



SOCIETY OF ACTUARIES

Article from:

The Financial Reporter

September 2013 – Issue 94

Questions

By Henry Siegel



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

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.