Article from

Financial Reporter
September 2016
Issue 106

Details, Details

By Henry Siegel

At its June meeting the International Accounting Standards Board (IASB, the board) made important clarifications to several aspects of the upcoming Insurance Contracts Standard. Regrettably, those clarifications did not always go as far as they should have.

AGGREGATION OF CONTRACTS

The most significant issue the board discussed was probably what level of aggregation should be used for amortizing the contractual service margin (CSM) and to determine losses that need to be recognized at issue. Originally, the board had tentatively concluded that the objective for amortization of CSM into net income should be at the individual contract level, but that it could be aggregated if contracts in the group met certain conditions:

a. they have "cash flows that the entity expects will respond in similar ways to key drivers of risk in terms of amount and timing;" and
b. at inception they "had similar expected profitability (i.e., similar contractual service margin as a percentage of the premium)."[1]

The idea was to be sure that the CSM ran out as the exposures did. So if a contract expired due to lapse or death, any CSM associated with it should also have expired. In the same way, the allocation should recognize the exposure on contracts as they expire so that if larger contracts lapse more quickly, for example, the CSM amortization should recognize this.

This made some sense from the board's perspective, but missed a few key considerations. First, insurance is based on the concept of the law of large numbers so measuring anything at the individual policy level is conceptually flawed. It's so flawed that there is a well-known actuarial joke about the type of actuary who can do this.

There's also a major problem interpreting what "similar expected profitability" meant. Is a 10 percent margin similar to 20 percent? Or 11 percent? Is 4 percent similar to 2 percent? Companies did rough calculations that showed results with great variety due to competitive issues and pricing simplifications (e.g., a single rate for five issue ages). There is a real chance that requirement b) above could necessitate thousands of groupings for a single year of issues.

It was not even clear whether a year of issues could be grouped together for some contracts such as annuities where the "price" would vary depending on interest rates at the time of issue. A separate grouping every time the interest crediting rate changed is a real possibility.

Apparently the board and staff received a lot of feedback on this, and the staff reacted by proposing a clarification to the basic objective for amortizing the CSM.

The staff proposed and the board tentatively decided:

a. "the objective for the adjustment and allocation of the contractual service margin should be that the contractual service margin at the end of a reporting period represents the profit for the future services to be provided for a group of contracts.

b. an entity should measure the contractual service margin using the group used for deciding when contracts are onerous. Consequently, an entity should measure the contractual service margin by grouping insurance contracts that at inception have:

   i. expected cash flows the entity expects will respond similarly in terms of amount and timing to changes in key assumptions.

   ii. similar expected profitability, i.e., the contractual service margin as a percentage of the total expected revenue. An entity can use as a practical expedient the expected return on premiums, i.e., the contractual service margin as a percentage of expected premiums.

c. an entity should reflect the expected duration and size of the contracts remaining in the group at the end of the period when allocating the contractual service margin of the group of contracts to the profit or loss statement."[2]

These changes eliminated the idea of measuring things at a single contract level, but otherwise kept the requirements for grouping almost the same. One important change is that the suggested measurement is now a percentage of revenue rather than premium. The board thereby eliminated the investment component of premium from the measurement.

The discussion on these changes was quite extended with several board members raising important points.

One member pointed out that the requirement in ii. above is very rule-like and not in accord with the board's desire to be principle based. Another correctly pointed out that the CSM is not, in reali-

ty, only profit and that calling it such was improper. Others correctly worried that this requirement could produce a huge number of groupings that would be difficult to manage.

In the end, 11 board members voted in favor of the change while three opposed it. The staff agreed, however, that they would request feedback on this issue from a limited number of interested parties before issuing a final standard.

EXPERIENCE ADJUSTMENTS AND CHANGES IN ASSUMPTIONS

The board next discussed language to clarify when the effect of experience adjustments and changes in assumptions about future experience would be recorded in profit and loss and when they would adjust the CSM.

The board agreed with staff recommendations that changes to estimates of incurred claims (e.g., the runoff of the IBNR) should always go to profit or loss even though some of the change may be in estimates of the future. After discussion, the board decided that while this principle is what they had in mind, the proposed wording needed to be improved, so staff will try to devise better wording for their fatal flaws draft.

