International Accounting and Progress on a New Insurance Accounting Standard

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Outline of Speech

1) Background (5 minutes)
2) IASB Exposure Draft (10 minutes)
3) FASB Discussion Paper (5 minutes)
4) Comment Letters (5 minutes)
5) SOA Research Project (5 minutes)
6) Recent Progress (10 minutes)
7) Implementation (10 minutes)
8) Q&A (10 minutes)

IASB

- Formed April 1, 2001, assuming standards setting from IASC
- 15 international members (4 from USA)
- Actions taken at monthly meetings
- Staff is located in London and most meeting take place in London
- www.IASB.org

IFRS in the US

- SEC has already decided that foreign companies no longer need to reconcile IFRS based financial statements to US GAAP
- SEC has published a roadmap that could lead to a decision to require US companies to report under IFRS
- FASB and IASB have a Memorandum of Understanding to converge IFRS and US GAAP
- FASB is working with IASB on new Insurance Standard

FASB

- Formed 1973
- 7 members (3 are new)
- Actions taken at weekly meetings
- Staff is located in Connecticut and most meeting take place in Connecticut (or London)
- SEC delegates standard setting to FASB
- www.FASB.org
Timeline

- IASB
  - Spring 2007 – Phase II Discussion Paper
  - July 2010 – Insurance Standard Exposure Draft
  - June 2011 – IASB Insurance Standard
  - 2014 or 2015 – Insurance Standard Effective
- FASB
  - September 2010 – Insurance Discussion Paper
  - June 2011 – FASB Exposure Draft
  - ? – FASB insurance Standard
  - 2014 or 2015 – Insurance Standard Effective

IFRS Insurance Project Objectives

- Reduce diversity of accounting practices that currently exist for insurance contracts
- Align insurance accounting with other business sectors, where possible
- Increase users’ understanding of insurance financial statements
- Help investors make decisions

Overview of Exposure Draft

- Principles-based approach with additional guidance
- Reflects the economics of insurance contracts
- Based on insurance contracts, not insurance companies

Goals of Exposure Draft

- A measurement model that focuses on the drivers of profitability and uses current estimates of cash flows
- Presentation of information about insurance contracts that reflects the changes in those drivers
- Consistent accounting for embedded options and guarantees in insurance contracts
- Consistency with market inputs, such as interest rates
- A coherent framework for dealing with complex and future insurance contracts

Measurement: Four Building Blocks

- Current estimate of future cash flows
- Time value of money
- Risk adjustment
- Residual margin
- For short-term contracts, required to use unearned premium liability as alternative model
  - The current P&C pre-claims model seen as working fairly well
Current Estimate of Future Cash Flows

- Current
- Unbiased
- Explicit
- Probability weighted
  - Expected value (mean), not “best estimate”
  - Number of scenarios depend on product

Acquisition Costs

- The ED limits acquisition costs to incremental at a policy level and only for successful sales
- This is more restrictive than other cash flows which are to be based on a portfolio of similar contracts

Time Value of Money

- Consistent with current observable market prices
- Exclude factors not present in the insurance liability
  - Independent of assets held unless obligation is a direct function of a set of assets
- Guidance in ED is risk free plus adjustment for illiquidity
- Any discounting would be a change for P&C

Risk Adjustment

- The maximum that the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flow exceed those expected
- Designed to take into account that insurers/investors have a preference for an expected cash flow of 10 with a standard deviation of 1 versus an expected cash flow of 10 with an expected deviation of 12
- Remeasured at each period
- Not a PAD

Measuring Risk Adjustment

- ED limits methods allowed to calculate Risk adjustment to:
  - Confidence interval
  - CTE
  - Cost of Capital

Residual Margin

- Residual Margin is the plug so that there is no profit at issue
- The IASB Discussion Paper allowed a profit at issue, but insurance industry generally supported not allowing profits at issue
- Residual Margin is locked in at issue and is amortized over the coverage period of the insurance contract.
Presentation of Income Stmt

- Summarized Margin
- Expected cash flows are not part of income statement
- Release of Risk Adjustment and Residual Margin equals Underwriting Margin
- Add experience adjustment for current period plus changes in estimates for future periods to get Underwriting Results
- Add investment income minus interest on insurance liability to get to Profit

