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Continuing Education

By Henry Siegel

Actuaries and other professionals rightly put great importance on continuing education (CE). After all, without remaining knowledgeable about recent developments in one's field, actuaries cannot truly claim to be competent at what they are doing, the first requirement for being a professional. This is why our professional organizations have continuing education requirements. To my surprise I received a request a few days ago from the Society of Actuaries (SOA) to provide documentation that I had met the SOA's CPD requirement, as I had maintained in the Actuarial Directory.

There must be, however, a point at which one stops being educated and actually starts to do things; continuing education should not be for its own sake.

The International Accounting Standards Board seems to have taken the concept of continuing education to new extremes. It has been working on the insurance contracts project for well over a decade now and is still having educational sessions on basic issues. It may well be that by the time this article is being read, education will have been abandoned and decisions will have been reached. I hope so, just as I hope those decisions make sense.

In the first quarter of 2015, however, education was still largely the order of the day. Those educational sessions covered levels of aggregation for participating and non-participating contracts and profit recognition for certain participating contracts. These issues cover the vast bulk of long-duration contracts issued in Europe and might cover a substantial portion of contracts in North America as well.

JANUARY MEETING

In its only decision-making session of the quarter, the IASB met on January 22 to discuss transition relief. It did so because the earliest possible effective date of the new insurance contracts standard will be after the mandatory effective date of the new IFRS 9 on Financial Instruments.

"The IASB tentatively confirmed the transition relief proposals in the 2013 Exposure Draft that, on the initial application of the new insurance contracts Standard:

a. an entity is permitted to newly designate financial assets under the fair value option as measured at fair value through profit or loss to eliminate (or significantly reduce) an accounting mismatch in accordance with paragraph 4.1.5 of IFRS 9;

b. an entity is required to revoke previous fair value option designations for financial assets if the accounting mismatch that led to the previous designation in accordance with paragraph 4.1.5 of IFRS 9 no longer exists; and

c. an entity is permitted to newly designate an investment in an equity instrument as measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 and is permitted to revoke previous designations."[1]

The board also tentatively decided:

"a. to consider providing further transition relief to permit or require an entity to reassess the business model for financial assets at the date of initial application of the new insurance contracts Standard. This reassessment would be based on the conditions for assessing the business model in paragraphs 4.1.2(a) or 4.1.2A(a) of IFRS 9 and the facts and circumstances that exist at the date of the first application of the new insurance contracts Standard; and

b. not to consider deferring the mandatory effective date of IFRS 9 for entities that issue insurance contracts."[2]

These decisions were relatively non-controversial since they would allow entities to measure their assets and liabilities consistently in certain circumstances that would otherwise be difficult to achieve due to the differing effective dates of the new standards.

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FEBRUARY MEETING

The IASB met on February 19 at an education session. The topic of this session was on the level of aggregation required for issues such as initial loss recognition and unlocking of the Contractual Service Margin (CSM) for participating and non-participating contracts. While no decisions were made at this meeting, there appeared to be a clear consensus on the approach the board preferred.

The board clearly stated that entities should recognize at issue losses on all contracts that are expected to be loss-making over their lifetime. This is in parallel to the decision to not recognize at issue profits on profitable contracts by setting up the CSM. The problem with this position, however, is that it states it at the contract level. Not only could this cause significant administrative issues, but it's contrary to both the principle of insurance, which relies on the performance of large groups of contracts, and the manner in which companies manage their business.

In further discussion, industry members have raised significant problems with this approach. Consider, for instance, situations in which companies are required to use unisex pricing on annuities. In this situation, all policies issued to women would be loss-making while those issued to men would be profitable. Companies manage this situation by looking at the combined results and attempting to manage the relative percentage of males and females. The board's position would require the losses on the policies issued to women to be recognized at issue, however, while the profits on those issued to men would only be recognized over the lifetime of the policies. This would result in financial statements that give an impression of the results far different from how management looks at them.

There are other situations where similar things happen. Sometimes companies have a broad range of underwriting policies where "standard" can be a maximum of 30 percent of expected mortality or more. Those at the top of the range may have expected losses.

