

The Financial Reporter

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ORSA Readiness: The Time Is Now

INSURERS THAT SEE BEYOND SEEMINGLY SIMPLE BASELINE REQUIREMENTS CAN LEVERAGE ORSA COMPLIANCE TO BOLSTER ERM CAPABILITIES

By Bill Spinard, Chad Runchey and James Collingwood

After several years of planning and industry input, the Own Risk and Solvency Assessment (ORSA) requirement will soon become a reality for insurers. Many jurisdictions—including the United States, Canada, the European Union and Bermuda—will require companies to maintain an ORSA process and provide periodic summary reports as part of their solvency regulatory regimes. With broad consensus about the requirements and agreement that the final regulations will be in place by 2015, the time has come for insurers to actively plan their compliance strategies and define how ORSA can boost existing enterprise risk management (ERM) practices.

The introduction of ORSA in the United States represents a significant milestone in the modernization of the regulatory supervisory framework for insurers. Further, it is evidence of the increasing convergence of international regulations around common principles and standards. The U.S. ORSA requires insurers to provide assessments of their capabilities in three specific areas:

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Embracing Change

By Matthew Clark

This edition of the newsletter will be published in September. Summer will be ending, football games will fill the weekends, and the SOA annual meeting will be just around the corner. Meanwhile, the editor (Lisa) has asked that I complete this article during the Fourth of July weekend. My procrastination is another topic for another time. The theme today is embracing change.

Change is upon us professionally. The IASB and FASB changes are arriving and will be the focus of attention between the time I write this and when you are reading it. I am anxious ... not the kid on Christmas Eve anxious, but more like the morning of the dentist anxious. I know what is ahead of us is for our own good, but at the same time I am aware that it will come with some discomfort. It is our responsibility as a profession and as individual practitioners to engage in this change. It has taken the time and effort of many to get us to where we are today. At a minimum, I ask that you spend the time to understand the changes and how they will impact you, the profession, and the industry. If the opportunity arises, I encourage you to embrace the opportunity to impact the proposed changes.

Addressing my current excuse for procrastination, I am in the midst of a move back to Chicago. Somewhere in the sea of boxes are my possessions. I always find it therapeutic to unpack after a move. Unpacking I find myself questioning the thought process I employed to rationalize packing many of the items I am finding in the boxes. Yet, I continue to find a place for them in a closet or a drawer. One of those items is the green jacket. To remind you, this jacket offends the color green. Finding it during the move and placing it into my closet is one of those moments I mentioned.

The good news is that change is right around the corner. Bill Sayre will be accepting the jacket during the annual meeting. While I am happy to pass along the jacket, I will miss my time on the council. It has been an honor and a privilege to serve on the council over the last three years. I would like to take the opportunity to also thank Dan Harris and Mark Yu as they join me as outgoing elected members of the council. I am certain that all of us will continue to contribute to the SOA and the section. This is a change that will continue to bring new faces and fresh ideas to the council. It is always great to see the energy and excitement of the new members.

I have encouraged each of you to get involved and make an impact on the profession. With so many changes in process, there are more opportunities than ever before. In conclusion, I thank you for the opportunity to serve on the Financial Reporting Section Council. ■



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Plan to take part in these sessions, sponsored by the Financial Reporting Section:

Research Project Results on Setting Dynamic Policyholder Behavior Assumptions for Life Insurance and Annuity Companies

Session 77 Panel Discussion

Tuesday, Oct. 22

8:30 – 9:45 a.m.

Understanding past policyholder behavior and making assumptions about how current and future policyholders are likely to behave in the future are critical to the insurance industry as these assumptions about future policyholder behavior form a key aspect of insurers' pricing, reserving and risk management policies. This session will cover a recent research project on setting dynamic policyholder behavior.

NAIC RBC U L8TR!

Session 146 Panel Discussion

Wednesday, Oct. 23

8:30 – 9:45 a.m.

What are the pending changes to the National Association of Insurance Commissioners (NAIC) risk-based capital (RBC) formula? How will this formula be used in the future? Attend this session to find out about the recent activity related to NAIC RBC, as well as how future regulation may impact regulatory required capital.

SOAAnnualMeeting.org



1. Risk management framework,
2. Quantitative measurements of risk exposure in normal and stressed conditions, and
3. Group risk capital and prospective solvency assessment.

Today, with clarity about the basic requirements, there is a seemingly clearer path to near-term compliance. Insurers that have long been uncertain about what ORSA will mean to them—both strategically and practically—must begin weighing the impacts on specific processes, functions and teams across the enterprise.

While it is tempting to focus on the best process for achieving compliance and completing the report, forward-looking insurers are placing more emphasis on the strategic opportunity ORSA presents; that is, they recognize that the quality of an ORSA report is bounded by the quality of an insurer’s ERM framework and, as such, are looking for ways ORSA compliance efforts can generate ERM improvements and additional business value. The key variables in the ORSA value proposition include:

- Better use of risk capacity for new and existing businesses while remaining within stated risk appetites.
- Improved risk-based decision-making through a single framework for risk, capital and performance management.
- Increased understanding of risk exposures across the enterprise.
- Promotion of a risk management culture and greater visibility for risk on the senior management and board agendas.
- Deeper insights into the solvency impacts of future economic conditions.
- Clearer visibility into capital tiers supporting risk-taking activity and optimization of capital structures.

The bottom line is that ORSA readiness represents an excellent opportunity for insurers to bolster their overall risk management capabilities—provided they look beyond a strictly compliance-driven, “check the box” attitude and align their readiness efforts to longer-term risk management needs.

CORE CONCEPTS FOR INITIAL ORSA ACTION

Before building the ORSA implementation work plan, organizations must understand a number of core concepts that will help drive substantial returns on ORSA efforts and investments:

- **ORSA should not be underestimated.** The baseline ORSA requirements, what might be called “the letter of the law,” are deceptively simple. The Guidance Manual itself is about 10 pages, with questions and information requirements that are somewhat vague and generalized. It will be tempting, then, for carriers to simply develop a summary report that “checks the boxes.” However, insurers taking such a stance will miss the opportunity to fundamentally strengthen their ERM capabilities in a number of key areas.
- **Future requirements are likely to be more complex and robust.** There is ample reason to believe that

future ORSA requirements will be more robust, complex and prescriptive. Thus, aiming to meet minimum requirements today may ultimately lead to higher compliance costs in the long run; this is another reason for organizations to adopt a forward-looking view now.

- **ERM assessments are the right first step for ORSA.** Conventional wisdom holds that insurers with active ERM programs in place need not worry about ORSA; this is a dangerous assumption. ORSA can become a critical part of the ERM toolkit (especially as it relates to solvency measures), if risk managers and compliance teams can make it meaningful to management across the business. That is a big “if” for many companies. Because the quality of an ORSA report is bounded by (but not equal to) the quality of an insurer’s ERM framework, an important first step relative to ORSA is a full ERM assessment, which will help clarify organizational readiness for ORSA.

By acknowledging these realities, insurers will lay a foundation for both efficient and effective compliance processes and, more importantly, chart a course to stronger ERM capabilities in the long term. The latter point represents the most significant value creation opportunity for insurers as they approach ORSA.

