section 3 – Group Risk Capital and Prospective Solvency Assessment
Section 3 links risk assessment functions to the insurer's business and capital management. The manual requests that insurers integrate capital management with their business strategy and decision-making process over longer time horizons, between two and five years. This capital adequacy test is not only based on the projection of the current business plan. A prospective solvency assessment must be coordinated with any relevant internal and external changes in both normal and stressed circumstances. In other words, this forecasting process will be part of the insurance operation decision-making process in the event that any additional business action is required under a stressed environment, any business plan has to be modified based on different environments, or where there are any capital adequacy concerns.

The ORSA Guidance Manual allows flexibility in the capital adequacy testing approach, as it does not specify any accounting basis or projection horizon. Insurers can select the appropriate projection horizon and the most suitable risk capital reflecting the company's risk culture, objective and decision-making process. However, although ORSA respects flexible approaches based on each company's different risk profile and business objectives, the ORSA Summary Report should include a description of the approach including key methodologies and assumptions used in capital analysis. The examples provided in the manual are:

- Definition of Solvency;
- Accounting or Valuation Regime;
- Business Included;
- Time Horizon;
- Risks Modeled;
- Quantification Method;
- Risk Capital Metric;
- Defined Security Standard; and
- Aggregation and Diversification.

NAIC ORSA (E) SUBGROUP UNDER FINANCIAL CONDITION (E) COMMITTEE

The ORSA (E) Subgroup, created under NAIC's Financial Condition (E) Committee, is responsible for issues related to ORSA implementation, including[1]:

- Creating an ORSA Feedback Pilot Project in 2012 for five to 10 undisclosed groups to voluntarily submit an ORSA Summary Report for regulatory review under a confidentiality agreement, in order for regulators to be able to provide some high-level feedback to the industry prior to the actual report's effective date.

- Developing an ERM education program where regulators will benefit from additional guidance and/or training.

- Developing a glossary to include in the ORSA Guidance Manual to provide clarification on terminology.

- Studying the need for the NAIC to hire an ERM expert to provide staff support and future mainte-

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nance of the guidance on ERM and ORSA, and to provide assistance and training to states as they begin the examination and analysis.

Twelve insurers initially volunteered to participate in the ORSA Feedback Pilot Project. The insurers, who remain confidential, were expected to submit a full or partial mock ORSA Summary Report. The Pilot Project is intended to show how the ORSA Guidance Manual is understood by insurers and to identify which areas need more clarification. The analysis of the reports will influence the next version of the manual. International insurance organizations have also expressed interest in the result of the pilot project.

OWN RISK AND SOLVENCY ASSESSMENT MODEL ACT

The Group Solvency (E) Issues Working Group initially considered the NAIC's Insurance Holding Company System Regulatory Regulation Form B as the reporting vehicle for the ORSA Guidance Manual. However, the industry expressed concerns, particularly on confidentiality issues, because some states considered the Form B public information. Instead, the group agreed to draft an ORSA Model Act and expose it for comment. During the NAIC Spring Meeting, the request to create an ORSA Model Act was formally adopted.

An initial draft of the ORSA Model Act is currently being discussed by working group members and interested parties. In accordance with the fact that an "Enterprise Risk Management (ERM) Framework" is requested in section 1 of the ORSA Summary Report, maintaining an ERM framework was added to the draft. It is now the *Risk Management* and Own Risk Solvency Assessment Model Act. Consequently, a section was added for the requirement of the maintenance of a risk management framework.

During the NAIC Spring Meeting, the request to create an ORSA Model Act was formally adopted.

According to the draft, insurers shall conduct ORSA regularly, no less than annually, and at any time when there are significant changes. The ORSA Summary Report will be submitted to the commissioner on an annual basis.

The NAIC working group respects the flexibility of ORSA and will try to allow an adequate level of discretion in determining terminologies, directing ORSA Summary Report contents, and guiding ORSA processes.

One of the main concerns from the industry is confidentiality protection. The ORSA Summary Report and supplemental information include insurers' essential strategies developed internally, which may be highly confidential. Within the industry, there are concerns that the commissioner may share such confidential documents with other state, federal and international regulatory agencies or law enforcement authorities, with the NAIC or with third-party consultants. The Model Act draft was amended so that report recipients agree in writing to maintain confidentiality, and verify in writing the legal obligation to maintain confidentiality. The Act also extended the information-sharing provision to more than necessary regulatory entities, which can lead to insurers' reluctance to disclose highly confidential risk management information. Some of the information sharing entities listed on the current Model Act draft are not clearly identified or necessarily relevant to regulations.

