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10 Things I Think About the New Insurance Contracts IFRS

By Henry Siegel

I was originally going to title this article "Nothing" since the International Accounting Standards Board (IASB, the board) made no new decisions this quarter about the new insurance contracts standard. I decided, however, that the title would be unfair since the staff and board are, in fact, doing a lot. Just all of it behind the scenes.

They are field testing the most recent versions of the standard in order to get feedback from preparers and users. This takes time and for obvious reasons needs heavy confidentiality. Hopefully, this will result in a better, clearer standard when it finally comes out early (I hope!) next year.

So, having nothing to report on, I decided to try to summarize the major areas where I am happy and where I have concerns about the new standard.

1. The new standard will ultimately be a good one. While there are ongoing problems, some of which I discuss below, the new standard will generally produce reasonable results. The use of current assumptions and the availability of the top-down approach to discount rates are huge steps in the right direction. Most importantly, the beefed up disclosures should allow any user to far better understand what is going on in the financials of the company. Overall, almost all the numbers on the right side of the balance sheet and in the income statement will be produced by actuaries; this can only be good for everyone.

2. If I'm an analyst, I don't care whether a loss on a contract at issue is subtracted from the equity at issue or reduces the contractual service margin (CSM) and is allowed to flow into earnings over time. When I try to figure out the value of the company, I'm going to take the CSM, subtract the portion of it that is not due to expected profit and then add the current equity. If I'm doing things in a consistent manner, the reduction in the CSM due to contracts with losses at issue will more or less equal whatever the reduction in the equity would have been. Of course, I want to know if the company is selling a product at a loss intentionally, but more so I can understand its strategy than because I think they're trying to put one over on me or because it will distort my evaluation of the company.

3. The rules about grouping of contracts had better be fixed in a reasonable way. The current proposals (as of August) would require large companies to keep track of potentially thousands of groups in order to measure loss recognition, DAC recoverability and other items. While computers can handle lots of data, the cost of reviewing and auditing all these groups by people would be excessive; especially since, as I say above, it shouldn't matter much to users.

   The best solution would be a return to the groupings management uses to run the business and to eliminate the "similar profitability" requirement that is in the tentative conclusions. This would give users the same information that management uses to run the business and prevent obscuring the important items by data overload.

4. Users should be very happy about the new disclosure requirements. The only way to really understand insurance company financial statements is to look at earnings by their source. You need to understand, for instance, whether mortality experience is better or worse than expected and what the effect of that difference is on earnings. The new disclosures should allow analysts to calculate that. The same applies to gains from lapsation, morbidity and expenses. Having reserve roll-forwards and showing the effects of assumption changes explicitly should greatly enhance this understanding.

   Even more importantly, the difference between investment earnings and interest credited on liabilities should allow a user to understand whether those margins are deteriorating or whether the company has been able to pass along interest risk to the policyholder. Interest rate movements may or may not be important to a company depending on how much of its business is interest sensitive. I don't really care if interest rates go up 50 basis points if I have to credit all the increase to my policyholders. I will only care about how much it reduces any spread compression or how much I don't credit to policyholders. Until the post 2008 situation, this has not generally been a huge concern.

   If a company I'm analyzing doesn't provide me enough information in its disclosure to do a full gains-by-source analysis, I'd insist they do so in their management discussion & analysis (MDA).

5. While requiring discounting of claim liabilities makes sense for the balance sheet, I will still want to see the undiscounted values. I am very concerned with whether a company consistently underestimates or overestimates its liability. It's a lot easier to analyze that without discounting getting in the way.

Fortunately, the disclosure requirements include the undiscounted values.

Of course, the same cannot be said for undiscounted values of liabilities for long-duration contracts; such numbers would be worse than useless. I can't think of a use for the total expected surrender values or death benefits of a block of policies.

6. The new definition of revenue will prove to be of little value, but a pain to calculate. Use of a gains-by-source approach for analysis will make the exact revenue number irrelevant except for short-duration contracts. It might be a better indicator of a company's size, I suppose, but it isn't useful for things like loss ratios or expected profits.

   Similarly, the risk adjustment will likely be of little value to users on long-duration contracts since the adjustment is generally a small part of the total liability.

7. The accounting for closed blocks of participating business in demutualized companies should finally produce results that make sense. In most cases, this should mean zero earnings and equity for the block every year since the assets are designated as belonging to the designated contracts and no profits can be realized by the entity from that block.

8. Mutual insurance companies have equity. Any company that expects to exist long term must keep a permanent amount of assets in excess of its liabilities. Even when a product is finally extinguished, there will be assets arising from those contracts that will remain with the company (unless they are part of a closed block from a demutualization as mentioned above).

9. Any company that expects to produce results using IFRS should be starting on implementation already. Even those European companies that already do Solvency II and embedded value calculations will find that their reporting systems will require major overhauls to make them auditable and as automated as possible. Other companies will likely have even further to go.

10. The IASB should definitely appoint an implementation working group consisting of actuaries and accountants from preparers and users to help with the transition to the new standard. Unexpected problems will undoubtedly arise and having a knowledgeable resource should help make the transition go as smoothly as possible.

And one extra thought:

11. The IASB should definitely sponsor a party to celebrate the final passage of the new standard. I suggested this to a couple of board members and I got the clear idea they did indeed intend to party; it wasn't clear, however, that others will be invited! I guess I can understand that. There have been a lot of people involved in this project over the decades.

So with all this in mind, I reiterate

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

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