ORSA SHOULD NOT BE UNDERESTIMATED

The ORSA Guidance Manual is a relatively quick read, and the key components are summarized within the first few pages of the document. But this deceptive simplicity masks a number of important subtleties and nuances across a number of critical risk areas. Collectively, these factors make ORSA compliance, both in the short and long terms, a trickier proposition.

For example, the Guidance Manual explicitly references to the International Association of Insurance Supervisor’s Insurance Core Principle 16 on ERM, which contains additional details that the Guidance Manual does not directly address. While it is not clear that insurers will be required to meet all of the guidance in the core principles document, it is clear that the spirit

of the ORSA summary report is intended to be consistent with the contents of this principle.

There are a range of other areas with similar “gray areas” within the Guidance Manual, where there are significant gaps between minimal initial compliance standards and bigger-picture opportunities relative to ERM. Those areas include risk appetite, risk measurement, future capital requirements and group risk and capital assessment.

Risk appetite: A risk appetite statement can be a very powerful tool to manage overall risk exposure; however, if poorly defined, it can appear to be a meaningless qualitative statement unrelated to day-to-day operations or decision-making. The concept is simple: have executive leadership, including the board, clearly state how much risk they are willing to take. That overall risk appetite can then be cascaded down through the business in order to ensure that risk exposure is always within the stated appetite and that formalized processes are in place to deal with exceptions. While such an approach to defining and operationalizing risk appetite is uncommon in the industry today, a meaningful risk appetite statement that has been approved by the highest levels of management is an enabler of effective ERM frameworks.

ORSA can become a critical part of the ERM toolkit, if [it’s] meaningful to management across the business.

Risk measurement: Another critical component of understanding risk is the ability to quantify exposure to key risk types. Consistency is important when trying to compare risks between different risk types (e.g., market to catastrophe), product lines (e.g., life insurance to homeowners to health insurance) and jurisdictions (e.g., Japan to the United States). While there are many approaches for quantifying risk, an approach that

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... a prospective look at capital can provide management with critical information. ...



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allows for consistency is critical to providing management with a full picture of risk exposure.

Future capital requirements: Typically, risk exposure and capital calculations are performed as of a specific point in time. While this is a valuable piece of information, the ORSA process requires the projection of future capital requirements over the next one to three years (taking into account the business plan of the organization). By incorporating the specific products and markets in which a company is looking to grow, a prospective look at capital can provide management with critical information as to what the capital requirements may be in the future. Incorporating stress testing can give management a clearer picture of potential issues related to their business plans.

For some product lines and balances, projecting risk capital may seem fairly straightforward (e.g., projecting NAIC RBC requirements for lines that do not require principles-based calculations). However, for any economic capital measurement or products that require a stochastic analysis to measure RBC, the projection of future capital requirements is very complex. Thus, it is important to think through potential approaches to simplify calculations while retaining the direction and magnitude of actual results.

Group risk and capital assessment: For large insurance groups, consistent views of risk and capital across various legal entities are difficult to achieve. Pulling together a consolidated view often requires mixing and matching accounting and capital regimes, product lines, currencies and other complicating factors, including the ability to use capital from one entity for another.

These important issues are all implicitly raised by the ORSA Guidance Manual, suggesting the hidden depth and complexity in that brief document and likely pointing the way forward for future evolution of the standards. To be clear, initial ORSA compliance efforts may not yield complete maturity along all of these critical ERM dimensions. However, they can certainly enable progress by sparking important conversations among business stakeholders, senior executives and risk management teams.

FUTURE REQUIREMENTS ARE LIKELY TO BE MORE COMPLEX AND ROBUST

Today, ORSA requirements are brief, principles-based and give companies wide discretion. However, experience with previous guidance confirms that in the future, ORSA requirements are likely to be increasingly complex, robust and prescriptive.

Consider how the current NAIC ORSA Guidance Manual does not prescribe a standardized reporting structure and allows for flexibility when calculating capital requirements. This means that the sections relevant to forecasting capital may prove especially tricky in that insurers with very limited capabilities in this area may describe a process that sounds more mature. Also, ORSA has made clear that the length, depth and granularity of information provided depend on the nature, scale and complexity of insurer. The bottom line is that insurers will find plenty of room for interpreting the requirements.

Companies will have to determine how to navigate through the general, principles-based structure of the Guidance Manual. This may seem minor in terms of initial compliance, but is almost certain to lead to greater complexity and higher compliance standards in the future.

Moving into initial compliance efforts, insurers must understand how and where ORSA introduces new concepts and nuances and how those might evolve in the future. For instance, the time horizon used for business planning—generally one to three years—can change depending upon the insurer and which risks are being

modeled. Areas like “management actions” and “stress and scenario tests” are also open to broad interpretations, which can result in wide variability in the reports.

Given the past experience of regulatory oversight in financial services, ORSA is highly likely to become a fundamental risk reporting metric in the future. Both risk-based capital (RBC) regulation in insurance and the Basel guidelines for banks provide a template for ORSA’s future evolution. It will almost certainly become more robust, with more specific, detailed and comprehensive reporting requirements, and an annual updating process with periodic milestones available to measure progress.

ERM ASSESSMENTS ARE THE BEST FIRST STEP

The connection points between ERM frameworks and the ORSA process are numerous and direct. In fact, the requirements outlined in the NAIC ORSA Manual can be aligned to overarching ERM framework components. For instance, ORSA summary reports will document the existing ERM framework and its outputs. ORSA Section 1 seeks information about overall governance arrangements and risk appetites, as well as risk monitoring, policies and internal controls. Other sections focus on risk reporting, management information, and decision and planning support. Similarly, ORSA reports emphasize risk assessment and measurement—critical components of any ERM framework.

This is not to say that ERM frameworks are by themselves sufficient for ORSA compliance. Rather, ORSA assessments can help insurers evaluate their current ERM capabilities, identify gaps and prioritize improvement plans. For instance, ORSA can help insurers address such common organizational challenges as unclear or fragmented committee structures and lack of board engagement. Similarly, the ORSA process can help clarify risk identification, risk categorization and control, as well as risk-reporting issues, including data quality.

In addition, insurers that use the ORSA requirements to enhance their ERM programs may discover valuable insights, including: risk-adjusted measures for product

pricing, improved metrics to identify underperforming businesses, ability to evaluate multiple risk mitigation strategies and more consistent risk-taking decisions to list a few.

Achieving an efficient path toward near-term ORSA compliance and strengthening overall ERM practices are not mutually exclusive goals. In fact, driving simultaneously on both of these fronts will enable insurers to realize several benefits at once. A more efficient compliance process can certainly result in cost savings associated with the automation of manual tasks and reduction of duplicative efforts. An efficient compliance process should be built on insights about current data feeds and information assets that can be used for ORSA compliance and a clear understanding of the resources necessary for compliance.

Further, it can provide insights into future requirements based on more engagement with regulators as standards are finalized. But, here again, insurers must take a broader holistic view, as opposed to simply seeing the “path of least resistance” to compliance.

Looking at longer-term ERM capabilities, ORSA provides clear justification for insurers to take a closer look at current structures and practices and identify gaps and opportunities for improvement. In this sense it is a unique opportunity to drive maturity into ERM models and help position risk management programs and teams for future evolution.