The draft of the Model Act did not specify the timing of the ORSA Summary Report submission to the commissioner. Though the draft gave insurers flexibility given each insurer's different schedule for strategic and capital planning processes, the industry commented that in practice insurers need a specific due date in order to coordinate internal ERM processes with reporting and filing requirements. When multiple states request reports without specific due dates, it could be particularly difficult for insurers. After several discussions about setting a specific filing date for the ORSA Summary Report (June 30th or September 30th were primarily discussed) to respect insurers' different strategic planning schedules, the current Act draft does not have a specific ORSA Summary

Report filing date. Instead, the Act requests that each insurer decide its filing date with its commissioner.

The effective date of the ORSA Model Act has moved to Jan. 1, 2015. The originally proposed effective date of Jan. 1, 2014 brought some concerns, since some states might not be ready to implement ORSA. This also means that they should have an appropriate risk management framework and establish a process for the ORSA Summary Report before the Act effective date. The new effective date of Jan. 1, 2015 can provide states time to pass the ORSA law and have experts to understand and review the reports.

ORSA IMPLEMENTATION

With adoption of the Guidance Manual and the development of the ORSA Model Act under way, insurers need to evaluate potential gaps based on the current guidance and take steps to address them. The more proactive insurers are developing mock ORSA Summary Reports to identify those gaps and to develop an efficient process for their ORSA Summary Report. Insurers need to make sure that they have a group-level risk profile that is regularly monitored with corresponding capital management strategies. Capital should be managed with a long-term perspective with appropriate projections of the insurer's business.

In implementing the ORSA process and developing the contents of the ORSA Summary Report, engaging the following areas is important:

- Actuarial: Developing actuarial models, maintaining and updating assumptions, performing calculations and long-term projections.
- Risk Management: Assisting with the development of the ERM framework, risk appetite, risk tolerance, and risk limits. Analyzing the risk profile of the insurer, and cooperating with all the other areas to oversee the risk management processes and controls.
- Underwriting: Having ownership in underwriting risk management and providing underwriting risk input.
- Internal Audit: Providing an independent oversight of the ORSA process.
- Information Technology: Enhancing systems to efficiently produce accurate information. Assisting in the development and filing of the ORSA Summary Report.
- Compliance: Providing a mechanism to identify changing regulations and evolving ORSA guidance. Managing ORSA compliance risks.
- Finance: Producing financial reports. Incorporating projections of the future capital management information within the business plan. Coordinating with other areas to consolidate financial data.
- Investments: Providing investment data and projections and managing ALM under both normal and stress conditions.

The ORSA is more than a pro forma, compliance exercise. It will strengthen insurers' forward-looking risk management, while linking capital management and risk management more closely. Insurers should be able to disclose whether their capital projections can meet the regulatory requirements under both normal and stress conditions. Insurers should understand the risks that can most significantly impact capital. They need to have dynamic risk monitoring procedures that include robust risk profile reporting to senior management. Insurers will find value in developing an early understanding of ORSA's requirements and an action plan for implementation. ■

REFERENCE

NAIC Spring 2012 National Meeting Executive (E) Meeting Summary Report *(http://www.naic.org/meetings1203/summary_ex_cmte.htm)*

NAIC Solvency Modernization Initiative Roadmap (March 29, 2012)

END NOTES

[1] NAIC Committees & Activities; Own Risk and Solvency Assessment (ORSA) (E) Subgroup, Financial Condition (E) Committee (*http://www.naic.org/committees_e_orsa_wg.htm).*

Report on the Los Angeles Meeting of the IAA

By Jim Milholland

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Waiting for the International Accounting Standards Board (IASB) to develop the new insurance standard is growing tiresome. At the meeting of the International Actuarial Association (IAA) in late May, members of the Insurance Accounting Committee and the Subcommittee on Education and Practice (collectively, the IACEP) found themselves in hurry-up-and-wait mode, eager to get started on responding to the new standard and frustrated by the ever-extending timetable. Fortunately there was a lot more on the agenda to make the time spent in Los Angeles worthwhile.

IFRS

The meetings of the Accounting Committee included an update of the status of the development of the emerging international standard on insurance and discussions of some of the possible challenges to actuaries responsible for implementing the standard. These discussions anticipate that the committee will submit a comment letter when the revised exposure draft is published by the IASB.

The work plan of the IASB calls for it to have a review draft or a revised exposure draft during the second half of 2012. Most observers think the document will be published at year-end at the earliest.

The IASB has requested input from interested parties on certain topics, but the Accounting Committee has not been able to generate interest among the members to draft responses. The feeling seems to be that the IAA has already provided commentary on all the subjects and at this time has nothing additional to add. The committee is aware that it will need to write a comment letter when the exposure draft is released. It seems sufficient to comment at that time.

In past comment letters, the IAA has emphasized two themes. The first is that the measurement of liabilities and the measurement of assets should have broad consistency in how the movement in insurance liabilities and backing assets affect profit and loss. The second theme is the desire to have a common standard with the Financial Accounting Standards Board (FASB) of the United States.

