SOCIETY OF ACTUARIES

Article from:

The Financial Reporter

December 2011 – Issue 87

A Slow Quarter

By Henry Siegel

I've always maintained that the difference between accountants and actuaries is that accountants emphasize the past while we actuaries emphasize the future. It's not surprising, therefore, that when accountants look at financial statements they are primarily interested in information about the current status of a company, while actuaries are more interested in where the company is headed in the future.

In looking at the most recent discussions between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) on risk margins and disclosures (see below for more on this), an important area of disagreement between the boards and actuaries is how to look at the riskiness inherent in an insurance liability. The standard setters want a statement of the confidence interval that the reserve/liability falls within. This is a current perspective; it answers the question of how reliable the reserve is today.

An actuary would realize that such a measurement or statement is not the most meaningful information to be provided. Providing a clear statement of the assumptions used, how those assumptions compare to past experience and, most importantly, the sensitivity of the liability to changes in those assumptions give a far more meaningful package of information for evaluating the reliability of the reserve. If changing the discount rate by 10 basis points erases half your earnings, you know that those earnings are very subjective. Furthermore, these disclosures give users the information they would need to adjust the results should they disagree with the assumption chosen.

Actuaries disagree whether a confidence interval is even possible to determine for many reserves. In particular, for life reserves there are so many variables that determining a probability distribution that is usable and meaningful for all of them is highly questionable. Of course, as one actuary mentioned, no one will ever know if the confidence interval is correct since even if the reserve proves to be inadequate, it could simply be one of the scenarios outside the confidence interval.

The boards claim they are simply looking for a way to compare the reserves among companies, to identify those whose liabilities are less reliable than others. It would seem, however, that they don't appreciate that the tools to do this are already in other disclosures in the financial package.

THE MONTHLY MEETINGS

At the July IASB/FASB joint meeting, the first under the leadership of Hans Hoogervorst, the boards discussed various issues but reached no conclusions. There were no meetings in August. It appears that under the new leadership the progress on the insurance project is going to slow down as other projects, particularly leasing, revenue recognition and financial instruments, get a higher priority.

SEPTEMBER JOINT MEETING

In September, the IASB and FASB once again took up their discussions on insurance contracts, talking about the risk adjustment and disclosures. In addition, the IASB heard a report on the FASB's recent decisions on the single margin approach.

Disclosures

The IASB and FASB tentatively decided to retain the disclosures proposed in paragraphs 90-97 of the IASB's exposure draft (ED) *Insurance Contracts*, with changes as follows:

a. Delete the requirement that an insurer should not aggregate information relating to different reportable segments (i.e., paragraph 83 of the ED) to avoid a conflict with the principle for the aggregation level of disclosures. The level of aggregation could thus vary for different types of qualitative and quantitative disclosures. However, the standard would add to the examples listed in paragraph 84 of the ED by stating that one appropriate aggregation level might be reportable segments.

b. Require the insurer to disclose separately the effect of each change in inputs and methods since the last financial statement, together with an explanation of the reason for the change, including the types of contract affected. It's not clear, however, how they expect this to be carried out. Presumably both a description and some type of numerical analysis

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will be needed. This is an area where actuarial practice will no doubt be an important issue.

c. Contracts in which the cash flows do not depend on the performance of specified assets (i.e., non-participating contracts) require disclosure of the yield curve (or range of yield curves) used. For contracts where stochastic methods are used, some explanation of how the various scenarios were determined would seem to be appropriate. This requirement still does not deal with the issue of how that yield curve should be determined.

d. Require the maturity analysis of net cash outflows resulting from recognized insurance liabilities proposed in paragraph 95(a) of the ED to be based on expected maturities, and to remove the option to base maturity analysis on remaining contractual maturities. Furthermore, within the context of time bands, require the insurer to disclose, at a minimum, the expected maturities on an annual basis for the first five years and in aggregate for maturities beyond five years.

In place of these disclosures, the FASB would rely on its tentative decisions relating to risk disclosures for financial institutions. These tentative decisions had been made in its project on financial instruments at the FASB board meeting held on Sept. 7, 2011. Those disclosures would apply to insurance entities.