ASSESSING ORGANIZATIONAL READINESS

It can be argued that the NAIC ORSA Guidance Manual is laid out at a high level because the industry has made the point that most of the components of a good ERM framework are currently in place and therefore compliance will not create additional work. Clearly, some ERM leaders have the ability to develop a quality ORSA summary report. However, it is just as clear that many carriers do not have the ability. There is a wide range of ERM maturity and practices across the industry, varying significantly based on lines of business and the size and strength of the insurer.



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Thus, the question becomes how insurers can assess their own readiness for ORSA. Key questions carriers should ask are:

1. Does the company understand the requirements as stated by the ORSA Guidance Manual and the key components of ICP 16 on ERM?
2. Is a documented risk appetite statement used to inform business decision-making?
3. Is exposure for all types of risks measured in a consistent way?
4. Can the company project future risk capital requirements consistent with short-term business plans?
5. Is it possible to create a group risk and capital assessment with a consistent measurement framework?

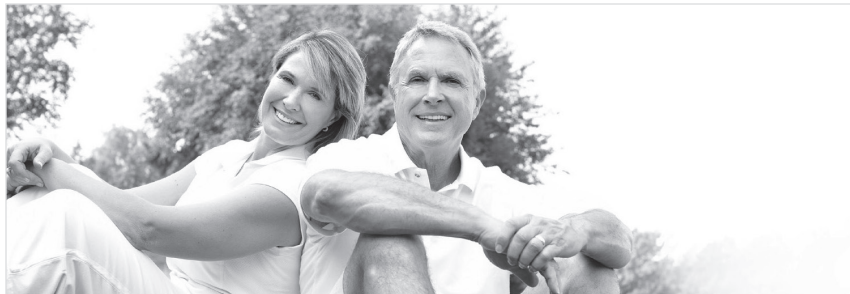
Organizations that answer “yes” to all of these questions are on the right track to deliver quality ORSA summary reports. Organizations answering “no” to any of these

questions can take some comfort in knowing that there is time to enhance their capabilities prior to ORSA’s effective date. Some of the items on the list above are straightforward and manageable. Others, however, can be complex and require significant planning and resources to implement. However, once implemented, capabilities like risk appetite, consistent-risk quantification, projection of capital and group risk and capital assessments are extremely valuable tools for effective ERM programs and for providing management a much clearer picture of companywide risk exposure.

CONCLUSION

ORSA introduces new risk disclosures into the insurance regulatory environment. Regardless of the present challenges that exist to comply with ORSA, there is a great opportunity for insurers to develop sound risk management processes that serve as the basis for sound business practices. The keys are to avoid underestimating ORSA requirements, develop solutions that go beyond superficial compliance and seize the opportunity to strengthen existing ERM practices and overall risk management functions. ■

The views expressed herein are those of the authors and do not necessarily reflect the views of EY.



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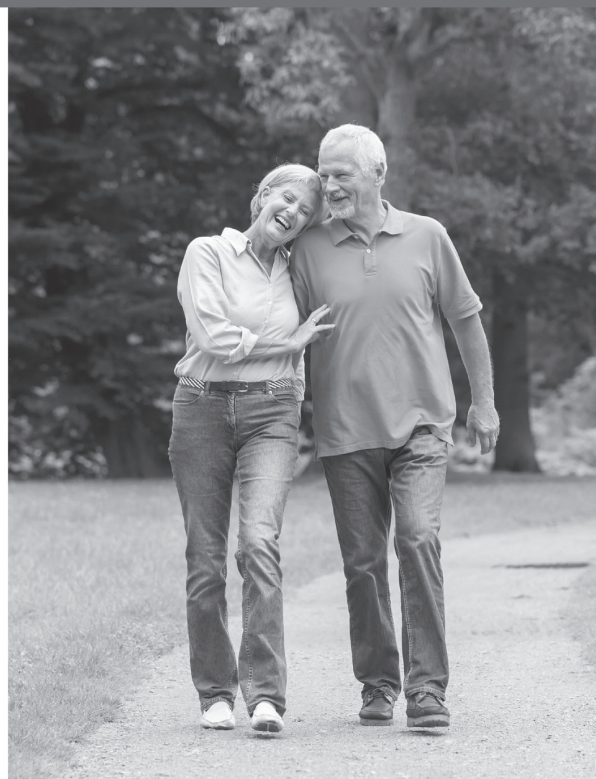
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The outcome of each Living to 100 Symposium is a lasting body of research to educate and aid professionals and policymakers in identifying, analyzing and managing the potential needs and services of future advanced-age populations. Questions may be directed Ronora Stryker, SOA research actuary, at rstryker@soa.org.

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OTHER COMPREHENSIVE INCOME FOR INSURANCE CONTRACTS

By Leonard Reback



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In June, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) released exposure drafts of their proposed accounting rules for insurance contracts, which would be effective under U.S. GAAP and IFRS, respectively. For the IASB, this was their second exposure draft, having released an earlier exposure draft in 2010. For FASB, this was their first exposure draft, but they had published a discussion paper in 2010 describing their views at that time. One of the key changes in both boards' positions since 2010 was the introduction of the use of other comprehensive income (OCI) to report certain changes in the value of insurance contracts.

OCI is currently used to present the change in value of certain financial assets backing insurance liabilities to the extent those assets are designated as available-for-sale. For such assets, the fair value of the assets is held on the balance sheet, but any unrealized gains and losses caused by changes in interest rates is shown in OCI rather than net income. Net income thus is based on the amortized cost of the asset, and reflects accrued interest and certain other events, such as impairment, until the asset is sold and any gains or losses are realized. As a result, net income is generally less volatile, since the impact of unrealized gains and losses from changes in market interest rates is excluded.

The introduction of OCI was in response to concerns expressed by both the insurance industry and financial statement users. Under the proposed insurance accounting model, the long duration insurance contracts would be valued under a building block approach, whereby the valuation would be based on the present value of

expected future cash flows, using current assumptions and current discount rates, in addition to a margin to eliminate any gain at issue. The concern was that by using current discount rates that are updated each reporting period, changes in the liability would be dominated by changes in market rates, obscuring the impact of underwriting results and management actions.

In addition, in order to maintain any degree of matching between the asset and liability accounting, insurers would be forced to hold assets backing insurance contracts at fair value with all changes in fair value flowing through net income, rather than OCI. This would differ from accounting for other financial institutions, which would be able to use OCI for their assets. To the extent that insurance liabilities and the assets backing them were not perfectly matched in terms of duration, convexity, any key rate duration, or other such measure, substantial net income volatility would result from any market interest rate changes.

Some duration mismatches are unavoidable, since in many jurisdictions there are no assets that are long enough to perfectly match the liability durations. Even if the asset and liability cash flows are perfectly matched, the durations would still have some mismatch due to the fact that the insurance accounting proposal generally prevents the liability discount rate from being the same as the implied asset yield.¹ In order to address these concerns, the boards agreed that while the insurance liability should be measured using current discount rates, the impact of changes in the discount rates should be shown in OCI rather than net income. This way, net income would reflect the impact of underwriting results and management actions and would not be obscured by the impact of changes in market interest rates.