The discussions of the IASB on the use of Other Comprehensive Income (OCI) to capture the effects of changes in discount rates and corresponding treatment of the change in the fair value of debt securities are encouraging. It appears that the IASB is on track to have consistency in the treatment of assets and liabilities.

Since the time of the meeting of the IAA, FASB has announced that it has given up on reaching an agreement with IASB on a common standard. It now is likely that actuaries in the United States and Canada will apply standards that differ in a few key respects. Actuaries in Canadian companies and U.S. actuaries working for foreign-owned companies, for example, will use IFRS. Actuaries for U.S. companies will use US GAAP. To be sure, US GAAP will not be the same as it is today; it will be, as noted, the same as IFRS in most respects but different in others. (Refer to Henry Siegel's article titled, "Convergence Once Again" in this *Financial Reporter*, for a summary of the key differences between the IASB's and FASB's proposed standard.) If the SEC decides to accept IFRS for domestic registrants (it already accepts IFRS for foreign registrants), some U.S. companies may opt for IFRS. It is unfortunate that the actuarial profession will have to contend with two sets of standards, even if they are largely similar.

The IAA is likely to repeat these themes in its comment letter to the IASB, first expressing gratitude for the consistent treatment of assets and liabilities and then expressing concern about the failure to reach agreement on a common standard with FASB.

MONOGRAPHS SUPPORTING IFRS

As previously reported, there are three monographs sponsored by the Education and Practice Subcommittee that are in various stages of completion. The objective of the monographs is to provide a technical foundation for implementation of IFRS for insurance. The three topics are stochastic modeling, discounting and risk margins.

The book on stochastic modeling for insurance has sold out of the first printing of hard copies. The IAA has just announced that a second printing is available and can be ordered at the IAA website. Electronic versions

are also available from the IAA website. The book has been well received and its success has provided a lot of the impetus for the other monographs.

The drafting of the monograph on discounting is well advanced. The timetable now calls for public exposure in late summer or fall of 2012 with publication by the end of the year. This timetable may be optimistic. Publication in the second half of 2013 is a more reasonable expectation.

The timetable for the monograph on risk margins calls for a draft in mid 2013 with publication late in the year. Experience with the stochastic modeling book and the discounting monograph suggests that achieving this timing is unlikely. Nonetheless, given the delays in the development of the insurance standard, it does seem likely that practitioners will have at least a public exposure draft to refer to when implementing the accounting standard.

INTERNATIONAL ACTUARIAL NOTES (IANS)

Writing technical notes to assist actuaries with the new accounting standard promises to consume a lot of the IACEP resources. In fact, the committee has started reaching out to member associations to recruit additional resources for the effort. In the meantime, the actual work on the IANS awaits the finalization of the standard.

INTERNATIONAL STANDARDS OF ACTUARIAL PRACTICE (ISAPS)

There is now a standing body to direct the development of ISAPs, namely the Interim Actuarial Standards Subcommittee. It is a subcommittee of the Executive Committee, although it will soon be a stand-alone committee. The general standard, ISAP 1, is the furthest advanced among the ISAPs in the pipeline. It will be the first standard published under the IAA's new protocol. The exposure draft of ISAP 1 has been published and has been sent to member associations for comment. Of course, anyone who wishes can comment. The exposure draft can be found at the IAA website.

Progress on an ISAP for accounting has been slow. A joint task force of the Insurance Accounting Committee and the Pensions and Employee Benefits Committee has been charged with deciding if there should be a common standard. The task force has not made much progress. A common standard would have guidance that is applicable to actuaries involved with accounting for pension plans and for insurance contracts. It would be supplemented by separate standards on insurance and on pensions for practice-specific topics. If the task force cannot find enough in common to have a standard applicable to both practice areas, then there will be two standards with some common elements.

RELATIONSHIP TO OTHER COMMITTEES

There is a growing awareness by the IACEP of the need to be informed of activities of other committees and to work jointly with them when necessary. For example, as already mentioned, the IACEP is working with the Committee on Pensions and Employee Benefits on a common ISAP on accounting. The IACEP stays informed of the activities of the Committee on Insurance Regulation and the Committee on Enterprise and Risk Management. With respect to the latter two, there does seem to be a lot of overlap in the modeling and technical issues, although the objectives are distinct and different. It would not be surprising to find that the committees decide to address efficiencies that can be found in common platforms and the extent of internal consistency among the various efforts that should be expected. For now, however, the discussions are informational in nature.

MEMORANDUM OF UNDERSTANDING (MOU)

The IAA announced that it has signed MOUs with the IASB and with the International Association of Insurance Supervisors. The MOUs provide formal recognition of relationships that already exist and cement the intent of the parties to stay involved with each other in areas of common interest. The MOUs are evidence that the IAA is seen as an increasingly important body in international affairs.