In addition, the IASB tentatively decided to delete the proposed requirement in paragraph 90(d) of the ED to disclose a measurement uncertainty analysis and to align that disclosure with the disclosure for fair value measurements in IFRS 13 *Fair Value Measurement*, as appropriate. Making this happen, of course, will require more discussion by the IASB. The FASB decided to retain the proposed disclosure. These disclosures, along with b. above, should give users a good sense of the risk inherent in a company's financial statement.

Risk adjustment: Objective and confidence level disclosure

The FASB listened to, but did not participate in, this part of the discussion since it has endorsed a single margin approach in which there is no explicit risk margin. The IASB tentatively decided that:

a. the objective of risk adjustment should be the "compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract"; and

b. the application guidance should clarify that:

   i. the risk adjustment measures the compensation that the insurer would require to make it indifferent between: (1) fulfilling an insurance contract liability that would have a range of possible outcomes; or (2) fulfilling a fixed liability that has the same expected present value of cash flows as the insurance contract. For example, the risk adjustment would measure the compensation that the insurer would require to make it indifferent between:

   (1) fulfilling a liability that has a 50 percent probability of being 90 and a 50 percent probability of being 110; or

   (2) fulfilling a liability of 100.

   ii. in estimating the risk adjustment, the insurer should consider both favorable and unfavorable outcomes in a way that reflects its degree of risk aversion. The boards noted that a risk-averse insurer would place more weight on unfavorable outcomes than on favorable ones. This was a key concern of actuarial commentators since it sounded from the ED that only adverse scenarios were to be considered, resulting in a higher compensation and therefore a higher risk charge.

jIn addition, the IASB tentatively decided to retain the confidence level equivalent disclosure that had been proposed in paragraph 90(b)(i) of the ED. As I discussed above, this is a huge issue for actuaries.

Risk Adjustment: Techniques and Inputs

The IASB tentatively decided:

a. not to limit the range of available techniques and the related inputs to estimate the risk adjustment; and instead,

b. to retain in the application guidance the list of characteristics, as proposed in paragraph B72 of the ED, that a risk adjustment technique should exhibit if that technique is to meet the objective of the risk adjustment.

This was another major concern of actuarial organizations with the ED and this change is certainly welcome.

The IASB also tentatively decided to retain as examples the three techniques proposed in the ED (confidence levels, conditional tail expectation and cost of capital), together with the related application guidance.

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Next Steps

There are a number of issues outstanding that both boards will need to discuss and clarify before they can have a final paper. Among those issues are:

1. Treatment of participating (including Universal Life) policies, particularly how the discount rate will be chosen and applied;

2. Unbundling (although this will at least partly depend on decisions made on the other issues);

3. Use of Other Comprehensive Income when earnings fluctuate because of mismatching accounting between assets and liabilities;

4. Treatment of reinsurance (The boards have had initial discussions on this but conclusions still need clarification.);

5. Presentation of the Income Statement; and

6. Transition (Everyone agrees the ED got it wrong; a replacement approach has not been agreed upon.)

All of these are potentially large issues that have so far eluded an easy solution.

In addition, the FASB and the IASB need to determine if they can reach agreement on those issues where they have so far disagreed, including:

1. Whether to have an explicit risk margin (as noted, FASB would have only a composite margin);

2. Which acquisition expenses to include in the fulfillment cash flows (FASB wants only costs of successful sales, IASB would include all sales costs); and

3. FASB would not unlock the composite margin for changes in non-financial assumptions, the IASB would unlock the residual margin.

They are also not in agreement on the closely related financial instruments standard. Without agreement on this, it will be difficult to have a converged financial standard for insurance companies that does not incorporate substantial non-financial volatility.

NEXT QUARTER

It's expected that by the end of the year all of the outstanding issues should have been discussed. FASB expects to put out an Exposure Draft of its own during the first quarter while the IASB will either put out another ED or some type of review draft for review.
It's important to keep focus as this project seems to drag on. And remember …

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