OCI FOR NON-PARTICIPATING INSURANCE CONTRACTS

The boards have come to consistent positions on the use of OCI for insurance contracts whose cash flows do not change when interest rates change. This would include many contracts currently accounted for under FAS 60 or FAS 97 limited pay guidance, such as term

The introduction of OCI was in response to concerns expressed by both the insurance industry and financial statement users.

insurance, non-participating whole life and single premium immediate annuities. For these contracts, the liability would essentially be valued twice. For the balance sheet, the expected cash flows would be discounted using a current yield curve. For determining net income, the expected cash flows would be discounted using locked-in interest accretion rates, which would be based on the yield curve that was in effect when the contract was issued.

This approach is similar to the way the amortized cost of a fixed interest rate bond is calculated. The amortized cost for a bond is determined by discounting future cash flows using an effective yield locked in when the bond is acquired. This approach should produce a reasonable match between these liabilities and available-for-sale assets.

There are some potential issues to consider. For one thing, rather than using a single effective yield discount rate for net income purposes, the liability would be discounted using a full yield curve. Also, in many cases the assets backing the liability are not all financial instruments classified as available-for-sale, so there could be a mismatch between a liability that reports changes in OCI and assets that do not. Moreover, the impact of interest rate changes on cash flows would be excluded from OCI. So if a change in interest rates caused projected interest sensitive lapses to change, the effect of the change in lapses would be reflected in net income, not OCI.

OCI FOR CONTRACTS WHOSE RETURNS ARE CONTRACTUALLY LINKED TO ASSET RETURNS

For contracts whose returns are contractually linked to asset returns, IASB and FASB have agreed to a concept of “mirroring” for the liability, although some details differ as to how each board would implement mirroring. Basically, mirroring would mean that to the extent the liability cash flows are contractually linked to asset returns, the liability value would mirror the asset value. This would avoid accounting mismatches on this portion of the assets and liabilities. So if the assets were



held at amortized cost, the liability would equal the amortized cost of the assets. If the assets were held at fair value, the liability would equal the amortized cost of the assets, and to the extent asset fair value changes were reflected in OCI, the change in liability would also be reflected in OCI. Insurance contracts that would likely qualify for mirroring on at least a portion of the liability include variable and unit linked contracts, European 90-10 contracts, and participating contracts held in a closed block.

Even for contracts that qualify for mirroring, any cash flows that do not meet the criteria for mirroring would be accounted for separately.² This would include items such as variable life death benefits, M&E charges and variable annuity guarantees.

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OCI FOR PAR AND UL CONTRACTS THAT DO NOT QUALIFY FOR MIRRORING

Late in 2012, the boards agreed to an approach to OCI for participating and UL contracts that do not qualify for mirroring. But in early 2013 FASB revised its approach, so that the boards' exposure drafts differ as to how they would treat OCI for such contracts.

Under the IASB approach, cash flows of such contracts would be bifurcated between fixed cash flows and asset dependent cash flows.³ Asset dependent cash flows would include cash flows that depend on interest credits, such as surrender benefits. Fixed cash flows would be the cash flows that do not depend on asset returns. Unfortunately, it is not always clear what the board has in mind for fixed cash flows. For example, on many UL contracts the death benefit is a fixed amount, which might suggest that it is a fixed cash flow; however, if the credited rate is low enough, the account balance may run out, leaving a death benefit of zero. That would suggest it may be an asset dependent cash flow. Similarly, it is not clear how premiums would be allocated (if at all) between fixed and asset dependent cash flows.

However defined, for purposes of determining net income (i.e., income excluding OCI) the fixed cash flows would be discounted using a locked-in yield curve as of the inception of the contract. Asset dependent cash flows would generally be discounted using a current yield curve; thus there would generally be no OCI associated with those cash flows.⁴

FASB's approach would not split the cash flows. Under FASB's approach, the initial discount rate curve at contract inception would be converted to a single effective yield, which would be the interest accretion rate used for net income purposes. Each reporting period, this interest accretion rate would be updated based on any change in credited rates on the contract.

The update process would be somewhat complex. Basically, the contract's projected cash flows would need to be updated just for the change in credited rates. A projection of future cash flows would be needed reflecting updated credited rates but not updating any other assumption. The interest accretion rate would be updated such that the present value of cash flows using the revised credited rates and updated interest accretion rate equals the present value of the cash flows using the prior credited rates and interest accretion rate. In other words, let:

i_t be the interest accretion rate at time t

c_t be the vector of projected future credited rates as of time t

$PVCF(i_t, c_t)$ be the present value of future cash flows given i_t and c_t .

i_t is determined such that $PVCF(i_t, c_t) = PVCF(i_{t-1}, c_{t-1})$, where the only difference in the projected future cash flows from time $t-1$ to time t is due to the change in credited rates.

WHAT ARE THE IMPACTS OF THE BOARDS' POSITIONS ON OCI FOR PAR AND UL CONTRACTS?

In order to see how the boards' differing proposals for OCI on par and UL contracts compare, I developed a relatively simple example using a single-premium 10-year UL contract. I wanted to see the extent to which the boards' positions accomplished the boards' intention to reflect the impact of duration and similar mismatches in OCI, but not in net income. The key assumptions are described in Table 1.

All experience except interest rates is assumed to emerge exactly as expected, and there are no future changes to assumptions. I assumed assets backing the liabilities were classified as available-for-sale, using fair value through OCI accounting. I assumed an initial flat yield curve of 5 percent, dropping to 3 percent at the end of year one. I looked at two investment strategies:

TABLE 1: KEY ASSUMPTIONS

Premium	Single premium of \$1000
Face amount	\$100,000 fixed amount
Mortality	0.1% per year
Surrenders	5% per year in the first 9 years, 100% in year 10
Expenses	\$0
Credited rate	Asset book yield less 100 bp; initially 4.00%
COI charges	0.11% per year, taken at beginning of the year
Benefit cash flows	Payable at end of year, death claims before lapse
Liability discount rate	Top down approach, with zero spread for expected and unexpected default (e.g., liability discount rate equals asset yield)

- a. A laddered investment strategy, in which initial cash was invested equally in one, two, three and four-year zero coupon bonds, and future reinvestments were in four-year bonds. This generated a close duration match at inception with the liability.
- b. A short investment strategy, in which all cash flows are invested and reinvested in one year bonds. This produced an asset duration shorter than the liability duration.

Because of the ambiguity about which cash flows the IASB considers fixed versus asset dependent, I looked at two approaches to splitting the cash flows:

1. Treat all cash flows as asset dependent.
2. Treat death benefit cash flows as fixed and surrender benefit cash flows as asset dependent.

For simplicity, I assumed an IASB risk adjustment of zero in all years. I also assumed a margin (FASB)/contractual service margin (IASB) release pattern that produced projected earnings at inception consistent with current US GAAP: \$24.18 in year one, declining slowly to \$20.18 in year 10 (shown in Table 2 on page 14).

Results under duration matched investment strategy:

Using the duration matched investment strategy and applying the FASB OCI approach, the results seemed to conform to the boards' intentions. After the drop in interest rates at the end of year one, the projected credited rate dropped from 4 percent to 2 percent over the next four years as the assets get reinvested at 3 percent. As a result, projected surrender benefit cash flows declined and so the interest accretion rate dropped from 5 percent to 3.95 percent. The revised cash flows are shown in Table 3 (page 15).

