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Covering the Bases

By Tom Herget

Have you possibly been overwhelmed by the many changing and emerging accounting bases that are encircling us? If retirement is not an option, then you need to be on top of not only what you will be reporting, but your competitors, too.

To support this need, the Society of Actuaries Financial Reporting Section along with the Committee on Life Insurance Research and the Reinsurance Section commissioned a study to compare the emergence of earnings on five different accounting bases. Ernst & Young stepped up to the plate and delivered a solid hit with the recently-released study, "Earnings Emergence: Insurance Accounting under Multiple Financial Reporting Bases." It can be found at *https://www.soa.org/Research/Research-Projects/Life-Insurance/2015-earnings-emergence.aspx.*

Rob Frasca managed the project; his lineup included Asad Khalid, Francis Rahil, Bruce Rosner and Joy Zhang. Sam Keller was project oversight group chair.

While the research report is more than a hundred pages long, its graphic display of results makes it an easy read. The team took two vanilla products, term life and fixed deferred annuity, through baseline and alternate scenarios, and projected balance sheets and income statements. The bases calculated are US Statutory, US GAAP, Canadian valuation (CALM), IFRS and Solvency II. The term product has both direct and ceded. The ceded illustration shows both a regular coinsurance arrangement and the results if reinsured to a captive.

The objective of the report is to help the reader interpret and compare results under these accounting regimes.

Here are some sample graphs from the report:

Figure 1

Term Life cashflows

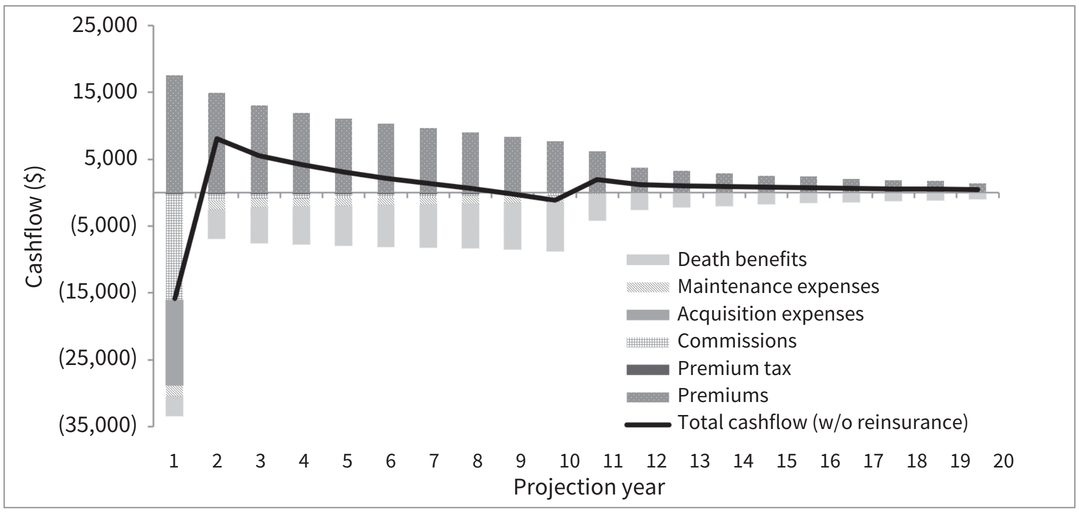


Figure 2

Term Life net liability positions

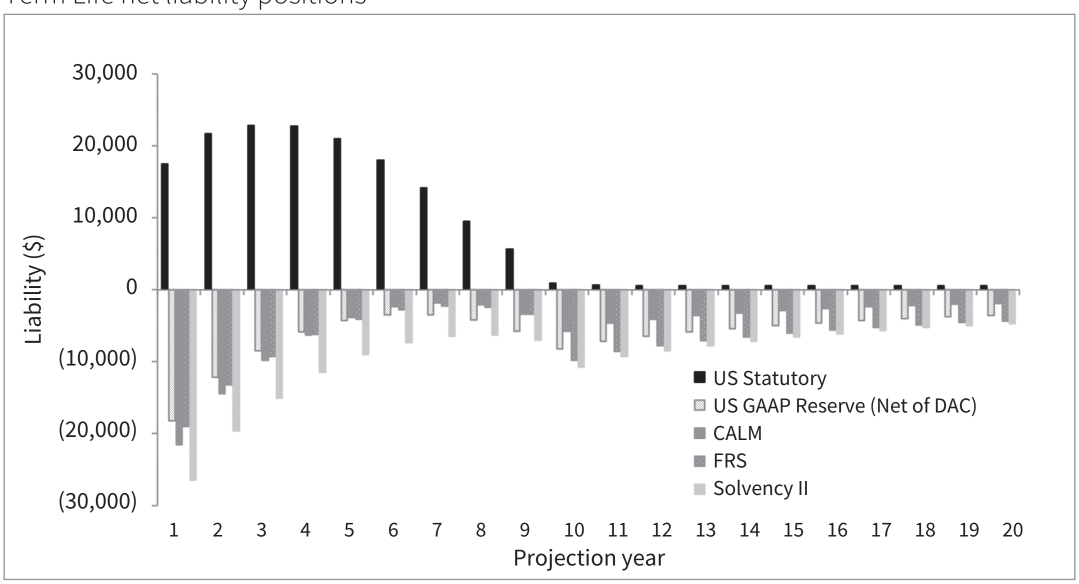


Figure 3

Term Life IFRS liability projections

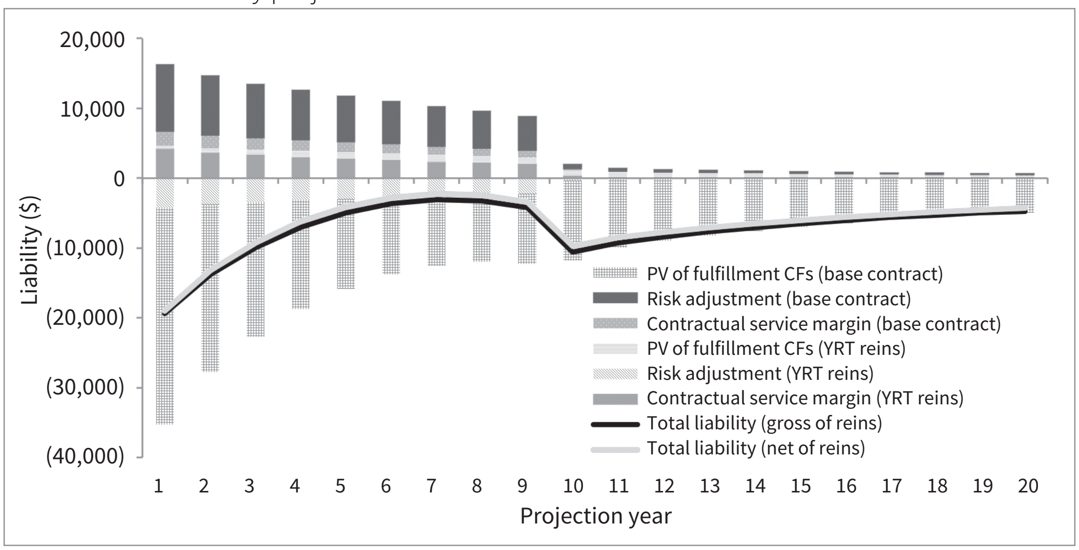
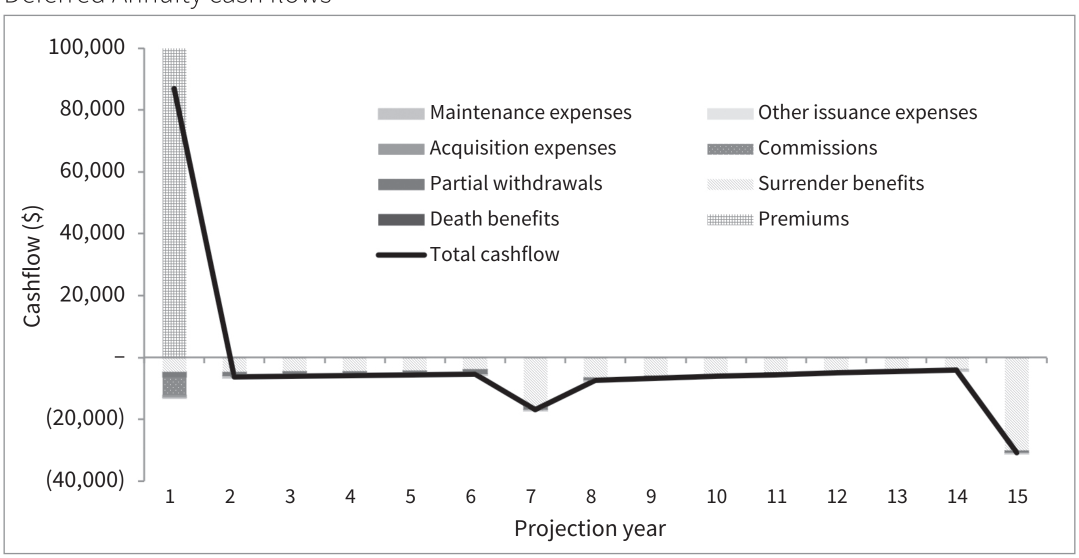


Figure 4

Deferred Annuity cash flows



There are more than 50 graphs illustrating important levels and comparisons of liabilities and earnings.

