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Almost Success!

By Henry Siegel

To achieve great things, two things are needed; a plan, and not quite enough time. — Leonard Bernstein

Well, this quarter the International Accounting Standards Board (IASB) moved ever closer to finishing its standard on Accounting for Insurance Contracts. Whether they've achieved a great thing remains to be seen. The exact wording of the standard and its associated guidance remain to be worked out and it's always possible that items will arise in drafting that will require the board to redeliberate certain issues.

If the final standard is not judged a great thing, it's most likely because there was, contrary to Bernstein's requirement, more than enough time. There were many plans; however, there was a constant tension between those who wanted the standard finished and those who maintained that it was better to get things right than to get things done quickly. Overall, despite there being a number of deadlines set in the course of the project, the smart money was always on the board missing those deadlines.

The project began in 1997, nearly 20 years ago, as a project of the International Accounting Standards Committee, the predecessor to the IASB. The IASB adopted the project in 2001. Over the course of the past 15 years, the IASB has had numerous discussions, produced many issue papers and issued two Discussion Papers and three Exposure Drafts. It now looks like a final standard will be produced either late this year or early next year.

Despite the extensive time already spent on the standard, important issues remained to be worked out this past quarter.

JANUARY MEETING

The board met on January 19–20 to deliberate the remainder of the planned technical decisions on the project.

Level of aggregation

A very important issue was how contracts can be combined for measurement purposes. In the past, policies were grouped as they were priced and managed. This gave users the same viewpoint as management. There was concern by the board, however, that this allowed companies to hide losses on some policies by grouping them with profitable ones.

The basic principle the board followed was that the Contractual Service Margin (CSM) should be measured at the contract level. Following objection by the industry, the board tentatively decided to require a loss for onerous contracts to be recognized when the CSM is negative for a group of contracts. Rather than allow groupings based on the pricing and management criteria previously used, however, the board tentatively decided that the group should comprise contracts that at inception:

> "a. have cash flows that the entity expects will respond in similar ways to key drivers of risk in terms of amount and timing; and
>
> b. had similar expected profitability (i.e., similar contractual service margin as a percentage of the premium)."[1]

There are significant problems with this definition. It's not at all clear what "respond in similar ways" means or what "similar expected profitability" means. With respect to the latter, are two policies whose CSMs are 25 percent and 15 percent of premium similar? If not, where do you draw the line? Are policies with -2 percent and -4 percent similar in profitability? Do universal life policies and variable universal life policies respond similarly to movements in interest rates? How about universal life and traditional participating whole life?

As a result of this decision, it's likely that companies will have many more groupings than currently. Consider how many would be required if similar profitability is not interpreted in a broad way. It could easily multiply groupings by hundreds. It's also not clear whether separate assumptions are needed for each grouping. Does there need to be separate expense assumptions for preferred and standard life insurance policies? In short, there are potentially huge practical issues that may make implementation even more difficult than previously expected.

In addition to loss recognition issues, groupings are critical for the purposes of releasing the CSM over time. On this issue, after discussion, the board tentatively decided:

> "a. The objective for the allocation of the contractual service margin is to recognize the contractual service margin for an individual contract, or groups of homogeneous contracts, in profit and loss over the coverage period of the contract in a way that best reflects the service to be provided by the contract. Hence, if there is no more service to be provided by a contract after the end of the report-

ing period, the contractual service margin for that contract should have been fully recognized in profit or loss.

b. An entity can group contracts for allocating the contractual service margin provided that the allocation of the contractual service margin for the group meets the objective in (a).

c. An entity that groups contracts is deemed to meet the objective in (a) provided that:

i. the contracts in the group:

- have cash flows that the entity expects will respond in similar ways to key drivers of risk in terms of amount and timing; and
- on inception had similar expected profitability (i.e., similar contractual service margin as a percentage of the premium); and

ii. the entity adjusts the allocation of the contractual service margin for the group in the period to reflect the expected duration and size of the contracts remaining after the end of the period."[2]

Again, there is the same vagueness in this wording and, if not clarified, it may require a very detailed calculation of the release of the CSM. Recognizing that the language needs work, the board instructed the staff to develop the wording during the drafting process to improve the clarity of these requirements.