CONTINUED ON PAGE 14

TABLE 2: INITIAL PROJECTED CASH FLOWS & NET INCOME

Year	Projected Death Claims	Projected Surrender Benefits	Projected Cash Flow	Projected Net Income/ Total Comprehensive Income
1	\$100	\$46	\$146	\$24.18
2	95	40	135	23.47
3	90	35	125	22.83
4	85	29	115	22.26
5	81	24	106	21.75
6	77	20	97	21.31
7	73	15	88	20.94
8	69	11	81	20.62
9	66	7	73	20.37
10	62	72	135	20.18

Net income remained at the originally expected level of \$24.18. Since the interest rate change occurred at the very end of the year, and since there were no experience adjustments or assumption changes, this seems to be the appropriate result, since any impact from the interest rate change is intended to be reflected in OCI. Net OCI was small—asset OCI of \$30.98 was mostly offset by liability OCI of \$30.95, leaving net OCI of \$0.03. This too seems appropriate, since there was very little duration mismatch. And total comprehensive income was \$24.21, slightly different from the original expectation of \$24.18 due to the impact reflected in OCI.

One effect of the FASB approach is that the pattern of future net income changes from the original slowly declining pattern. After the change to the interest accre-

tion rate, the expected net income in year two increases from \$23.47 to \$29.14, as the asset yield in year two is expected to be higher than the revised interest accretion rate. As the assets roll over and are reinvested at the new rates, earnings decline more rapidly than originally expected, such that in year five, when the assets are all earning 3 percent, below the 3.95 percent interest accretion rate, expected net income is \$14.20 compared to an original expectation of \$21.75.

The IASB approach produced very different results, regardless of how and whether the liability cash flows were split. If all cash flows were considered asset dependent, there was no liability impact reflected in OCI at the end of the first year. As in the FASB approach, there was a slight impact to total comprehen-

TABLE 3: DURATION MATCHED STRATEGY

Year	Projected Credited Rate (Actual for Year One)	Projected Death Claims (Actual for Year One)	Projected Surrender Benefits (Actual for Year One)	Projected Cash Flow (Actual for Year One)
1	4.00%	\$100	\$46	\$146
2	3.74%	95	40	135
3	3.36%	90	34	124
4	2.80%	85	29	114
5	2.00%	81	23	104
6	2.00%	77	18	95
7	2.00%	73	14	87
8	2.00%	69	9	79
9	2.00%	66	5	71
10	2.00%	62	33	96

sive income from the interest rate change, from \$24.18 to \$24.21, appropriately reflecting the slight duration mismatch between assets and liabilities. However, the asset OCI of \$30.98 was not offset by any liability OCI. Thus net income turned to a loss of \$6.77. This result does not appear consistent with the boards' intentions, since the OCI amount of \$30.98 is not consistent with the small impact of the duration mismatch, and the net loss is the result of an accounting mismatch between the assets and liabilities. In theory, this accounting mismatch could have been avoided in this scenario if assets were held at fair value through net income, but that would negate the boards' intention that duration mismatches should be reflected in OCI rather than net income.

The result of the IASB approach was no better if death benefit cash flows are considered fixed and surrender benefit cash flows considered asset dependent. In that case, total comprehensive income once again changes appropriately from \$24.18 to \$24.21. And in this case there is some liability OCI. In this case the liability OCI is \$49.56, greater than the asset OCI of \$30.98. The fact that the liability OCI is greater than asset OCI, despite the fact that not all liability cash flows qualify for OCI, appears to be the result of the fact that the liability cash flows which do qualify for OCI have a much longer duration than the asset dependent liability cash flows. As a result, the net OCI of -\$18.58 does not reflect the true impact of the duration mismatch. And the impact to net income, from an expectation of \$24.18 to \$42.79 does not seem to have any intuitive meaning.

CONTINUED ON PAGE 16

TABLE 4: SHORT INVESTMENT STRATEGY

Year	Projected Credited Rate (Actual for Year One)	Projected Death Claims (Actual for Year One)	Projected Surrender Benefits (Actual for Year One)	Projected Cash Flow (Actual for Year One)
1	4.00%	\$100	\$46	\$146
2	2.00%	95	40	134
3	2.00%	90	33	123
4	2.00%	85	27	113
5	2.00%	81	22	103
6	2.00%	77	17	94
7	2.00%	73	12	86
8	2.00%	69	8	78
9	2.00%	66	4	70
10	2.00%	62	12	74

Results under short investment strategy:

Using a short investment strategy, the FASB approach to OCI again appears to conform to the boards' intentions. After the drop in interest rates at the end of year one, projected credited rates drop immediately to 2 percent, reflecting the fact that all assets are expected to be reinvested immediately at 3 percent. The revised liability cash flows are shown in Table 4 above.

This causes the interest accretion rate to drop from 5 percent to 3.21 percent. Net income is again unaffected, remaining at \$24.18. This is again appropriate, since there are no experience updates or assumption changes. However, OCI is -\$6.64,⁵ showing a loss consistent with the fact that the assets are shorter than the liabili-

ties and interest rates declined. Total comprehensive income drops from an expectation of \$21.18 to \$17.54, consistent with the duration mismatch. In this case, the expected future pattern of net income drops immediately from \$23.47 in year two to \$19.05, since even in year two the interest accretion rate of 3.21 percent is higher than the expected asset yields of 3 percent.

Under the IASB approach to OCI, if all cash flows are considered asset dependent, year one total comprehensive income again decreases from the originally expected amount of \$24.18 to \$17.54, appropriately reflecting the duration mismatch. No amounts flow to OCI, however,⁶ and thus the entire impact of the duration mismatch flow through net income. This appears

to contradict the boards' intention that the impact of duration mismatches be reflected in OCI.

If under the IASB approach to OCI the death benefit cash flows are considered fixed and the surrender benefits considered asset dependent, the results are harder to interpret. Year one total comprehensive income again decreases from \$24.18 to \$17.54. But under this method, there is liability OCI of \$49.56. Asset OCI is zero, since all assets mature at the end of the first year, leaving net OCI of -\$49.56. While the direction of the OCI appropriately reflects the fact that the assets are shorter than liabilities and interest rates declined, the magnitude of the OCI amount is incommensurate with the degree of duration mismatch. And this causes net income to increase from \$24.18 to \$67.10, which is a counterintuitive direction and magnitude given the underlying economics.

ISSUES WITH THE IASB AND FASB OCI APPROACHES FOR PAR AND UL CONTRACTS

I believe that the problems with the IASB OCI approach stem from two key issues:

1. Splitting cash flows, and
2. Discount rate change incommensurate with the credited rate change.

These issues can be illuminated by analogy to calculating amortized cost for floating rate assets. When the amortized cost is calculated for a bond with an indexed interest rate, the cash flows representing interest payments change as a result of the change in the index, but the cash flows representing principal repayment are not impacted. However, when calculating the amortized cost of an indexed bond, an updated discount rate is applied to both the interest sensitive interest payment cash flows AND to the fixed principal repayment cash flows. While splitting the liability cash flows between fixed and asset dependent may appear to make intuitive sense, doing so creates an incoherent valuation.



Similarly, when the discount rate on an indexed bond is adjusted in an amortized cost calculation, the change in the discount rate is commensurate with the change in the credited rate. However, in the IASB OCI calculation, to the extent that cash flows are deemed asset dependent the discount rate is adjusted all the way to current market rates. That is inconsistent with the fact that the change in insurance liability credited rate is typically less than the full magnitude of change in market rates. This mismatch also generates an incoherent valuation.

