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No-See-Ums (Part 2)

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Zimbabwe at dusk

In my September, 2015, article in *The Financial Reporter* I wrote about my problems with bugs you don't see until they bite you. It was based on my experiences in Belize. This November, prior to the International Actuarial Association (IAA) meeting in Capetown, South Africa, I visited Zimbabwe and Namibia. Namibia is a desert and so there were few bugs; Zimbabwe, on the other hand, had lots of them. I again spent three nights trying to sleep while bugs crawled on and bit me despite layers of mosquito netting over the bed. Ironically, at the same time the International Accounting Standards Board (IASB or the board), was making what it hoped to be a final attempt to remove some of the no-see-ums from their insurance contracts standard.

In my earlier article, I mentioned that the board had then settled on the variable fee approach for participating contracts. I predicted that once the industry had had a chance to review the proposal, it was likely that problems would emerge, particularly with respect to the scope of the policies to which the approach would apply. While that was one of the issues discussed at November's board meeting, the only meeting this quarter where it discussed insurance contracts, it was not the most significant. Other issues had emerged as the board worked with insurers to perform field tests of the proposed standard.

NOVEMBER IASB MEETING

Level of Aggregation

Problems with the level of allowable aggregation of contracts was one of the most important issues raised by the industry in the course of field testing the proposed standard. The Board had tentatively decided that you could only group contracts with similar profitability and similar risks, among other issues. The problem with such criteria is that there were many differing ideas as to what "similar" meant. Furthermore, the criteria were so different from current groupings that companies feared that they could have to measure liabilities based on hundreds, if not thousands, of newly defined groupings with separate assumptions for each.

The board's concern has been that companies would hide contracts issued at a loss by combining them with contracts with profits. A prime example of this would be issuing immediate annuities based on unisex pricing and not recognizing the loss on females from such an approach. The board feels that the proper accounting for those annuities would be to recognize the loss (if there is one) on females immediately on issue while amortizing the profits on males over time.

While this situation was clear and could perhaps be justified, the vagueness of "similar" profitability made it possible that many more groupings could be required. For instance, if a product has a 2 percent profitability (measured somehow) at issue age 25 and a 5 percent profitability at issue age 50, are they similar enough to be combined?

After considerable discussion both prior to and during the meeting, the board tentatively decided to keep their definition of portfolio, i.e., that "a portfolio is a group of contracts subject to similar risks and managed together as a single pool."[1] Staff agreed to develop guidance stating that contracts within a product line, such as annuities or whole-life, would be expected to have similar risks, but that different product lines would not be expected in the same portfolio.

To deal with the problem of proliferating groupings, the board agreed that groups of contracts could be divided into three subgroups: those expected to have a loss at issue, those that are at a material risk of producing losses if things develop unfavorably and those that have no such significant risk. It's not entirely clear how that distinction would be made, but staff is no doubt working on guidance. It's entirely possible that entities will decide to have only one or possibly two (if there is a subset that shows a loss at issue) such groupings for a product. For instance, the company may decide that all policies are at risk of becoming loss making and therefore group all of them together.

The board also agreed that issues of more than a single calendar year should not be grouped together.

These decisions, while a definite improvement on the previous positions, still are likely to cause a material increase in the number of groupings an entity will need to keep track of. There is still considerable vagueness in the requirements and actuarial practice will need to develop over time to produce a reasonable process.

Experience Adjustments

Another problem that became evident during field testing is how to handle the effects of changes in assumptions under the general model. The board had previously decided that part of the effect should be recognized in the contractual service margin (CSM) and part in profit and loss. To simplify the adjustment, the board concluded that all the direct effects of the change should be recognized in profit and loss rather than in the CSM. Staff will draft guidance on the precise meaning of "direct effect."

For contracts accounted for using the variable fee approach, the board decided that experience adjustments from non-financial risks should also be shown in profit and loss.

Flying high over the desert

Transition Issues

The industry expects transition to be a major undertaking costing many millions of dollars. In particular, the board's preference for a retrospective approach could in many cases cause significant issues having to do with data availability and reliability. Since the groupings of contracts is likely to be much finer than under previous standards, even after the board's improvements discussed above, the required historical data may often not be available. This is particularly true for contracts issued more than seven or eight years previously.

Recognizing this, the board had allowed an alternative simplified retrospective approach to be used, but it appeared that entities would have to prove that a full retrospective approach was impractical before moving to the simplified approach. Even this approach might be impractical in some situations so the board allowed a fair value approach, again, requiring proof that it was necessary.

After discussing the issue further, the board allowed that the entity could decide to move to either a modified retro approach or a fair value approach without necessarily demonstrating that the modified approach was impossible in order to use the fair value approach.

For the fair value approach, the board agreed that the calculation could be at the inception of the contract or at the beginning of the first year presented. They also agreed that, for transition, contracts could be grouped over more than one year and could use an initial discount rate from the beginning of the period being shown rather than going all the way back to the initial issue.

Despite these changes, transition will still be a difficult and expensive process, but probably unavoidably so.

Transition Disclosures

The board decided that disclosures relating to the contractual service margin, insurance contract revenue, and insurance finance income or expense should be shown separately for insurance contracts that existed at the beginning of the earliest period presented and insurance contracts written after the beginning of the earliest period presented. This would allow users to better understand where the effects of transition estimates might have had an effect on the starting values.

Risk Mitigation

The board agreed to permit an entity that uses a derivative to mitigate financial risks arising from an insurance contract accounted for using the variable fee approach, such as an annuity with a Guaranteed Minimum Withdrawal Benefit or other types of benefit guarantees, to offset the movement in the derivative against the movement in the guaranteed benefits in profit

It's not easy being tall

and loss. This should produce a more meaningful result in the accounting.

Other Issues

There were a number of other sweep issues raised during the meeting. Most of these were clarifications to wording in the draft standard, but a few could be important to certain contracts. Details can be found in Board Paper 2G.[2] The recommendations in this paper were adopted without change at the meeting.

Mandatory Adoption Date

The board decided that the mandatory adoption for International Financial Reporting Standard (IFRS) 17 on Insurance Contracts should be for **annual periods beginning on or after Jan. 1, 2021**, assuming IFRS 17 is issued in the first half of 2017. They did not state what would happen if the issue date is after the first half of 2017. Entities can adopt earlier if they also adopt IFRS 9 (Financial Instruments) and IFRS 15 (Revenue) at the same time.

Overall, I think all these changes are a big help, but I'm not convinced that all the bugs have been found. As was true with our bed in the jungle, just because you eliminate the bugs one night, others have a way of finding their way in the next night.

My hope is that the board will now recognize the need for a transition advisory group to help with issues that have not been identified during the field testing process. The membership of the group should be at least one-third actuaries (plus one-third accountants and one-third financial statement users) from many different jurisdictions. Given the actuarial nature of most of the calculations that are required, this only makes sense. Remember,

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

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ENDNOTES

1 IASB Update, November 2016, *https://s3.amazonaws.com/ifrswebcontent/2016/IASB/November/IASB-November-Update-2016.html#6*

2 The board paper can be found at: *http://www.ifrs.org/Meetings/MeetingDocs/IASB/2016/November/AP02G-Insurance-Contracts.pdf*