One issue that the industry raised during discussion with the board concerned situations where regulation required combination of policies for pricing purposes that don't fit the above criteria. A prime example of this is the requirement in some jurisdictions for unisex pricing of annuities. Unfortunately, the board tentatively decided that "there should be no exception to the level of aggregation for determining onerous contracts or the allocation of the contractual service margin when regulation affects the pricing of contracts. Accordingly, contracts with dissimilar profitability, even if as a consequence of regulation, may not be grouped for determining onerous contracts and for the allocation of the contractual service margin."[3]

This will require recognition of losses on annuities issued on women, for example, while recognition of profits on annuities for men will be over the lifetime of the annuitant. The effect of this requirement is likely to make annuities less attractive for companies to issue. In this situation the users of financial statement will get a view of the product different from what management uses.

Specifying the effect of discretion in the general model

Another issue raised by the industry concerned how to deal with the effects of a company exercising its discretion on participating contracts. The board tentatively decided to require an entity to specify at the inception of the contract how it viewed its discretion under the contract, and to use that specification to distinguish between the effect of changes in market variables and changes in discretion. If the entity is unable to specify in advance how it will determine the amounts due to policyholders, then the default benchmark would be a current market return.

Discount Rates Research

In an unrelated discussion, the board continued to consider the staff's findings on its research project on present value measurements—discount rates. This project will not affect insurance contracts or pensions, but may have effects on other standards such as measurement methodology and treatment of taxes, present value measurement presentation and disclosures, present value measurement objectives and the use of present value measurements in IFRS Standards. The International Actuarial Association will be consulting with the IASB on this project.

FEBRUARY MEETING

At its February meeting, the board reviewed the mandatory and non-mandatory due process steps that it had taken so far in developing the new Insurance Contracts Standard and also considered the re-exposure criteria in its Due Process Handbook. All 14 board members confirmed that they are satisfied that the board has completed all the necessary due process steps on the Insurance Contracts project to date and that re-exposure was not needed. The board instructed the staff to commence drafting the final standard.

The board will discuss the effective date, and any sweep issues that arise in the drafting process, at a future meeting.

MARCH MEETING

Amendments to IFRS 4: Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts

Having for the time being disposed of the Standard on insurance contracts, at its March meeting the board considered feedback from the comment letters it received and the outreach meetings it conducted on the Exposure Draft on Applying IFRS 9 Financial Instruments (IFRS 9) with IFRS 4 Insurance Contracts (IFRS 4) (the ED). The board tentatively confirmed its proposals in the ED by deciding:

"a. to confirm the ED proposal to provide a temporary exemption from applying IFRS 9 for qualifying entities.

b. to confirm the ED proposal that the eligibility for the temporary exemption should be determined at the reporting entity level only. Hence, the assessment of eligibility should consider all of the activities of the reporting entity, and the reporting entity would apply only one Standard, either IFRS 9 or IAS 39 Financial Instruments: Recognition and Measurement, to all of its financial instruments in its financial statements.

c. to confirm that there should be a fixed expiry date for the temporary exemption.

d. to confirm the ED proposal to provide an overlay approach.

e. to confirm the ED proposal that the temporary exemption from applying IFRS 9 and the overlay approach should be optional."[4]

These decisions were made despite concerns by some users that they didn't need the deferral option and that allowing it might cause confusion in comparisons between companies.

Any remaining technical issues, including the qualifying criteria for the temporary exemption, will be discussed in the April and May board meetings. The board aims to issue the final amendments to IFRS 4 in September 2016.

We hope that all the time spent both by accountants and actuaries on this project will indeed produce a great result. If so, it will prove that, indeed

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

ENDNOTES

1 IASB January Update (http://media.ifrs.org/2016/IASB/January/IASB-January-Update_Monthly.pdf)

2 Ibid.

3 Ibid.

4 March IASB Update (http://media.ifrs.org/2016/IASB/March/IASB_Update_March_2016.pdf)

Henry W. Siegel, FSA, MAAA, is a semi-retired actuary most recently with New York Life Insurance Company. He can be reached at henryactuary@gmail.com.