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So Where Are We Now?

By Henry Siegel

Combined, the Exposure Drafts (ED) from the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) amount to almost 800 pages. Comment letters on them may run to nearly as many pages. The biggest challenges to both boards will be sorting through the comments to identify common threads and positions that they want to adopt. For those who have not been following things closely, it will be an even bigger challenge.

In this article, therefore, I will attempt to summarize the comments I've heard in no more than three pages of text. I won't, obviously, deal with the details of every comment and there are minor issues I won't mention at all. For example, the definition of policyholder is wrong in both ED's, but it has very little actual effect on measurement (OK, I had to mention it, it drives me crazy that they can't get something so simple correct).

Below are the problems and some indication of the proposed solutions I've heard. If you want more, you'll need to read the comment letters on the IASB and FASB websites.

MEASUREMENT ISSUES

1) Non-life carriers

Non-life carriers don't want any change. If there have to be changes, they want them to be as simple as possible. Many, but not all, users and non-life actuaries agree with this. They don't think the current system is broken. They say they don't manage their business thinking about assets and liabilities together so discounting claim reserves doesn't match their business model.

There are exceptions, like reserves for disability claims, for instance. They discount those claims today and are willing to continue doing so. There is also a continuing dispute between the P&C and Health preparers over whether claim reserves should have a margin in them.

2) Discount rates

The major issue for life insurers is the appropriate discount rates to use. There are several aspects to this.

For preparers, assets and liabilities should respond consistently to changes in interest rates. This means that changes in liability discount rates should go up if market rates go up and down if they go down, and they need to do so consistently.

The boards' proposals, however, start with the premise that discounting of future cash flows to calculate liabilities should be based on the characteristics of the liability, not the assets supporting them. Therefore, asset and liability measurements don't necessarily move consistently. The top-down approach for determining discount rates attempts to remedy this, but is not entirely successful.

One cause of this problem is how to determine discount rates for durations where there are no matching assets. For instance, there are few corporate bonds with durations of longer than 20 years and almost none beyond 30. Yet long-term contracts have substantial cash flows of 30 year durations or longer. The proposal for determining those rates needs improvement.

A more technical problem applies to the top-down approach for shorter durations. The guidance requires a deduction from the market returns of actual investments held to compensate for expected and unexpected defaults. The guidance references making use of market information to determine those deductions. Unfortunately, this can result in liability discount rates remaining constant if bond yields move because of changes in market liquidity or short-term expected defaults. The best solution to this is to use long-term expected and unexpected default rates as the deductive item in calculating the top-down rates. It's not clear if the guidance allows this.

One solution to ameliorate this problem is the use of OCI to capture the effects of movements in interest rates. This works for simple, non-participating products but presents issues for par contracts.

One question is how to deal with changes to interest crediting rates. Both standards call for changing the discount rate for liabilities when crediting rates change but handle the changes differently.

The IASB appears to call for unlocking the liability discount rate to be equal to the current market rate, thereby

CONTINUED ON **PAGE 10**

Henry W. Siegel, FSA, MAAA, is vice president, Office of the Chief Actuary with New York Life Insurance Company. He can be reached at henry_siegel@newyorklife.com.

eliminating OCI on interest sensitive cash flows. For contracts like Universal Life, it's arguable that all cash flows are interest sensitive to some extent since lapse rates are considered to be. This means there is no offset at all for these contracts and all the volatility falls to the bottom line.

FASB, on the other hand, only unlocks to the extent that the crediting rate changes. If you change your crediting rate by 50 basis points, the discount rate changes by 50 basis points. This produces a better match and less volatility in earnings and equity.

Because of these technical issues, many commentators are urging that OCI be made optional to avoid accounting mismatches.

Another solution to this problem in both EDs is the use of the mirroring concept. This was originally intended to be used for contracts such as variable annuities, unit-linked products and participating contracts with specifically assigned assets. Unfortunately, the concept fails again except for these very specific situations. For contracts like VUL, some VA's and other types of participating contracts where there may be both separate accounts and non-separate account cash flows, it's not clear how this concept works. Revisions to the guidance are needed.

On the other hand, there are also industry proposals to eliminate the mirroring concept and to just use a building blocks approach that matches the cash flows closely. The details of such a proposal are still being worked out as I write this and whether it will be a complete solution to this problem remains to be seen.

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3) Unlocking margins

Another measurement issue has to do with whether and when to unlock margins for changes in assumptions about future cash flows. The IASB allows for the contractual service margin (CSM) to be unlocked if assumptions about future cash flows change. Originally, this was meant to cover things like changes in mortality assumptions. Some readers, however, have interpreted the guidance to include changes due to current year experience. If there are more lapses than expected this year, the effect of that would get run through the CSM. The guidance needs to clarify the intent of the board.

On the other hand, the FASB decided to let those changes flow directly into earnings. This produces significant volatility in earnings whenever assumptions change. At the same time, FASB decided that when, as a result of an assumption change, a portfolio of contracts is determined to be in a loss position for its entire life, all remaining margin should be released. It's very likely, however, that the margin released will be greater than the effect of the assumption change in the current year, particularly if the current year change is the last in a series of changes. This could result in a company showing a profit in a year when the final unfavorable assumption change is made. FASB needs to rethink its position, particularly when combined with the problems it causes for presentation described below.

PRESENTATION ISSUES

Both EDs include proposals for presentation that try to make insurance revenue consistent with the revenue recognition standard for other types of contracts. There are two major adjustments needed from the traditional presentation of premium. First, deposit-like amounts (e.g., surrender values) need to be removed from the premium. Second, the remainder needs to be reallocated to make it consistent with the benefits and expenses provided. While some actuaries and users think this is a theoretically justified method, many others think it's not particularly useful. In the end, feedback from users

will determine whether this proposal will survive or the basis proposed in the IASB's original ED will hold. The original ED showed only margin release and differences between expected and actual experience on the face of the income statement.

A secondary issue for the presentation arises in the event of assumption changes. Because FASB requires the effect of assumption changes to flow directly to earnings, it's necessary in the future to adjust expected benefits or expenses to reflect those changes. This greatly complicates the calculation, particularly for long-term products that can expect to have a number of assumption changes over time.

TRANSITION ISSUES

Transition to the new standard will have a significant cost. Both EDs allow some simplified methods, but more flexibility is needed. Otherwise, companies may be required to hold a zero margin for some portfolios. This will result in losses for the lifetime of those portfolios since there will be no margins to cover overhead.

There are a number of possible safe harbor methods that could be considered. More work is needed on this.

There will be significant changes to the EDs before they become final standards. Several North American companies would prefer that FASB make no changes at all unless convergence is achieved with the IASB proposals. ■

Pay attention to developments – ***Insurance Accounting is too important to be left to the accountants.***