The variation in product design causes the differentiating features of the measurement bases to manifest themselves quite differently across the two products.

For term life, the two balance sheet focused bases (U.S. Statutory accounting and the market consistent balance sheet) show the most extreme results. U.S. Statutory exhibits large losses at issue due to a conservative rules-based formula designed to protect solvency, while the market consistent balance sheet shows "profits" at issue, as it is unconstrained by any need for conservatism in a market-value world. The other bases lie somewhere in between, with US GAAP showing perhaps the least volatile income due to its tying of earnings emergence to premium income, with CALM and IFRS emergence tied to the less predictable provisions for adverse deviation and provisions for risk respectively.

By contrast, for the annuity product, U.S. Statutory and the market consistent balance sheet show more front-ended income emergence than either US GAAP or IFRS. This, however, is a consequence of the construct of the various bases. The lack of significant insurance risk elements provides little opportunity to incorporate pads within the U.S. Statutory valuation while the market consistent balance sheet shifts to be slightly more conservative, ef-

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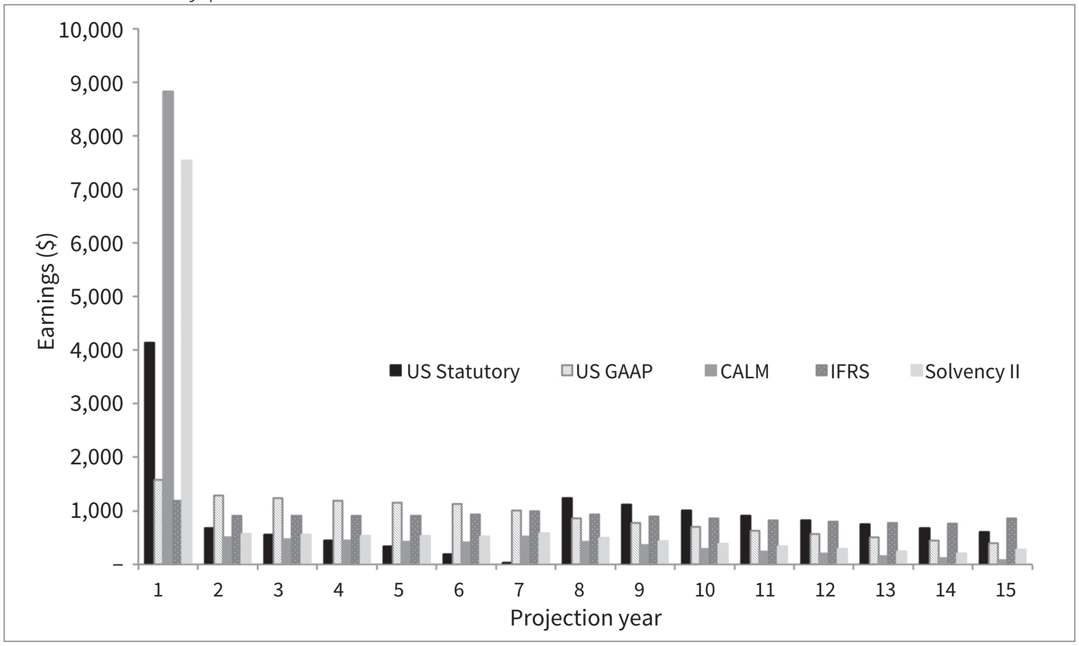
Figure 5

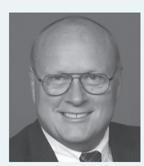
Deferred annuity pre-tax income



fectively penalizing the product for its real-world foundation for crediting interest. CALM front-ends the earnings further still, it finding nothing significant to pad while adhering to a real-world view of investment returns that renders it less conservative, at least in that regard, than Solvency II. US GAAP and IFRS, on the other hand, are content to wait and recognize earnings as revenue or release-from-risk emerge. Theirs is a more deliberate measurement of income arising from bases that place paramount importance on earnings emergence rather than treating it as an afterthought.

This is merely a high-level summary of the observations made. The full report shows the projected income emergence on each basis for baseline runs as well as for a variety of sensitivity tests. Differences in earnings emergence can be subtle and a thorough analysis of the modeled projections is needed to appreciate their sources. Even at that, this study can only hope to present in broad terms and for an admittedly small selection of products the differences in reporting that the various measurement bases may generate.

Don't hesitate to access this study. The first one hundred to download it will be able to follow any quarterly earnings conference call in almost any country. ■



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