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ARE YOU GETTING READY FOR CHANGE?

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INTERNATIONAL AND U.S. ACCOUNTING STANDARD setters are hard at work rewriting the rules governing insurance contracts. Given the resources demanded by short term concerns, including both the economic environment and regulatory reform, what are insurers doing now and what should they consider doing in the near future?

THE FINANCIAL REPORTING ENVIRONMENT for insurance companies is about to enter a new stage in its evolution, this time led by the International Accounting Standards Board (the IASB, author of International Financial Reporting Standards or IFRS). A new international financial reporting standard for insurance contracts is expected to be finalized by the IASB in June 2011, with implementation possibly three or four years later, although this period has yet to be determined.

Importantly for insurers currently reporting under U.S. GAAP, the Financial Accounting Standards Board (the FASB, author of U.S. GAAP) joined this project in 2008 with the objective of developing a joint standard with the IASB. To further this goal, (1) in July 2010 the IASB issued a proposal for the future accounting of insurance contracts in the form of an exposure draft, seeking comments from a wide range of stakeholders, and (2) in September the FASB issued a separate discussion paper of its preliminary views[1] based on the IASB's proposals, supplemented with additional FASB-specific perspectives, seeking input into their decision-making process from its stakeholders. During the boards' respective public comment periods, many respondents strongly urged that if the ultimate goal in the United States is convergence with IFRS, a common standard needs to be adopted. In February 2011, the FASB took a step toward achieving convergence by voting unanimously to move forward jointly with the IASB to pursue the development of accounting for insurance contracts that would improve existing U.S. GAAP and converge with IFRS.

Many aspects of these proposals continue to be debated by the two boards and have been influenced by the significant amount of feedback received from their public outreach activities and the comment letter process. However, the FASB's vote is an important milestone that affirms its intent to overhaul the current U.S. GAAP insurance accounting model. The purpose of this article is not to describe the details or explore arguments underlying these proposals. Rather, it is to describe how life and health insurers have been preparing for the inevitable and fundamental changes involved.

SUMMARY OF THE PROPOSALS

Proposals from both the IASB and FASB, which have a great deal in common, would establish a common measurement approach for the large majority of life insurance and annuity products, often referred to as the building block approach. Its underlying concept, a current estimate of the liability for a portfolio of insurance contracts, is fairly straightforward—although it also incorporates many complex provisions and implications, explanations of which are outside the scope of this article. A separate approach has been proposed for certain short duration contracts, such as group term life and health insurance, which is not described here. [2]

The current estimate is made up of the IASB's building blocks that are updated at each reporting date during the contracts' coverage and claims periods and consists of the following components:

- The expected value of the cash flows within the existing contract boundaries;
- A discount of the expected value associated with the time value of money;
- An explicit adjustment for the risk associated with the expected cash flows; and
- The amortized amount of a residual margin, which at issue is determined as the present value of expected cash flows, less the adjustment for the risk, if positive.

The most significant difference between the IASB exposure draft and the FASB discussion paper is that the FASB's building block model includes a single composite margin that at issue is equal to the sum of the IASB's adjustment for risk and residual margin. This composite margin would be amortized using a prescribed formula, whereas the explicit adjustment for risk would be re-measured each period and the residual margin only re-mea-

Status of IFRS in the United States

THE SEC HAS THE LEGAL AUTHORITY to establish generally accepted accounting principles for the U.S. capital markets. In November 2008, the Securities and Exchange Commission (SEC) issued a proposed "Roadmap" for a possible path to the adoption of IFRS in the United States. The SEC received over 200 comment letters on the Roadmap.

In February 2010, the SEC held an open meeting to advance the dialogue of incorporating IFRS into the financial reporting system for U.S. issuers. At the meeting, the SEC unanimously agreed to publish a statement of continued support for a single set of high-quality global accounting standards and acknowledged that IFRS is best positioned to serve in that role. The SEC stated that if it moves forward with IFRS, U.S. issuers would not be required to report under IFRS until at least 2015 or 2016.