The FASB approach has the effect of changing the pattern of future earnings, because the single interest accretion rate does not necessarily reflect the pattern of future changes to interest credits. It may be desirable to mitigate this effect by using a set of interest accretion rates in the pattern of projected future interest credits or asset book yields, although this would likely increase the complexity.

CONTINUED ON PAGE 18

Ideally, the boards will be able to agree on a converged solution, which reflects the economics of these contracts. ...

OTHER POTENTIAL OCI ISSUES

There are some other issues around the implementation of OCI for insurance contracts that may be worth considering.

One such issue is the classification of assets backing insurance contracts. Currently, assets backing long duration insurance contracts are often classified as available-for-sale and are accounted for at fair value, with certain changes in fair value in OCI rather than net income. Concurrently with the insurance contracts project, FASB and IASB are undertaking a project to update accounting for financial instruments. Certain proposals under this project may prevent the use of OCI for certain assets, including equities, bonds that contain an embedded derivative, and lower tranches of structured securities. Eliminating OCI from some assets backing insurance contracts may create accounting mismatches if insurance liabilities are required to use OCI.

The requirement to use OCI for insurance liabilities has other implications as well. If the liabilities are backed heavily by derivatives or other assets for which OCI is unavailable, mandatory OCI for insurance liabilities can create more accounting mismatches than it resolves. And in some circumstances, OCI for insurance liabilities may be more effort than it's worth. This may be the case particularly for IBNR and for P&C

claim liabilities. This appears to be a particular concern for P&C actuaries.

Another possible issue is the interaction between OCI and a floating margin. Under the IASB proposal, the contractual service margin would be updated to offset certain changes in projected cash flows. If the margin is adjusted to offset effects that are already reflected in OCI, that could result in double counting the offset and further distort the financial results. If a floating margin is used, it is important that it be coordinated with the OCI approach in order to produce meaningful results.

CONCLUSIONS

The IASB and FASB both were responsive to industry and investor concerns by implementing OCI for insurance contracts. For contracts whose cash flows are not sensitive to interest rates and for cash flows that qualify for mirroring, the boards' approaches seem to appropriately reflect the economics of the contracts, although there may be issues worth addressing before a final standard is issued.

With respect to par whole life and UL contracts, I believe there is more significant work needed to make the process operational. Although FASB's approach may not be consistent with some industry proposals, it does seem to reflect the economics of the contracts, though it may be desirable to adjust the methodology to avoid the impact to future earnings. The IASB approach, while well intentioned, needs some revisions in order to reflect the economics of the underlying contracts.

Ideally, the boards will be able to agree on a converged solution, which reflects the economics of these contracts before the final standard is issued. Whatever is decided, it is likely that the modeling and accounting for OCI will be a challenge to implement for both actuaries and accountants. ■

END NOTES

- ¹ For example, assume we had a liability that paid \$100 per year for 20 years, backed by an asset paying \$100 per year for 20 years. Assume that the asset yield is 5% and the liability discount rate is 4.6%. The asset would have a Macaulay duration of 8.61 years and the liability would have a Macaulay duration of 8.72 years, thus producing mismatched changes in value as interest rates change.
- ² The accounting for such cash flows would be similar, though in the case of the IASB not necessarily identical, to the accounting for par and UL contracts that do not qualify for mirroring.
- ³ Paragraph 60(h) of the IASB exposure draft states that for contracts that do not qualify for mirroring, the discount rate for net income should be locked in except for cash flows that are "expected to vary directly with returns on underlying items." Arguably, UL and par whole life cash flows vary only indirectly with the returns on the assets backing those contracts. I am assuming that the board considers such contracts as having cash flows, which vary directly based on my understanding of board discussions on the topic, and the fact that it would clearly be nonsensical to discount cash flows which vary with interest rates at a locked in rate.
- ⁴ The exception would be if a contract's projected credited rates did not change at all during the reporting period. Then the discount rate curve for net income would remain locked in as of the prior reporting period, and so there would be some amount in OCI.
- ⁵ In this case, the OCI amount is generated entirely by the liabilities, since all assets are assumed to mature at the end of year one, leaving asset OCI of zero at the end of year one regardless of how interest rates move.
- ⁶ Asset OCI is zero due to the fact that all assets mature at the end of the first year, and liability OCI is zero due to the methodology.

Questions

By Henry Siegel



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I'm writing this just after Andy Murray ended Great Britain's 77 year wait for a Wimbledon gentleman's champion. OK, it's not as long as Chicago Cub fans have been waiting for a World Series winner, but it was a pretty long time. The International Accounting Standards Board (IASB) hasn't taken quite that long to agree on an insurance contracts standard, but it feels that way for many of us who've been following it for longer than a decade.

I'm not going to summarize what's in either the IASB or Financial Accounting Standards Board (FASB) standard. I've described their major decisions in previous articles. Instead I offer some questions for the reader. The IASB included seven questions in its Exposure Draft (ED), FASB included 48. I also have seven; and I offer some partial answers as well.

Discounting:

1) Is it necessary to use a complete yield curve in all the discounting required in the ED's?

In the past, discounting for insurance liabilities has used a single discount rate representing an average return for the duration of the policy. Using a complete yield curve as it appears to be required in both ED's vastly complicates matters. FASB allows preparers to assume an equivalent level yield curve (i.e., a single rate) in doing certain interest accretions. I would hope similar simplifications could be used in other circumstances. Using complete yield curves is not only difficult to program, but can raise complicated issues and possibly strange results if all the assets supporting the liabilities are not corporate bonds.

2) The IASB seems to require using different discount rates for interest sensitive and fixed cash flows included in the same contract. Is this necessary?

FASB doesn't think so. Because of the required use of Other Comprehensive Income (OCI),¹ every additional yield curve requires two additional calculations. Splitting the cash flows does not seem to add any significant accuracy to earnings and does significantly add to cost and complexity. This might be the largest problem in the IASB standard.

Margins:

3) The IASB requires a preparer who doesn't use a confidence interval to calculate the risk adjustment in the building blocks approach to disclose what the equivalent confidence level would be for whatever is used. Does anyone think this is doable in a manner that is meaningful and can be audited in a timely way?

I don't but someone might have a way. The International Actuarial Association has been urging this requirement be dropped since it was first put in the original ED, but without success. Remember, the risk adjustment does not include either default risk or asset/liability mismatch risk, the two greatest risks that a life insurer has. Stating that a risk adjustment is at the 90th percentile can be exceedingly misleading since it omits the most important risks of the business.

4) The IASB allows changes in future assumptions to be run through the contractual service margin. The FASB requires those changes to be taken directly into earnings. Which approach do you prefer?

The IASB's approach spreads the effects of assumption changes out over the future, eliminating current year volatility, but changing future year earnings. The FASB's approach allows the company to show continued earnings on business that has had an unfavorable assumption change. I think the IASB approach is preferable since it gives a more realistic picture of future cash flows and earnings; others have said they prefer the FASB method since it maintains future earnings better.

Presentation:

5) Does anyone think the earned premium approach makes sense? Or is useful?