NEXT MEETING

The next meeting of the IAA is in the Bahamas in November. At that time surely there will be a revised exposure draft on insurance accounting to occupy the IACEP. Otherwise the members will just have to sit on the beach. ■

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ICAAP – The New Risk and Capital Management Framework

By Jennifer Lang

This article was first published on the blog, www.actuarialeye.com, and is reprinted here with permission. The acronym, APRA, referenced in the article stands for Australian Prudential Regulation Authority.

Regulatory change is a constant in most financial services areas these days. Insurance in Australia is no different. APRA is in the middle of a major upgrade to the regulatory capital regime for life and general insurers, which is due to start from 1 January 2013.

So far, most of the focus has been on the likely changes to capital levels. The first and second round of QIS (quantitative impact statements) suggested that some companies would have substantial increases.

APRA's changes to capital governance, however, could have an equally large impact in many companies.

THE BOARD IS IN CHARGE

APRA's new proposals make it very explicit. Capital levels for insurance companies are the Board's responsibility. Not only that, but the Board has to send its own report to APRA every year (the ICAAP report) explaining its capital plans to APRA, and reviewing the last year. In a recent speech, Helen Rowell (Executive General Manager, Supervisory Support Division) made it quite clear:

APRA expects that the ICAAP will be developed by the insurer's senior management with input from relevant areas and experts. However, the ICAAP is fundamentally the responsibility of the Board: the Board should be actively engaged in the development of the insurer's ICAAP and its implementation, and must ultimately approve the ICAAP.

This change, and APRA's requirement for a report from the Board, is a step-up in Board responsibilities for insurance companies. While Boards have always had overall accountability, APRA is expecting the Board to have a deep understanding of the capital framework of their business. Expect an in depth conversation at the next APRA Board lunch.

CAPITAL IS THE PRICE FOR RISK

The capital management framework needs to be explicitly linked to the risk management framework. There needs to be a clear path from the Risk Appetite Statement to the level of capital held. The path needs to be quantitative, so that an explicit risk appetite statement can be linked to the capital held to support that risk.

Not only that, capital must be a key part of the decision making framework for an organisation. Every decision which changes the risk levels of an organisation (eg changes in price, sale of big new contracts, introduction of an outsourcing arrangement) must be considered through a capital lens.

The measurement of performance (monthly review of KPIs) must also show evidence of a capital lens – an improvement in profit at the price of increased risk should be explicitly measured that way, using capital as the price of risk.

For more about using capital as the price for risk, see my paper on this topic from 2009.

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RISK APPETITE AND CAPITAL MANAGEMENT MUST BE LINKED

APRA is expecting an explicit link between risk appetite and capital management. That means that you need to be able to show the path between your high level risk appetite ("we are targeting medium insurance claims volatility") and the way in which you manage your capital – both the level of target surplus, and the way in which you make decisions on insurance issues. Again, APRA sees this as a key part of the new framework. Helen Rowell again:

APRA expects there to be a clear link between an insurer's risk appetite and its risk and capital management framework, including the target capital levels determined as part of the insurer's ICAAP. APRA expects that target capital levels will be set in accordance with the insurer's risk appetite and not solely by reference to APRA's minimum capital requirements.

So you need to translate that statement (medium insurance claims volatility) into a quantified measure ($xm potential variance against budget) and a level of target surplus and decision making framework.

Most companies have some part of that series of steps, but very few can show the full end-to-end path.

CAPITAL IS AN INTEGRAL PART OF BUSINESS PLANNING

The capital implications of business plans (including the associated risks of the plan) must be important considerations in all business planning. That means capital projections, discussions of sources of capital (if the plan envisages capital being required) and scenario testing of the capital as well as profit position.

OPPORTUNITIES FOR COMPETITIVE ADVANTAGE

The companies that can make these requirements work for them, rather than treating them as another compliance burden will be the companies that win from the change. Companies need to:

- Use the opportunity to understand the capital intensity of their products and incentivise their team accordingly
- Use their superior understanding of risk and return to find the gaps in the market where they can achieve extra returns
- Source capital in advance of likely need by developing a good early warning stress and scenario testing framework

SO IS THIS MORE REGULATION GONE MAD?

Insurance companies in Australia do bear a large burden of regulation. On the other hand, they also weathered the GFC very successfully, at least partly due to that regulation (and supervision). My own view is that using a change in capital standards to pointedly change the level at which capital conversations take place inside an insurance company is a good development.

It's going to take time to bed down, but the companies who embrace the new requirements and take advantage of them will ultimately be the winners. ■

The companies that can make these requirements work for them, rather than treating them as another compliance burden will be the companies that win .

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