In December 2010, the SEC chairman, Mary Shapiro, confirmed that the SEC will be in a position to make its decision by the end of 2011 and, if the decision to incorporate IFRS is made, the SEC will allow for at least a four-year transition period. IFRS is only one of many challenges the SEC currently faces, including coming to grips with the recently passed financial regulatory reforms and a continued focus on enforcement. Because there are many financial and political factors at play, it is anyone's guess as to what the future holds and what the final timing of IFRS in the United States may be.

Although insurers will be greatly affected by the proposed financial reporting changes for insurance contracts, it is not the only significant change looming on the horizon. Perhaps the most important is the joint project by the IASB and FASB to change the accounting model for financial instruments (for example, invested assets and derivatives), which is proceeding with much fanfare and controversy. Both the insurance contracts and financial instruments projects are part of a wider convergence plan under which both boards agree to draft, debate and issue similar accounting standards. However, significant differences of view remain and the extent to which convergence will really be achieved is as yet unclear. If the IASB and the FASB agree on converged standards for both insurance contracts and financial instruments, the SEC's decision on whether to move to IFRS may be proven to be less of an impact compared to other industries, as insurers will have been, in essence, converged in their most significant financial reporting areas.

sured if contract persistency is worse than expected. This difference can have important consequences for both the timing of profit recognition and future earnings volatility. Under either of the boards' proposals, the future insurance measurement model is expected to result in greater earnings volatility and different profit emergence compared to today's approaches, especially because of its greater emphasis on current estimates.

For those familiar with general purpose financial reporting, both proposals—and any further changes that may occur prior to the IASB issuing a final standard in June—represent a significant change from existing methodology, whether an insurer currently reports under U.S. GAAP, IFRS or another accounting basis. Insurers that currently report under IFRS will clearly be subject to the IASB's proposed standard, including U.S. subsidiaries of European or Australian parents and insurers domiciled in countries transitioning to IFRS, such as Canada, South Korea and Brazil. However, it is not yet clear how or when U.S.-based insurers will be affected, due to uncertainty regarding, (1) whether and when the FASB may adopt a version of the IASB's final standard for insurance contracts, and (2) whether the Securities and Exchange Commission (SEC) may in due course adopt IFRS as a replacement for U.S. GAAP.

CURRENT ACTIVITY

Those companies that reacted early to the possibility of IFRS conversion by undertaking initial assessments in 2008 and 2009 have generally put these activities on hold. Instead, the focus has shifted to a more limited approach centered on a core list of emerging FASB and IASB projects under the broad umbrella of accounting convergence. This approach recognizes that U.S. insurers are about to enter a period of fundamental financial reporting change, regardless of whether the SEC adopts IFRS. Importantly, insurers will need to evaluate the proposed changes to insurance accounting in conjunction with other IASB and FASB standards and exposure drafts, particularly the proposed changes to accounting for financial instruments as mentioned earlier. To date, the number of companies that have taken an integrated approach to evaluating the impact of these changes on both the asset and liability sides of the balance sheet have been limited.

Because there is significant uncertainty regarding both content and timing of an insurance contract standard for U.S. GAAP, companies face difficult resource decisions in determining how they should begin to prepare for these changes. The approach may differ depending on whether insurers currently report under IFRS, or are U.S. GAAP preparers, and how quickly and how far they believe the FASB will drive toward convergence. What is clear, however, is that adoption of the IASB, FASB or other foreseeable alternative proposals will require a significant effort, not just by the actuaries and accountants, but also their business partners, including IT, risk management and treasury.

The extent of action among insurance companies to date has varied significantly. Although most insurers have begun to dedicate resources to monitoring developments, and some have performed a preliminary high-level assessment, very few have taken a deeper dive and begun to model the impact on products, performance or processes.

