Communication

By Henry Siegel

"The single biggest problem in communication is the illusion that it has taken place."
—George Bernard Shaw

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One of the great problems with the International Accounting Standards Board's (IASB's) Insurance Contracts project is the difficulty explaining to the IASB and staff concepts that actuaries know very well, including their many nuances. One example of this is the use of the portfolio concept in the 2013 Insurance Contracts Exposure Draft (ED).

The ED defined portfolio as: "A group of insurance contracts that: (a) provide coverage for similar risks and that are priced similarly relative to the risk taken on; and (b) are managed together as a single pool."

This would seem a reasonable basis except for the phrase "priced similarly relative to the risk taken on." This could imply that policies with different issue ages but that are otherwise identical would have to be in different portfolios if their profitability was different, a rather common situation.

As actuaries, we also know that we group policies together differently for different purposes. For assumption setting, we group policies in rather large groups to get sufficiently credible experience. On the other hand, when we actually calculate reserves, we take into account every relevant factor. This will result in very different groupings for these purposes. Furthermore, for management purposes, companies may group many different types of contracts together (e.g., all auto insurance policies or all annuity policies). The groupings thus depend on the purpose for which they are used.

In all our discussions with the IASB and staff, the concept of portfolio was generally considered well understood by both sides. Recent discussions, however, have made it clear that our use of the term and the staff's understanding were not in accord. At its recent meetings, the IASB has clarified the use of portfolio. As we go forward, we must be careful to confirm that our communication is actually well understood.

More generally, one can rarely be overly careful to make sure communication has actually taken place.

This quarter the IASB had important discussions on a variety of subjects, most importantly on participating contracts. It appears that its discussions will not end until the fourth quarter.

APRIL IASB MEETING

The IASB met on April 25, 2014 to discuss insurance contract revenue. After discussion the IASB tentatively confirmed the revenue proposal in the ED, namely that revenue should exclude amounts that resemble deposits and should be allocated by year based on expected expenses. Many commenters believe this will confuse rather than clarify the income statement of insurers but the IASB opted for consistency with its revenue recognition standard.

The IASB also approved disclosures that would reconcile beginning and ending reserves, as well as premium and revenue.

According to the *IASB Update*,[1] "… the IASB tentatively decided that an entity should be prohibited from presenting premium information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue." I don't understand exactly what this means, but at a minimum it would seem to prevent use of premiums in the income statement since premium is not recognized in accord with how services are provided.

In addition to approving a list of non-targeted issues for future discussion, according to the *Update*, the IASB also agreed not to discuss further the following issues:

1) Disclosures;
2) Premium allocation approach;
3) Combination of insurance contracts;
4) Contract boundary for specific contracts;
5) Unbundling—lapse together criteria;
6) Treatment of ceding commissions;
7) Discount rate—top-down and bottom-up approaches;
8) Tax included in the measurement; and
9) Combining the contractual service margin with other comprehensive income.

MAY IASB MEETING

On May 20, the IASB continued its discussions on the 2013 ED by holding an education session on contracts with participating features. The IASB has been having considerable difficulty dealing with participating contracts, starting with how to define them and then how their measurement and presentation should be different

from non-participating contracts. The IASB continued this discussion at its June meeting and is not expected to deal with making decisions until the September or October meeting.

One complicating element is that the European industry has made a separate proposal on how to handle these contracts that the IASB is attempting to understand. This proposal is specifically targeted to situations where a specific percentage of profits (e.g., 90 percent) is allocated to policyholders. For universal life and traditional participating contracts it's not clear exactly how well that proposal works.

The IASB met on May 21 to discuss the following issues raised in the response to the ED on which the IASB had not specifically asked for comments:

- Recognizing the contractual service margin (CSM) in profit or loss; and
- Fixed-fee service contracts, significant insurance risk, portfolio transfers and business combinations.

With respect to how to recognize the CSM in profit or loss, the IASB tentatively decided to confirm the principle in the ED that an entity should recognize the remaining contractual service margin in profit or loss "over the coverage period in the systematic way that best reflects the remaining transfer of the services that are provided under an insurance contract." It's not exactly clear how to implement this principle for every type of contract. They did clarify that, for contracts with no participating features, the service represented by the CSM is insurance coverage that is provided on the basis of the passage of time and reflects the expected number of contracts in force. One way of interpreting this is to amortize the CSM based on either face amount or number of policies in force.

OTHER ITEMS

The IASB tentatively decided, according to the Update:

1) That entities should be permitted, but not required, to apply the Revenue Recognition Standard to the fixed-fee service contracts that meet the criteria in paragraph 7(e) of the 2013 ED.
2) To clarify the guidance in paragraph B19 of the 2013 ED that significant insurance risk only occurs when there is a possibility that an issuer will incur a loss on a present value basis.
3) To clarify the requirements for contracts acquired through a portfolio transfer or a business combination in paragraphs 43-45 of the 2013 ED, that such contracts should be accounted for as if they had been issued by the entity at the date of the portfolio transfer or business combination.

