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No-See-Ums

By Henry Siegel

I spent the last full week of June vacationing in Belize. The day I arrived, I covered myself in suntan lotion and bug repellent. The next day I went out and bought anti-itch medication because the repellent hadn't worked. I essentially spent large parts of the rest of the week itching. The culprits in this were no-see-ums, also called sand flies. The problem with these bugs is, as their name suggests, you don't know they're there until they bite you. When they do, the itch stays for longer than you would think. (By the way, notwithstanding the itching I really enjoyed the diving and spelunking I did in Belize—see photos.)

I thought of the International Accounting Standards Board (IASB) as I was going through this torture. They, too, are enduring a lot of suffering. Why? Because so many times they have thought they had solutions to the problems of accounting for insurance contracts only to find some unexpected problem that bites them.

They thought using Other Comprehensive Income would solve the problem of getting assets and liabilities on the same basis. It didn't. They thought that mirroring would work for

participating contracts. It didn't work for the types of contracts most important to the European industry. They are now proposing the use of the Variable Fee Method for certain participating contracts. I predict they will find this also doesn't completely work, as it was designed to fit those certain European contract types and excludes several types of contracts that are important elsewhere in the world, such as Universal Life.

The problem with all these solutions is the more they move away from a principle basis toward a solution that works for particular types of contracts, the more they find it doesn't work for other types. Those other types of contracts then arise like no-see-ums to bite the nearest person. The past quarter, the board seems to have settled on moving forward with the Variable Fee Method. We'll see what no-see-ums turn up when the industry has a chance to completely study it.

Again this quarter, the IASB held mainly educational sessions on the insurance contracts project. In fact, they didn't discuss the subject at all in April. They did, however, have an important tentative decision making session at the end of June.

MAY EDUCATION SESSION

On May 19, 2015, the IASB held an education session in which it discussed additional implications of the variable fee approach for certain participating policies with respect to the following issues:

- mutualization;
- revenue; and
- transition requirements.

The most interesting discussion to me was on "mutualization." This topic came up for a variety of reasons, not necessarily to deal with mutual insurers. In Europe, there are blocks of policies where dividends are determined based on the performance of the entire block. The block may include issues of many years and many types of contracts with the key attribute

being that 90 percent (or some other high percentage) of total profits are paid out to policyholders. For these blocks, the concept of losses being measured at the policy level, as the board has previously discussed, does not work well since losses on one set of policies can be offset by profits on another. This offsetting is the mutual property that the board discussed. Discussions revolved around what requirements a block has to meet to allow such offsetting of profits.

One concern is that the board discussed the need for policyholders to be "aware" of this arrangement or that it is included in the policy language. Unless an insurer wrote its policies in the specific language being discussed, the business may not be included even if in practice the





contracts were identical. How this will affect U.S. policies remains to be seen.

In addition, the IASB also discussed:

- the treatment that would apply to contracts with participation features that would not be accounted for using the variable fee approach;
- whether to provide an accounting policy choice when an entity presents interest expense—to use the effective yield approach or the current period book yield approach; and
- an update from the staff on the interaction between International Financial Reporting Standard 9 (IFRS 9) Financial Instruments and the Insurance Contracts project.

As usual, no decisions were made; however, the discussion about IFRS 9 was to continue the following quarter.

JUNE MEETINGS

In June, there was an education session and then a decision making session.

The education session focused primarily on the issue of IFRS 9 changes to asset valuation being implemented before the insurance contracts standard is finished. This could cause asset/liability mismatches since choices are required to implement IFRS 9 that might be different if the liability valuation is simultaneously changed.

After extensive discussion, including recognition of the complexity of deferring the introduction of IFRS 9, the staff agreed to look at possible amendments to the current IFRS 4 to ameliorate the situation. Those possible changes include:

- introduction of shadow accounting when,
 - gains or losses from assets don't directly affect the measurement of liabilities, or

- when those gains and losses would be attributable to the insurer and not the policyholder.

b) permitting insurers to recognize an adjustment for the differences between the change in value of the assets under IAS 39 and the change in their fair value under IFRS 9, if those changes are recognized in profit or loss.

Several board members expressed support for these ideas and the staff will develop them further after discussion with users. We'll see what no-see-ums arise when they report back.

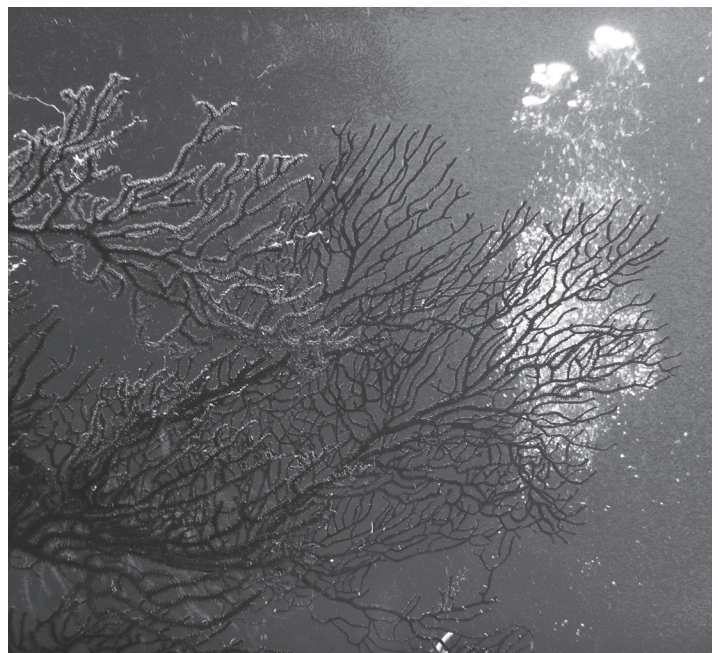
At the decision making session the board tentatively approved use of the variable fee approach for certain par contracts that have been discussed since the beginning of the year. This is how the staff update describes it:

“Variable fee approach for direct participation contracts

“The IASB tentatively decided that, for insurance contracts with direct participation features, it would modify its general measurement model for accounting for insurance contracts so that changes in the estimate of the fee that the entity expects to earn from the contract are adjusted in the contractual service margin. The fee the entity expects to earn from the contract is equal to the entity's expected share of the returns on underlying items, less any expected cash flows that do not vary directly with the underlying items. ...

“The IASB tentatively decided that contracts with direct participation features should be defined as contracts for which:

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ENDNOTES

¹ <http://media.ifrs.org/2015/IASB/June/IASB-Update-June-2015.html#1>

² *ibid*



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- a. the contractual terms specify that the policyholder participates in a defined share of a clearly identified pool of underlying items;
- b. the entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items; and
- c. a substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items.”¹

profit or loss on the basis of the passage of time.”²

These decisions leave lots of holes for actuarial practice to fill. For instance, what is a “clearly identified pool of underlying items”? Does the entity need to hold the assets or is an index acceptable? Is a proportion of a defined pool OK? If so, can that proportion vary over time?

How does one recognize the CSM over time for a contract without a specific term (e.g., for an immediate annuity)? One suggestion is that if the maximum life of the policy anticipated is 50 years, then 2 percent of the CSM is released each year plus the CSM on any policies that terminate during the year. This would make the actual release of the CSM highly dependent on policy termination and for some policy types

make it very front-end loaded. For others, like Long-term Care or immediate annuities, it might make profit recognition very deferred.

All of this makes it necessary for well thought-out actuarial guidance on implementing the eventual standard. The International Actuarial Association has more than 20 working groups looking to produce International Actuarial Notes on these and other subjects. This reminds us again why

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

At the same meeting, the IASB tentatively decided that “for all insurance contracts with participation features, an entity should recognize the contractual service margin (CSM) in

IAA Report

By Jim Milholland

It's been business as usual at the IAA since the last report. While there is much activity, agendas have not changed much and little has come to completion. There is, however, news of sorts coming from the conversations in the hallways that take place during the meetings.

To recap, major activities of the Insurance Accounting Committee (IAC) and the Education and Practice Subcommittee (EPS) include:

- Writing International Actuarial Notes (IANs) on the new accounting standard—IFRS for insurance. There are 25 topics that will be combined into an as-of-yet undetermined number of notes. When done, the IANs will provide fairly comprehensive guidance on the accounting standard. When they will be done is of course a function of the progress of the IASB. Much of the work on the IANs to date has been updating existing IANs on the current IFRS 4 and otherwise opportunistically beginning writing where the direction of the IASB with respect to the new standard is fairly clear.
 - Working with or developing relationships with other supranational organizations. The IAA has a memorandum of understanding with the IASB, and a member of the IAC, Micheline Dionne, is a member of the consultative advisory group, the IFRS Advisory Council. The IAC may have some involvement with the IASB's research project on discount rates. Another member, William Hines, is a member of the consultative advisory group to the International Auditing and Assurance Board. Members of the IAC and members of the Pensions Committee have regular communications with staff of the International Valuation Standards.
 - Publishing a monograph on the adjustment for risk. The firm preparing the monograph, Deloitte, is progressing well, although there is the standard caveat that the monograph cannot be finished until the IASB completes the insurance standard.
- The Insurance Accounting Task Force of the Actuarial Standards Committee continues with the development of an

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International Standard of Actuarial Practice that will relate to the new IFRS standard on insurance. While very active, the Task Force is, like the EPS, able to progress only so far without a final IFRS for insurance.

The silver lining on the fact that IFRS continues to get pushed into the future is the fact that actuaries are already stretched thin with reporting and compliance requirements. Perhaps by the time that the new IFRS for insurance comes into effect, companies will be in a better position to deal with the requirements. They likely will have actuarial platforms, developed for other purposes—such as Solvency II—that they can leverage. This includes not only projection systems, but the requisite tools and procedures around the cash flow projects. These are the analyses and considerations that support the inputs—mortality, lapse, and expense, to name a few—that likely can be used for IFRS as well. Inputs may not be the same, but there should be a rationale for differences, and one is likely a modification of the other. Most importantly, a common robust model office can be used for all the projections.

Notwithstanding the silver lining, one wonders if the number of reports and analyses is not creating overload on actuar-

ies. Actuarial departments are stretched to produce figures for multiple purposes. The number of analyses and the reporting deadlines can create an operating environment that is oriented to compliance; i.e., meeting deadlines. The value that might be derived from the reports may be lost in the rush to meet the next deadline. Too much time is spent producing figures and too little time is spent understanding them.

Do you share my concern? Have I over-reacted to the number of requirements, or do you, like me, wonder what would really be beneficial to the various stakeholders? Which reports and which analyses would address the information needs of shareholders and regulators? Certainly actuaries want to be responsive to the needs of the various parties, but shouldn't we be more involved in shaping the standards? While there is not a forum for responses, comments to me or letters to the *Financial Reporter* are welcome. Let us know what you think. ■



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