FASB Discussion Paper

- IASB and predecessor organization has been working on an insurance standard since 1997. FASB started in 2008
- FASB wanted to get users opinion on whether the proposal was an improvement on current GAAP
- FASB had certain areas where they disagreed with the IASB

Differences from IASB

- Composite Margin instead of Risk Adjustment plus Residual Margin
  - Concerned about reliably measuring the Risk Adjustment
- Amortization of Composite Margin would take into account that risk adjustment is part of CM and the CM would need to also cover the claims period

Comment Letters

General comments

- Support for building block approach
- Most believe ED is a significant improvement over the IASB 2007 Discussion Paper
- The are specific issues with each of the building blocks
- There is general, but not unanimous, support for a current measurement model

Issues for Redeliberation

- Volatility in profit and loss
- Discount rate
- Residual vs Composite Margin
- Remeasurement of Residual Margin
- Unbundling
- Presentation
- Short duration contracts
- Probability weighted cash flows
- Transition rules
Comments specifically to FASB

- Produce a converged standard
- Resolve any differences between IASB and FASB
- Problems with the discount rate
- Many supported the Composite Margin but did not like the proposed amortization
- Didn’t like the summarized margin presentation

SOA Research Project

SOA Research Project

- Financial Reporting for Insurance Contracts Under Possible Future International Accounting Standards
  November 24, 2010
- 2011 Extension – Discount Rates, Subsequent Measurement of Margins, and Expenses
  March 16, 2011

High Level Observations

- The relative size of the Risk Adjustment is small
  - Only liability risks, not asset risks
- The relative size of the Residual Margin is large
  - Overhead expenses
  - Other acquisition expenses
  - Asset risks
  - Taxes
- Assumptions affect amortization of Residual Margin
  - Benefit pattern vs coverage pattern
  - Interest

Pursue New Standard

- On February 9, 2011, FASB voted to pursue a new insurance standard based on a converged view with IASB
- Decision was unanimous
Expenses

- Increased the amount of maintenance expenses that would be part of the model and decreased overhead
- Increased the amount of acquisition costs that would be part of the model by basing them on a portfolio of policies. The IASB voted to include expenses for both successful and unsuccessful sales. The FASB stuck with only successful sales

Discount Rate

- Confirmed that discount rate should reflect the characteristics of the liability
- Final Standard will not prescribe method for determining discount rate
  - Consistent with observable rates but excluding insurer’s own credit risk
  - Reflect only risks and uncertainties not reflected elsewhere in the measurement of liabilities
- Top-down can be used as well as bottom up

Risk Adjustment

- Both IASB and FASB agreed the inclusion of a Risk Adjustment would be relevant
- This is a change for FASB
- Caveat that there must be techniques that could faithfully represent the risk inherent in the insurance liability

Discounting Insurance Liabilities

- Don’t need to discount if effect is immaterial
  - P&C pre-claims UEP
  - Short duration claim reserves
- Long term P&C claims should be discounted for time value of money

Implementation

Probability Weighted Cash Flows (Mean)

- Must capture option costs
  - Term, SPIA – single scenario
  - UL, SPDA – must capture floor on crediting rates
  - Variable products – stochastic to capture cost of guarantees
- Current assumptions
  - Experience studies
  - Expense studies
  - Ability to update model assumptions at each valuation date and describe the financial impact of individual changes
Discount with Current Interest

- Bottom up – risk free rate plus illiquidity spread where the illiquidity spread may vary by liability portfolio
- Top down – model asset portfolio (not same as cash flow testing)
  - Make deduction for credit spread and other deductions
  - Goal is a yield curve for each major currency you do business in
  - Deductions, and therefore yield curve, may vary by liability portfolio
- Reference rate

Residual Margin

- Residual Margin is only assumption that is locked in (although re-measuring is being discussed)
- Allocate down to policy level?
- Run off over life of the contract
- If Composite Margin, then need to take release from risk into account with run off

Presentation

- Will be a significant change from current practice if the Boards stay with Summarized Margin

Disclosures / Explanations

- Possible use of a database
- New canned reports

Questions?