Many insurers are actively monitoring the FASB and, if applicable, IASB's ongoing deliberations during 2011. Some of these have formed small task forces to analyze the boards' actions, read and respond to draft standards, and participate in industry lobbying groups. Actuaries have an important role to play, not only in staying informed of developments, but also in engaging with senior management and helping to drive the call to alert and action within their organizations. Although time now appears quite short to influence the remaining joint IASB/FASB deliberations, as previously noted the FASB will need to reexpose their proposals for public comment prior to issuing a final standard, thus providing another opportunity to influence the future of U.S. GAAP, both individually and through affiliated industry and professional groups. Recent board deliberations indicate that the standard setters are listening to their constituents' concerns and in many cases have shown an apparent willingness to change their position as demonstrated in other projects. Given the controversial nature of many of the proposals for insurance contracts, the actuarial profession should take advantage of this opportunity to provide focused and thoughtful leadership to their firms as well as the insurance industry.

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EXPECTED FUTURE ACTIVITIES: EVALUATING THE IMPACT OF CHANGE

U.S. insurance companies currently reporting under IFRS typically do so to support consolidated group financial reporting requirements of parent companies located overseas. These U.S.-based operations usually rely on the parent organization to drive the group's response to significant financial reporting changes. As such, the subsidiary's role tends to be one of compliance—making sure that the parent's directives are properly executed and embedded within the organization. So far, this approach seems to be the model that U.S. subsidiaries are following for the IASB's proposed insurance contracts standard. However, only a few U.S. subsidiary teams are becoming actively engaged with their parent management to ensure that the wide-ranging implications of the IASB's proposals on U.S. operations are fully understood and adequately evaluated, even though there may be significant reporting consequences, particularly for products such as universal life and variable annuities and other types of spread business. Furthermore, the U.S. parents of overseas subsidiaries will need to make sure they exercise appropriate oversight of their IFRS subsidiaries. This is important not only to ensure that the overseas locations are taking appropriate actions and will be compliant with IFRS, but this may also provide the U.S. parent with useful insights that can be leveraged to assist in adoption of U.S. GAAP changes.

U.S. GAAP-only preparers may have the luxury of being able to wait a while for further direction from the FASB before taking comprehensive action. Not surprisingly, most U.S. insurers are taking a "wait and see" approach. In general, U.S. GAAP preparers have not yet begun to formally evaluate the impact of the FASB's proposals on internal resources, systems and data, or products. However, even in this uncertain environment, companies—and actuaries—can begin to take tangible steps to prepare for change.

While there has been a great level of interest and activity from the industry in the standard setting process, companies should now begin a more comprehensive analysis across a wide range of business activities.

INSURERS WILL NEED TO EVALUATE THE ADEQUACY OF THEIR CURRENT RESOURCES TO IMPLEMENT AND SUSTAIN THE PROPOSED CHANGES.

Resource considerations

Insurers will need to evaluate the adequacy of their current resources to implement and sustain the proposed changes. In particular, the demands on the actuarial function are likely to increase significantly; some companies have expressed concern that the added workload may place a strain on their ability to adhere to their close process and reporting timetable that have almost inexorably shortened over the years. Much of this concern stems from the expanded volume of data that actuaries will need to process, as well as the extensive modeling that will be necessary to set actuarial liabilities rather than just to test their adequacy.

Actuaries have often become the de facto owners of data and therefore spend a significant amount of time scrubbing or modifying source information prior to performing valuations. Accordingly, as many insurers have been moving toward an increased use of data warehouses or a centralized data strategy, actuarial input will be an increasingly important factor in helping companies meet the expanded reporting requirements. Many companies will need to hire external advisors to assist with these further implementation efforts (whether from a technical or project management perspective), but so far most appear to be deferring any decision on whether to engage outside help or to expand their current in-house resources.

Impact on existing projects

Companies have begun to reevaluate existing projects to determine whether their scope and timing should be modified in light of IASB and FASB developments. For example, many insurers have transformational projects underway intended to improve the effectiveness and integration of the financial reporting process across business functions. The modification or replacement of legacy systems could result in significant re-work and future cost if today's solutions have not adequately considered tomorrow's challenges. The impending changes have motivated some insurers to evaluate their current state of reporting. For example, those companies that already struggle with current U.S. GAAP reporting processes may believe this platform is not a sustainable starting point from which to drive future change. These companies have begun to invest time and money into identifying "easy wins" that can begin to relieve pressure without over-committing in an uncertain environment.