The problem is that if you speak to an analyst and explain what is being proposed, some of them will say it makes sense since it's similar to the revenue recognition on other types of contracts. Others will say they don't use the income statement anyway (relying on segment level disclosures) so they don't care. Still others

will say that as long as premiums due are disclosed in the notes or MD&A, they will simply use those.

For actuaries, calculating earned premiums is not theoretically difficult and with enough time to make systems changes, could be done mechanically. Trying to explain what it means, however, will be a challenge.

Transition:

6) The current transition requirement is for a complete retrospective calculation of the contractual service margin. Do you have the information needed to do this (e.g., pricing models used for each policy in force)?

Information will be needed going back many years. Most companies will only be able to go back a limited number of years. Practical approximations can be used where information is needed. This sounds easier than it will be but I think it's the right approach. It's certainly better than the approach included in the first IASB ED which would have guaranteed losses for the lifetime of the portfolio.

Language:

7) The IASB apparently feels it necessary to revise the language currently used in the industry. So reinsurance ceded and assumed are replaced by reinsurance held and reinsurance issued. The definition of policyholder is what we normally call a beneficiary. Does this seem necessary to anyone?

To me, all these language changes do is make it harder to read the standard.

CONCLUSION

Over the time between this writing and October 25 when comments are due, a huge number of man-hours will be spent reading, analyzing and commenting on both exposure drafts. Actuaries need to begin planning how to make models more auditable and to produce the large increase in disclosures required by the ED's. In doing this, we need to keep in mind the new ASOP ED on models recently released by the ASB. It is important that this ASOP take into account the use of models for financial reporting purposes.



I have told both boards that actuaries can do anything. They seem to have taken my words to heart in setting the requirements in the ED. I hope they, and our auditors, will allow simplifications to make the results less expensive and complex. That's why

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

END NOTES

- ¹ See Len Reback's article titled, "Other Comprehensive Income for Insurance Contracts," in this issue of *The Financial Reporter* for more information on OCI.

Report on the International Actuarial Association Meeting in The Hague, May 2013

By Jim Milholland



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Actuaries at the meeting of the International Actuarial Association (IAA) in The Hague in May got the message directly from a member of the staff of the International Accounting Standards Board (IASB) that the revised exposure draft (ED) on accounting for insurance contracts would be out in June. And in fact, since the time of the meeting, the IASB has released the revised ED. Internationally active insurance groups are also anticipating expanded reporting on capital adequacy in the near future. These topics headlined the meetings of the Insurance Accounting Committee and Education and Practice Subcommittee (IAC) and of the Insurance Regulation Committee (IRC) in The Hague (den Haag) in May. This report is prepared from information provided by Burt Jay on the IAC and Tom Herget on the IRC.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

The long-anticipated replacement to IFRS 4 is finally within sight.¹ The IASB has released the revised ED, and there will be a 120-day comment period. The IAC's top priority in the near term is responding to the ED. This is in fact the second exposure draft (the third preview if you consider the initial Preliminary Views). The IASB targets certain issues for which it will seek feedback. These are aspects of the ED that are different from the first exposure draft or that have been more fully developed. The IAC has organized to comment on these topics and will likely comment on topics not specifically targeted by the IASB.

The targeted issues and some preliminary views by actuaries are profiled in the following chart (page 23).

The IAC's comment letter will likely reflect the actuarial perspectives shown in the chart. It may also comment on issues that the IASB has not targeted. It will likely include a comment that the IASB and the United States Financial Accounting Standards Board should resolve their differences and adopt a common standard. The IAC has done some preliminary work to write a comment letter and will get started with a special meeting in late July.

SOLVENCY REPORTING

There is clearly a global movement to expand analysis and reporting on solvency and capital adequacy. By now the names of the regulatory initiatives are familiar to reporting actuaries, even those not involved in solvency testing. In Europe, there is Solvency II; in the United States, Own Risk and Solvency Assessment (ORSA)—although this term is also used elsewhere; and in Canada Directive IV.

The effective date for Solvency II in Europe was variously reported as 2014, 2016 and 2017. The 2014 date seems unrealistic, given the common perception, purportedly based on not-yet-published reports of Solvency II studies. If the reports show what was discussed at the meeting, the testing will indicate that many companies have too little capital if the capital ratio (ratio of actual capital to the minimum required capital according to the Solvency II calculations) is based on discounting at risk-free rates. Testing will indicate that more companies generally have adequate capital if the discounting is at risk-free rates adjusted for liquidity and countercyclicality.

As an editorial aside, one is not surprised that the results are sensitive to the discount rate. Deciding if the results indicate a problem with the capitalization of the industry or a problem with the testing criteria may cause the effective date to slide.

In the United States, ORSA is slated for a 2015 effective date. Results of field-testing will be ready in October 2013. U.S. companies are concerned about confidentiality of results.

Regardless of the floating facts about the effective dates, expanded solvency reporting is not far away. The discussions showed that there are a lot of unresolved issues—about operational risk, mortality trends, long-term guarantees, catastrophes, and, above all, discount rates.

As another editorial aside, the profession will be challenged to find practical solutions before the effective date. The issues and topics should sound familiar to

Targeted Issues	Description	Actuarial Perspective
Presenting information on insurance contract revenue.	<p>The approach presents amounts released from the liability for benefits and expenses, the amortization of the contractual service margin and the change in the risk margin as revenue. It also excludes the deposit element of contracts from revenue and expenses.</p> <p>A description of the proposed approach can be found in <i>The Financial Reporter</i> issues of June 2012, Sept. 2012 and Feb. 2013.</p>	Most actuaries do not like the earned premium approach that appears in the ED. They prefer premiums as revenue and they dislike disaggregating the deposit element from the insurance element.
Presenting in OCI the effects of changes in the liability due to discount rate changes.	The objective is to have matching treatment of the movement of liabilities and of supporting assets.	Many actuaries believe that there will be situations where matching is improved if the changes in the liability due to discount rate changes is in profit and loss. They believe the proposed treatment should be optional.
Adjusting the contractual service margin to reflect changes in cash flows for future services.	Rather than creating profit or loss in the period in which a change in assumptions is made, the effect of the changes would be offset by an adjustment to the contractual service margin.	This approach is generally liked by actuaries, although some actuaries want to see the effects of changes in discount rates on cash flows (e.g., for interest-sensitive products) in OCI as well, rather than as an adjustment to the contractual service margin, as the ED proposes.
Measuring and presenting cash flows from contracts with contractual link to underlying items.	The board wants to avoid accounting mismatches for contracts for which the cash flows are contractually linked to assets. They propose a mirroring approach under which the movement in the liability is presented in the same manner as the movement in the assets.	There is a lot of confusion about what the IASB expects with contracts that are contractually linked to assets and with respect to participating contracts in general. For example, it is not clear if mirroring means that the liability value is the same as the asset value and if or how the building blocks in fact apply—to the contract as a whole or in part.
Approach to transition—apply standard as if always effective with some simplifications and relief provided.	The IASB's initial proposal was to have no contractual service margin on a contract in effect before the transition to the new rule. Actuaries universally disliked this idea.	Actuaries generally welcome this proposal. The relief is an acknowledgment that the estimate of the contractual service margin may be less precise for contracts in effect before the transition date.

