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A Retrospective Look at History

By Henry Siegel

"Those who don't know history are destined to repeat it."
- Edmund Burke

"I like the dreams of the future better than the history of the past."
- Thomas Jefferson

"An actuary, an underwriter, and an insurance salesperson are riding in a car. The salesperson has his foot on the gas, the underwriter has his foot on the brake, and the actuary is looking out the back window telling them where to go."
- Attributed to Fred Kilbourne, FSA, MAAA

One of the first principles new actuarial students learn in actuarial mathematics is that reserves can be calculated on either a prospective or retrospective basis and you get the same result. It's not until later in training that students learn that this is not always the case, particularly if experience has not gone exactly according to expectations.

I've always worked on the principle that reserves (liabilities) must be based on the prospective approach. It's the only way we can be sure that they reflect our best view of what the future will be and how much we need to have today in assets to fulfill our future obligations. This is why, for instance, immediate annuity liabilities typically reflect an assumption about mortality improvement in the future.

On the other hand, cash values and other policyholder values should be based on a retrospective approach. They reflect what has already happened rather than what will happen. Having the cash value on Universal Life products reflect the accumulated account value therefore makes sense. It's also why having the account value used as the liability does not necessarily make sense and why FAS 97 has needed so much tinkering to reflect guarantees embedded in the contract.

Every time I hear an accounting standard setter talk about using a retrospective approach to setting liabilities, I get upset. Fortunately, it looks like the International Accounting Standards Board (the IASB) has almost entirely escaped this ill-advised approach. The only time they are using a retrospective approach now is upon initial implementation and while I wish there was another way, I've been unable to find one that really works well.

Of course, in doing anything retrospectively a little common sense is needed. The retrospective mortality rate on a living policyholder is obviously zero; however, if we use that rate to calculate the liability at initial implementation we get nonsense. Things need to be calculated on a portfolio basis from inception and therein lies the difficulty. Many large insurers have blocks of business for which the initial portfolio is long lost in the depths of history. An alternative approach will be needed for these situations in order to get a sensible result. For those portfolios where the history does exist, it will still take considerable effort to get a proper result. This is one of several reasons why an implementation task force is needed to help properly apply the new IFRS.

On the other hand, the FASB is still discussing retrospective unlocking of margins and liabilities. For the reasons outlined above, I wish they'd give this up and just move to a prospective approach. Not only is it simpler, but it gives a much more consistent explanation for what has happened. We've had retrospective unlocking of DAC for some time and most people I've spoken with think this is the most difficult explanation they have to make or, if they are users, understand. I know it can work; it just doesn't seem like it's worth the trouble when there's a better way to handle it.

Remembering the past can, as Burke noted, prevent repeating mistakes. It can also prevent one from realizing the dreams of the future as Jefferson alludes to. Too often remembering the past and trying to remedy it prevents us from doing the right things going forward.

> "As actuaries, we are particularly tasked with both understanding the past, but not being bound to believe that the past predicts the future."

As actuaries, we are particularly tasked with both understanding the past (e.g., by doing experience studies), but not being bound to believe that the past predicts the future. As a friend told me back in the '70s while pricing Guaranteed Interest Contracts, "Interest rates have never gone to double digits" so he wasn't worried about the dire effects of that scenario. He was right historically, but dramatically wrong about the future. That cost the company we both worked for dearly. That's one aspect of my personal history I resolved to never repeat.

The IASB met twice this quarter, in October and November, to discuss the Insurance Contracts Standard to deal with miscellaneous outstanding issues.

OCTOBER MEETING

At its October meeting the IASB discussed accounting for financial assets when the insurance standard is finally adopted, whether to retain the mirroring approach included in the last Exposure Draft and certain items concerning presentation and disclosure.

Treatment of financial assets on transition to the new insurance contracts standard

The board tentatively decided that when an entity first applies the new insurance contracts standard it would be permitted, but not required, to newly assess the business model for managing financial assets that are accounted for in accordance with IFRS 9. This would allow the entity to better match its accounting for assets supporting insurance contracts and the related liabilities.

The choice made by the entity should be reflected in the opening balance sheet. The rationale for and effect of that choice would, of course, be shown as a disclosure to the opening statement.The board set rather detailed requirements for those disclosures, including a requirement to show the effects by asset class.

Restatement of comparative information on initial application of the new insurance contracts Standard

The IASB confirmed the proposal in the 2013 Exposure Draft Insurance Contracts (the 2013 ED) that, on first application of the new insurance contracts standard, all entities must restate comparative information about insurance contracts.

Retaining the mirroring approach from the 2013 ED

The decision to not retain mirroring was mostly pro forma since the board had already decided to use the variable fee approach instead for most of the relevant contracts.

Other presentation and disclosure issues

The IASB tentatively decided to confirm the 2013 ED proposals related to presentation of line items relating to insurance contracts in the financial statements.

The IASB also tentatively decided to confirm the disclosures proposed in paragraphs 69-95 of the 2013 ED with additions to reflect the use of the variable fee approach. It also added a requirement that if an entity disaggregates investment interest expense into an amount presented in profit or loss and an amount presented in OCI, the entity should disclose an explanation of the method that the entity used to calculate the cost information presented in profit or loss.

The board also added a requirement to disclose changes in the fulfillment cash flows that adjust the contractual service margin. An explanation should be given of when the entity expects to recognize the remaining contractual service margin in profit or loss, either on a quantitative basis using the appropriate time bands or by using qualitative information and how the figures at transition were calculated.

Finally, the board decided to delete the proposed requirements that an entity should disclose a reconciliation of revenue recognized in profit or loss in the period to premiums received in the period (paragraph 79 of the 2013 ED). It also agreed to delete a requirement for an analysis of total interest expense included in total comprehensive income (a tentative decision from March 2014).

Both of these deletions will make life easier for actuaries, although it's doubtful this was the reason for deleting them.

NOVEMBER MEETING

On Nov. 18, 2015, the IASB considered the similarities and differences between the general model and the variable fee approach and three narrow consequential issues arising from the variable fee approach.

Comparison of the general model and the variable fee approach

The IASB tentatively decided that the variable fee approach should not be amended so that a financial guarantee embedded in an insurance contract would be treated as if it were part of the underlying assets. It also tentatively decided not to require or

permit in the general model the re-measurement of the contractual service margin using current discount rates.

Consequential issues arising from the variable fee approach

The board dealt with issues involving the measurement of certain assets underlying contracts with direct participating features, measuring the CSM on transition and measuring guarantees on transition.

For more on all these decisions consult the Update for the relevant month.[1]

The board did not discuss the insurance contracts project in December, but is still expecting to release a final standard by the end of 2016. Of course, looking at history, we have to take that expectation with the usual grain of salt.

I have always thought that the difference between accounting and actuarial science is that accounting is concerned primarily with what has happened while actuarial science is primarily concerned with what will happen. That's why

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

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.

ENDNOTES

1 http://media.ifrs.org/2015/IASB/October/October-IASB-Monthly-Update.pdf and http://media.ifrs.org/2015/IASB/November/IASB-Monthly-November.pdf