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Myth, Magic and Mysticism

By Henry Siegel

DEFINITIONS FROM GOOGLE

Myth - a traditional story, especially one concerning the early history of a people or explaining some natural or social phenomenon, and typically involving supernatural beings or events.

Magic - The power of apparently influencing the course of events by using mysterious or supernatural forces.

Mysticism - belief that union with or absorption into the Deity or the absolute, or the spiritual apprehension of knowledge inaccessible to the intellect, may be attained through contemplation and self-surrender.

There have been times recently when I have thought of one or all of these words in connection with the International Accounting Standards Board's (IASB's) insurance contracts accounting project.

For instance, there was this headline in The New York Times: "Insurers Use Deals to Avoid as Much as $100 Billion in Taxes!" The article involved the use of captive reinsurers to move liabilities around inside a holding company. Surely this kind of accounting manipulation could be viewed as actuarial magic by some. Earnings were created mysteriously by the use of a pen and paper rather than any change in real financial situation. Avoiding the growth of this kind of actuarial magic is surely why the IASB has written such detailed guidance for how to calculate liabilities.

Furthermore, as the board delves ever more deeply into the details of accounting principles for participating contracts, the discussions become more and more difficult to follow, taking on a nearly mystical quality. Only actuaries and a few accountants who have spent extensive time studying the theory behind the discussions will be able to understand the final conclusion. It then becomes our job to explain results in a way that is clear and simple rather than inaccessible.

The word myth has been adopted in recent times to mean any false belief or statement. So we discuss the myth that an insurance company can be systemically risky or that you have to hire an investment banker in order to do an acquisition. I prefer the traditional definition above, however, and have been wondering what myths there will be in the future about current times.

Will our successors say today's actuaries invented International Financial Reporting Standards (IFRS) in all its complexities to keep actuaries fully employed? Will the long development period be attributed to obstruction from insurance companies or the Financial Crisis of 2008? What other myths might develop to explain the origins of IFRS for insurance?

Whether actuaries become the subjects of myth also will only emerge over time. We are, though, in danger of becoming both the magicians and mystics of insurance accounting. Almost half the balance sheet and all the income statement will be made up of numbers calculated by actuaries rather than accountants. I'm not sure, however, that this is what we should aspire to be. Making it clear we are neither magicians nor mystics will inspire confidence in us as a profession.

If this quarter demonstrated anything, however, it's that either the IASB has become tired of the topic or the resolution of outstanding issues is proving to be very difficult. Only one decision making meeting was held on insurance, along with a single educational session.

OCTOBER MEETING

The IASB met on Oct. 23, 2014 to discuss an entity's initial application of the forthcoming Insurance Contracts Standard for non-participating contracts.

"The IASB tentatively decided to confirm the 2013 Exposure Draft on Insurance Contracts (2013 ED) proposals that at the beginning of the earliest period presented:

a. an entity should apply the Standard retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors unless impracticable.

b. if retrospective application of the Standard is impracticable, an entity should apply the simplified approach proposed in paragraphs C5 and C6 of the 2013 ED with the following modification:

CONTINUED ON PAGE 12

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instead of estimating the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented, an entity should estimate the risk adjustment at the date of initial recognition by adjusting the risk adjustment at the beginning of the earliest period presented by the assumed release of the risk before the beginning of the earliest period presented.

The assumed release of risk should be determined by reference to release of risk for similar insurance contracts that the entity issues at the beginning of the earliest period presented."[1]

This change was made as a result of comments on the ED that the Board had received from preparers.

"The IASB also tentatively decided that:

a. if the simplified approach described in paragraph (b) above is impracticable, an entity should apply a fair value approach in which the entity should:

   i. determine the contractual service margin at the beginning of the earliest period presented as the difference between the fair value of the insurance contract at that date and the fulfillment cash flows measured at that date; and

   ii. determine interest expense in profit or loss, and the related amount of other comprehensive income accumulated in equity, by estimating the discount rate at the date of initial recognition using the method in the simplified approach proposed in paragraphs C6(c) and (d) of the 2013 ED.

b. for each period presented for which there are contracts that were measured in accordance with the simplified approach or the fair value approach, an entity should disclose the information proposed in paragraph C8 of the 2013 ED (i.e., the disclosures for contracts for which retrospective application is impracticable) separately for:

   i. contracts measured using the simplified approach; and

   ii. contracts measured using the fair value approach."

Using a fair value approach was considered a last resort by the board and it is unclear how often it's actually expected to be used. Determining a fair value for a contract in the absence of an active market and without an actual transaction could be very subjective.

NOVEMBER MEETING

The IASB held an education session on Nov. 19, 2014 in which it considered a paper prepared by the European Insurance CFO Forum setting out its proposals for accounting for contracts with participating features.

The presentation by the CFO Forum can be found on the IASB's website at the following link:

http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/November/AP02-Insurance-Contracts.pdf

The paper itself begins on page 22. The paper lays out a detailed proposal, the general principles of which are:

- "Applicable to all participating contracts ensuring consistent treatment of economically similar contracts.
- In our opinion, provide for a single measurement basis for all types of contracts, with a single discount rate applied for liability measurement and consistency in the treatment of options and guarantees with all other cash flows.
- Full unlocking of the CSM for all assumption changes that impact expected future profits, including financial assumptions which are impacted by the change in value of underlying assets and reinvestment assumptions. The CSM represents

all expected future profits from the provision of services in the contract.

- CSM is released to profit or loss in a way that best reflects the transfer of services under the contract.

- Current portfolio book yield used to determine interest expense in profit or loss to provide consistency in the reporting of interest expense and interest income.

- The insurer elects to present the effect of changes in the discount rate in OCI or profit or loss as an accounting policy choice which is needed to reflect the insurer's asset liability management strategies and as a result of the accounting policy for the assets."

The paper then states that in the opinion of the preparers:

> "The key principles of the Alternative Proposal interconnect and taken together as an integrated package provides an accounting basis which reflects the economic substance of participating contracts. The proposal addresses industry concerns whilst retaining the IASB building block principles and providing transparent reporting and disclosure of the financial position and performance of the insurer. The Alternative Proposal ties back to the IASB's existing framework and provides transparency through the current fulfillment value balance sheet, the measurement of all the options and guarantees and transparent presentation of (changes in) estimated future profits in the CSM.
>
> Under the Alternative Proposal the insurer's financial position and performance would be very transparent to users of financial statements. The current fulfillment value balance sheet reveals the insurer's financial position under current conditions and the CSM shows the future profitability of in-force business on a consistent basis for all contracts; this is more transparent than any other industry. This is highly relevant information for long-term contracts, but only where the CSM is fully unlocked."

While the IASB did not act on these proposals, they are clearly considering them seriously. Use of a current portfolio book value discount rate has been proposed previously but not accepted by the board which preferred a discount rate based on the characteristics of the liability. It will be interesting to see if the board accepts this proposal now in the interest of getting industry acceptance of the new standard. It's very likely that some variation of these proposals will be put forward by staff at a meeting early in 2015. This is the only aspect of the new standard, other than transition and a few presentation issues, that has not yet been resolved by the board.

The board did not discuss the insurance contracts project in December.

At the same time that the IFRS discussions are going on, the International Association of Insurance Supervisors is developing an International Capital Standard using a related but different valuation basis for insurance liabilities. That basis would appear to use a current discounted value of future cash flows with no margins as the liability. The discount rates are set by the regulator. These changes to both accounting and capital requirements will make for interesting times for internationally active insurers and remind us again that

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

ENDNOTES

[1] All quotes are from the IASB's Update for the appropriate month unless otherwise indicated.