Consider further the situation after issue. Certain groups of policies may evidence losses. For instance, an entity may have underpriced morbidity for issue ages 40-45. Should the entity be required to recognize those losses immediately while there are unanticipated gains for other age groups that are absorbed by the CSM? Where is the line drawn?

The precise guidance the board gives on this issue will greatly affect the results a company shows soon after the effective date. Companies that have not been showing losses under US GAAP, for instance, may well need to show them here. Furthermore, going back and reconstructing potential loss recognition from the past will not be an easy task.

For reasons I don't completely understand, the board seems to be extremely concerned that insurers are hiding the effects of loss-making contracts on their financial statements by combining their results with profitable contracts. I can understand this concern to some extent, but the solution seems unduly extreme. The level at which loss recognition should be done is at the product level, not the individual contract level. Hopefully when this issue is discussed for a decision, a more reasonable view will prevail.

MARCH MEETING

The IASB met on March 19 at another education session. The IASB discussed three key issues concerning contracts with participation features:

"• if and how the contractual service margin should be adjusted to reflect changes in entity's share of underlying items;

- how to determine interest expense in profit or loss; and
- how the amounts in the contractual service margin should be allocated to profit or loss as the entity provides services to the policyholder."[3]

The first issue dealt primarily with contracts that have a direct relation between participating payments and investment performance.[4] A pure variable annuity would be an example of such a contract. The staff also opined that European-style 90/10 contracts, where the policyholder is guaranteed 90 percent of the profits on the book of business, or unit-linked contracts would also be covered. Of some interest, U.K.-style participating contracts are also anticipated to be covered since they promise distribution of most of the profits of the company. Staff did not think Universal Life contracts would be included.

The precise criteria for when contracts would be covered by this concept were debated at some length. Staff proposed three criteria that would need to be met:

> "(a) the contract specifies that the policyholder participates in a clearly identified pool of underlying items. …
>
> (b) the entity expects that a substantial proportion of cash flows from the contract will vary with changes in underlying items. …
>
> (c) the entity expects the policyholder to receive an amount representing a substantial share of the returns from underlying items."[5]

If a contract met these criteria, it would be treated as if it was a variable investment fee arrangement and profits would emerge as a percentage of assets. Specifically, variances in investment results, as well as changes in embedded derivatives, would be absorbed by the CSM while they would not be for other contracts. In addition, interest expense in the income statement would be set equal to the investment income on the underlying assets rather than the book yield or effective yield as were previously proposed.

There are several issues with these criteria. What does a "clearly identified pool" mean? Could it mean the entire company? Could it mean a pro-rata share of a general account? Guidance would be needed to clarify this. How this is resolved could have significant impacts on U.S. contracts.

For instance, a variable annuity contract with a fixed account might not qualify under these criteria if the fixed portion is not participating in a clearly identified pool. Would participating contracts issued in the United States qualify if they don't specify participating in a pool of assets, only that dividends will be paid? How about a variable annuity with a fixed annuity payout option? All these contracts were written before these accounting standards, of course. Could they be given some kind of dispensation if the clear intent and practice meet the criteria even if the contractual language is absent?

Hopefully the staff and board members will think this issue through prior to any decisions being made. The concept has benefits, particularly for pure variable and unit-linked contracts.

The board's discussion on how the CSM should be recognized was not without controversy. Staff and some board members proposed recognizing it over time. Others proposed using a driver such as mortality costs as the basis. Using time as the basis has some appeal since it's simple to understand and explain. However, it may result in recognizing profit in a manner that is not consistent with how services are provided under the contract or how risk is released. More discussion should be had on this issue as well.

It has indeed been a long time that the IASB has been discussing insurance accounting. We need to stay involved because, as I've also said many times

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

ENDNOTES

1. From the January IASB Update
2. Ibid
3. From the IASB Update for March, 2015.
4. It can also be things other than assets such as the performance of the entire company or some kind of external index.
5. From Staff Paper 2A for the March IASB Meeting