JUNE IASB MEETING

The IASB met on June 17 in an education session to continue its discussions on insurance contracts, in particular on contracts with participating features. The IASB has acknowledged that some adjustments are

CONTINUED ON **PAGE 20**

needed to the non-par standard for these contracts but wants to limit the scope of the application of any such alternatives. Having more or less given up on its proposed “mirroring” concept, it is still focused on those contracts where the liability relies on the underlying items, such as variable contracts. After discussion, the IASB tentatively directed staff to continue work on the following basis:

1. Should an entity adjust the CSM for changes in its share of the underlying items on the grounds that the insurer’s share represents an implicit management fee? The IASB tentatively agreed that should happen only when:
   a. The returns to be passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payments to policyholders);
   b. There is a minimum amount (either fixed or determinable) that the entity must retain[2]; and
   c. The policyholder will receive a substantial share of the total return on underlying items.

2. The IASB will also discuss if an entity should apply a book yield approach for determining the interest expense presented in profit or loss if:
   a. The returns passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items); and
   b. The policyholder will receive a substantial share of the total return on underlying items.

The book yield approach would use existing book yields on a portfolio of assets rather than market yields in order to more closely reflect the returns credited to policyholders. For participating policies where the crediting rate is based on a portfolio book yield rather than current market yield, this will produce more reasonable results.

At its June meeting, the IASB also discussed issues raised in the response to the 2013 ED that were unrelated to the five targeted proposals, but that the IASB nonetheless agreed to reconsider. These issues related to:

- The discount rates for long-term contracts when there are few or no observable market data;
- The asymmetrical treatment of gains from reinsurance; and
- The level of aggregation.

DISCOUNT RATES FOR LONG-TERM CONTRACTS WHEN THERE ARE FEW OR NO OBSERVABLE MARKETS

This issue arose as a result of testing done by a group of insurers who found that selection of rates at the very long end of the yield curve has a significant effect on the liability for long-term contracts. In particular, there is no clear guidance when the duration is beyond the point where there is useful information from the market. After discussion, the IASB tentatively decided to:

a) Confirm the principle that the discount rates used to adjust the cash flows in an insurance contract for the time value of money should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract; and
b) Provide additional application guidance that, in determining those discount rates, an entity should use judgment to:
   i) Ensure that appropriate adjustments are made to observable inputs to accommodate any differences between observed transactions and the insurance contracts being measured.
   ii) Develop any unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting how market participants assess those inputs. Accordingly any unobservable inputs should not contradict any available and relevant market data.

This agreement would seem to allow sufficient leeway for insurers to use appropriate judgment in setting discount rates for the longest duration contracts, provided auditors don’t place undue emphasis on the “not contradict” clause and allow companies to consider the relevance and reliability of observable inputs. I believe this is what the IASB intends but, again, communication may not be perfect.

ASYMMETRICAL TREATMENT OF GAINS FOR REINSURANCE CONTRACTS THAT AN ENTITY HOLDS

According to the Update, "the IASB tentatively decided that, after inception, an entity should recognize in profit or loss any changes in estimates of fulfillment cash flows for a reinsurance contract that an entity holds when those changes arise as a result of changes in estimates of fulfillment cash flows for an underlying direct insurance contract that are recognized immediately in profit or loss." This would appear to make reinsurance accounting more symmetrical with the accounting on underlying contracts.

LEVEL OF AGGREGATION

This issue is a perfect example of the communication problem writ large. The IASB has had a very difficult time understanding how policies are grouped for a variety of purposes (e.g., loss recognition, assumption setting and liability calculation). There appeared to be considerable surprise when they discovered that portfolio means various groupings in different situations. Accordingly, the IASB tentatively decided to:

a. Clarify that the objective of the proposed insurance contracts Standard is to provide principles for the measurement of an individual insurance contract, but that in applying the Standard an entity could aggregate insurance contracts provided that it meets that objective.
b. Amend the definition of a portfolio of insurance contracts to be:
   "insurance contracts that provide coverage for similar risks and are managed together as a single pool"; and
c. Add guidance to explain that in determining the contractual service margin or loss at initial recognition, an entity should not aggregate onerous contracts with profit-making contracts. An entity should consider the facts and circumstances to determine whether a contract is onerous at initial recognition.

This result is very important in that it more closely aligns the standard with how liabilities are really calculated. The change to the definition of portfolio also would seem to reduce the number of portfolios that will need to be used for various purposes; the previous definition might have resulted in many hundreds of portfolios.

The issue of combining onerous and non-onerous contracts remains a potentially difficult one depending on how one measures this. If one includes only marginal expenses in the calculation, you might get a very different result than if you include all overhead. Many insurers price in a way that might appear to produce losses on part of a portfolio (e.g., life policies issued to individuals over age 65) that are offset by gains on another part, depending on how overhead is allocated. The same problem can arise on policies issued in different years. Whether those types of losses must be recognized at issue or can be combined may be an important issue for further discussion.

In another example of alleviating the confusion caused by misunderstanding the nature of a portfolio, the IASB tentatively decided to clarify that an entity should select and apply its accounting policies consistently for similar contracts, considering the portfolio in which the contract is included, the assets that the entity holds, and how those assets are accounted for. In other words, accounting can differ for contracts within a portfolio if, for instance, assets supporting one type of contract are held at fair value through other comprehensive income (OCI) while for another the assets are held at fair value through income. This clarifies an earlier tentative decision that accounting had to be consistent for all contracts in a portfolio.

Communication seems, therefore, to be improving between the industry and the IASB. Another example of why

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

ENDNOTES

[1] *http://www.ifrs.org/updates/iasb-updates/Pages/iasb-updates.aspx.*
[2] *The "must" probably eliminates almost all U.S. contracts from consideration here.*