Given the significant uncertainty surrounding the FASB's proposals, it is impossible to plan for all contingencies and probably unwise to lock into a single course of action. Nevertheless, in many instances these projects do not appear to have adequately considered the potential state of future GAAP. In contrast, IFRS preparers can choose to delay significant final project or investment decisions until mid-2011 when the IASB's expected issuance of a final standard will provide more clarity.

Implications for products and performance

Most companies view future financial reporting change through a compliance-oriented lens. While this is clearly a primary objective, insurers should also think and plan more broadly about how the IASB and FASB proposals might affect product pricing and design from a business perspective. For example, increased earnings volatility and use of a lower discount rate could make spread-based products less attractive to some insurers. Similarly, the proposals to immediately expense non-incremental acquisition costs may incentivize insurers to move increasingly toward variable compensation structures for sales agents. Both pricing and reserving actuaries have a role to play in evaluating the proposals from a business perspective. To date, very few U.S. companies have modeled the effects of the IASB or FASB's proposals on their existing or planned products to explore business alternatives. Those U.S. companies that have performed preliminary modeling have also used this exercise as a way to identify data gaps and existing systems limitations. In contrast, some European life insurers appear to be further along with their evaluations and have been shying away from heavy savings contracts, such as annuities, because of the proposed approach to discount rates.

Other business impacts

For those insurance companies that have implemented enterprise risk management (ERM) programs or use economic capital modeling (ECM), the proposals may provide an opportunity to further integrate these activities with the financial reporting process. However, even those insurers with sophisticated ERM programs have generally not yet taken steps to assess the impact of future accounting change on risk appetite, risk mitigation or economic capital needs. While it may be too early to make meaningful changes, insurance companies should begin to assess whether their ERM or ECM programs are currently prepared to react to the developing insurance contracts proposals and therefore able to provide management with the data necessary to make informed decisions regarding risk and capital.

Many parent companies of U.S.-based IFRS preparers are domiciled in the European Union and in 2013 will be subject to Solvency II, a comprehensive regulatory regime that will integrate capital requirements and risk management into a single EU-wide regulatory framework. The companies that will need to comply with Solvency II have already initiated detailed work plans and have begun to develop the necessary capital models. Interestingly, however, it appears that these companies have not yet integrated consideration of expected financial reporting changes for insurance contracts into their work efforts for Solvency II. Although the two work streams are separate and distinct, a significant overlap exists. Both are focused on a more market consistent approach than current U.S. GAAP and will require significant modifications to data, systems and modeling. Accordingly, U.S. insurance companies currently supporting Solvency II initiatives should look for opportunities to potentially leverage synergies. Similarly, few U.S. life insurers have yet to integrate their planning efforts relating to the introduction of the principle-based approach to reserving for statutory accounting purposes and revisions to IFRS or U.S. GAAP.

A PRAGMATIC CALL TO ACTION

U.S. insurers find themselves at a crossroads in 2011. Not only are they faced with potentially transformational changes to financial reporting, they will also face the impact of regulatory reform under the Dodd-Frank Wall Street Reform and Consumer Protection Act and will need to follow the NAIC's initiatives on solvency modernization. While the vast majority of companies are taking an appropriately cautious approach and waiting for further clarity, particularly from the FASB, all insurers have an opportunity to engage in the debate. Those companies best positioned for change have begun to communicate with internal stakeholders, educate management on the potential magnitude of change, and lay the foundations for eventual convergence. While this engagement takes time and effort, it is an investment well worth making and could ultimately save significant pain and cost in the future. In this period of uncertainty one thing is clear—actuaries will continue to be at the center of this perfect storm. A

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ENDNOTES

1 The boards are required to issue an exposure draft before a final standard can be issued. As a result, the FASB will be required to publish an exposure draft prior to adoption of a final U.S. GAAP standard.

2 A modified approach has been proposed for contracts with a coverage period of 12 months or less. A liability would be established over the coverage period equal to the unearned net premium (that is, the amortized value of the expected present value of premium less incremental acquisition costs), with any claims liabilities determined according to the basic building block measurement approach (excluding a residual margin).