The staff also proposed additional wording changes in the guidance for when changes in other types of assumptions are reflected in the CSM and when in profit and loss. This new wording was included as an Appendix in Agenda Paper 2B for the June meeting.

PRESENTATION AND DISCLOSURE OF INSURANCE FINANCE INCOME OR EXPENSES

A number of presentation issues were discussed next. The major issue was the requirement to split changes in the risk adjustment between an underwriting and finance component. The board agreed that this was an unnecessary complication to the reporting and eliminated that requirement. The entire change in the risk adjustment could therefore be shown as part of the underwriting result if the company's accounting policy called for it.

The board also agreed that the objective for disaggregating finance income and expenses between P&L and OCI was not to present the income or expenses on a cost measurement basis. Rather, the objective of disaggregating insurance finance income or expenses between P&L and OCI "should be to present in profit or loss a systematic allocation of the total expected insurance finance income or expenses over the life of the contract."

Therefore, "the forthcoming insurance contracts Standard should provide guidance that, in this context, a systematic allocation:

a. is based on characteristics of the contract without reference to factors that do not affect the cash flows of the contract. For example, the allocation of the total expected finance income or expenses should not be based on expected recognized returns from assets if those expected recognized returns do not affect those cash flows.

b. results in the amounts recognized in OCI over the life of the contract totaling zero."[3]

The board also decided that

a. "for insurance contracts for which changes in financial assumptions do not have a substantial effect on the amounts paid to the policyholder, the systematic allocation is determined using the discount rate(s) applicable at the inception of the contract; and

b. for insurance contracts for which changes in financial assumptions have a substantial effect on the amounts paid to the policyholder, a systematic allocation can be determined in one of the following ways:

   i. using a rate that allocates the remaining revised expected finance expenses over the remaining life of the contract at a constant rate; or

   ii. if the contracts use a crediting rate to determine amounts due to the policyholder, using an allocation based on the amounts credited to the policyholder in the period and expected to be credited in future periods."[4]

The board also tentatively decided:

a. "it would not require an entity to disclose an analysis of the total insurance finance income or expenses recognized in the statement(s) of financial performance disaggregated at a minimum into:

   i. the interest accretion calculated using current discount rates;

   ii. the effect of changes in discount rates in the period on the measurement of insurance contracts; and

   iii. the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period, measured using discount rates that applied on initial recognition of those insurance contracts, and measured at current rates; and

b. it would include an objective in the forthcoming Standard that an entity should explain the total amount of insurance finance income or expenses in a reporting period, and to fulfil that objective an entity should:

   i. explain the relationship between insurance finance income or expenses and the investment return on the related assets the entity holds to provide investors with sufficient information to understand the sources of net

finance income or expenses recognized in profit or loss and other comprehensive income; and

ii. disclose an explanation of the methods the entity uses to calculate the insurance finance income or expenses presented in profit or loss."[5]

REINSURANCE CONTRACTS AND THE SCOPE OF THE VARIABLE FEE APPROACH

The board tentatively decided an entity should not apply the variable fee approach to reinsurance contracts issued or reinsurance contracts held. The board was concerned that reinsurers might be able to justify using the variable fee approach on all their contracts, a result that it did not intend. This change simply clarifies that intent.

NEXT STEPS

As mentioned above, the staff will continue to develop a revised working draft for further discussion. They will use that draft to seek input from selected external parties on some aspects of the revised draft including those discussed above.

The board expects to discuss further any sweep issues that arise from testing and from the continued drafting process in the third quarter of 2016. At that time, the board aims to set a mandatory effective date for the Standard.

The issue of aggregation of policies has been the subject of considerable discussion among actuarial and industry groups this month. Another reason why

Insurance Accounting is too important to be left to Accountants! ■

ENDNOTES

1 January 2016 IASB Update (http://media.ifrs.org/2016/IASB/January/IASB-January-Update_Monthly.pdf)

2 June 2016 IASB (https://s3.amazonaws.com/ifrswebcontent/2016/IASB/June/IASB_June_Update.pdf)

3 Ibid.

4 Ibid.

5 Ibid.

Henry W. Siegel, FSA, MAAA, is a semi-retired actuary most recently with New York Life Insurance Company. He can be reached at *henryactuary@gmail.com.*