CONTINUED ON **PAGE 24**



financial reporting actuaries, even if they are not also the solvency testing actuaries. They are also topics that must be addressed for IFRS reporting. It seems too that there should be consistency between financial reporting and solvency testing. There are economies to be had if common platforms and analysis are used, and the risk of sending conflicting messages if they are not.

The International Association of Insurance Supervisors (IAIS) ComFrame initiative continues to move forward. The IAIS began developing ComFrame, which is a Common Framework for the supervision of Internationally Active Insurance Groups. A Field Testing Task Force has been formed to recruit participants to test and determine the best ways to report on group capital adequacy to regulators. The field-testing will evaluate ComFrame so that it can be modified as necessary prior to formal adoption. The next exposure draft is scheduled for release in September 2013, but may be deferred to November 2013. The IAA will seek ways in which to provide input to the field-testing process, such as input on the use, purpose and value of economic capital models.

OTHER TOPICS

Pension actuaries and insurance actuaries continued their discussion about what would happen if the concepts in the insurance standard were applied to pension liabilities. The focus of the discussion is on risk margins and discount rates. The profession is ahead of the accounting standard setters on this topic. It is not on the agenda of the IASB. However, the implications are potentially huge to many companies and the profession is wise to take up the topic while there is plenty of time for deliberations.

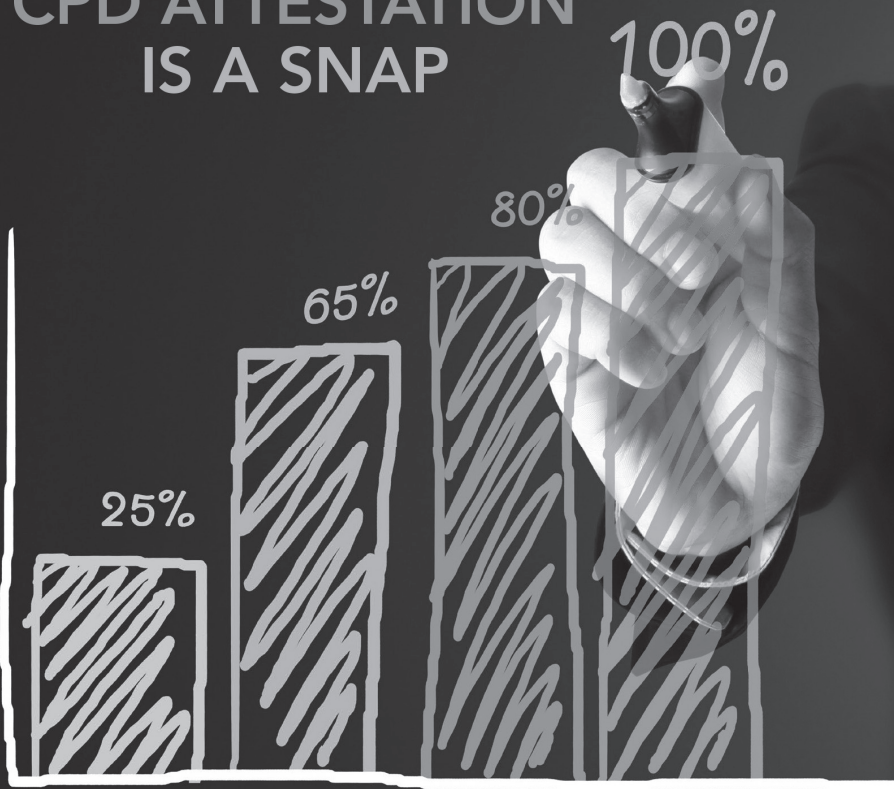
The monograph on discounting is well advanced and may be published by mid-2014. The monograph on risk margins is also progressing and could be published as early as the end of 2014. This timing makes them available for practitioners when they pick up the conversion to the new insurance standard.

The IAA will also commence creating a “purple book,” an addendum to the 10-year-old “blue book” that addresses solvency topics. New chapters will include items such as intra-group reinsurance, group solvency, diversification, concentration, dependency of risk, and time horizon. The IAA will also be developing a sample ORSA report, illustrating the value of such a report to regulators and boards of directors. ■

END NOTES

- ¹ I realize the reader may have heard this before.

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SOA Assumption Development and Governance Discussion — 2Q 2013 Calls

By Liz Olson



Liz Olson is an assistant vice president at Nationwide Financial in Ohio and can be contacted at olsonl@nationwide.com.

With increased scrutiny on assumptions, companies are ramping up efforts and resources to increase governance around assumptions. The Assumption Development and Governance Group (sponsored by the Financial Reporting and Product Development Sections) was formed in April to offer an opportunity for actuaries to participate in discussions around key topics and establish industry contacts in this field.

The first discussions of this new group were held May 8th through May 23rd in a series of four conference calls. There were 72 companies represented, with additional participants from these companies listening in. The topic of discussion was “Top of Mind” for assumption management at your firm in 2013. The group discussed top initiatives and top challenges that they are dealing with this year. The format enabled company representatives to provide updates on their company assumption initiatives, with a few minutes to toss out questions to the group. Several common themes emerged.

The most frequently mentioned topic was governance. Larger U.S. companies and international companies

have had infrastructure up and running for about three years; however, most are continuing to improve their processes. Governance for these companies includes formal committees, approval processes, established frequency of review of assumptions and documentation (in one case with written standards for documentation). Committee membership varies greatly by company with representation from the following areas: chief actuary, appointed actuary, valuation, risk management, CFOs, pricing actuaries, accountants and illustration actuaries. The frequency of meetings varied. Most other companies that talked about governance were either just starting to form formal committees and processes or were thinking about it.

The second most mentioned topic was dynamic lapse rates, with considerations for the low interest rate environment coming up frequently. Many companies are considering the impact of potential interest rate rises by sensitivity testing across plausible scenarios. With no recent data with increasing rates, it is a challenge to predict actual policyholder behavior under the various new contract options that are available. There was some discussion around difficulties in defining “base” lapses vs. “dynamic” lapses, as well as the growing complexity around these assumptions as we learn more from emerging experience and consider the efficiency to which policyholders could exercise options. One company mentioned success with predictive modeling around variable annuity living benefit behavior and anticipates using the same techniques for fixed annuities.

When discussing the storage and documentation of final assumptions, the idea of an assumption database came up frequently. Many companies are considering a comprehensive assumption database as an option and some have started to build them. Other solutions ranged from spreadsheet storage to SharePoint, and tools available within the modeling software.

Resources appeared to be a consistent constraint, especially among small companies, which led to questions such as: What is the right amount of effort to put into governance? What are the benefits? Companies that



have had processes in place did not seem to have decked substantial amounts of new staff behind assumptions. Although the governance has added additional steps to the process, some noted the benefits of an increase in the quality and consistency in assumptions.

In addition to the issues above, the following were brought up as challenges:

- Lack of credible data for small companies and newer product designs
- Audit-ready documentation
- Consistency across assumption uses

- Legacy assumptions with little or no documentation
- Small company considerations—few resources and lack of credible data
- Provision for Adverse Deviation (PAD) definition

Discussions are anticipated to occur quarterly. If you are interested in participating or just being in the loop, please contact Liz Olson at olsonl@nationwide.com or 614-249-0605 to get on the distribution list. There is no on-going commitment involved. Also, look for our group on LinkedIn by searching for “SOA Assumption Development.” ■

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