

Reactions to the IASB and FASB Insurance Contracts Papers

January 3, 2011



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Reactions to IASB Insurance Contracts Paper Webinar Webinar
January 3, 2011

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Agenda

- Welcome (5 minutes) Rowen Bell
- IASB and FASB proposals (10) Rowen Bell
- Academy's responses to IASB and FASB (20) William Hines
- IASB comment letters (30) Tom Herget
- Recent activities (10) Marc Oberholzer
 - Insurance Working Group
 - Round Tables
- Timetable ahead (5) Marc Oberholzer
- Questions and answers (10)



Speakers

- Rowen Bell, FSA, MAAA
 - Outgoing Chair, Financial Reporting Committee
 - Former Academy Director
 - 2010 Jarvis Farley Service Award winner

- Tom Herget, FSA, MAAA, CERA
 - Chair, Solvency Committee; member, Financial Reporting Committee
 - Former Academy Director
 - SOA Insurance Contracts study POG chair



Speakers (cont'd)

- William Hines, FSA, MAAA
 - Incoming Chair, Financial Reporting Committee
 - Outgoing Chair, IFRS Task Force
 - Member, IAA Insurance Accounting Committee

- Marc Oberholtzer, FCAS, MAAA
 - Director, American Academy of Actuaries
 - Member, Financial Reporting Committee; IFRS Task Force
 - Member, IAA Insurance Accounting Committee



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IASB and FASB Proposals

Rowen Bell, FSA, MAAA

Outgoing Chair, Financial Reporting Committee



IASB and FASB Proposals

- IASB objective: Replace IFRS 4
 - Discussion Paper (2007)
 - Exposure Draft (July 2010)
- FASB objective: More unstructured
 - Participation in IASB insurance project relatively recent, driven by interactions with other projects as well as convergence considerations
 - Endgame could be full convergence with IFRS 4 replacement, or could be more incremental in nature
 - Discussion Paper (September 2010)



IASB Exposure Draft

- Applies to insurance contracts, not insurance entities
- Comprehensive measurement approach using four building blocks:
 - Current estimate of future cash flows
 - Discounting
 - Explicit risk adjustment
 - Residual margin (if needed to avoid gain at issue)
- Modified approach (premium allocation) for pre-claims liability of some short-duration contracts



IASB Exposure Draft (cont'd.)

■ Cash flow projections

- Explicit, unbiased, and probability-weighted estimate
- Current (i.e., no locking of assumptions)
- Reflect existing contract only unless renewal is required and repricing is constrained (requires a definition of contract boundary)
- Fulfillment-based (i.e., cash flows involved in fulfilling contract)

■ Acquisition costs

- Immediately expensed and then offset by premiums included in liability measurement
- But: Defined as being incremental to the *contract*, not incremental to the *portfolio*



IASB Exposure Draft (cont'd.)

- Discounting
 - Rate reflects characteristics of insurance liability
 - Risk-free rate plus an adjustment for illiquidity
- Explicit risk adjustment
 - Stated principle is, maximum amount insurer would rationally pay to be relieved of risk that ultimate cash flows will exceed expected
 - Three acceptable techniques only:
 1. Confidence level
 2. Conditional tail expectation (CTE)
 3. Cost of capital



IASB Exposure Draft (cont'd.)

- Residual margin (in pre-claims liability only)
 - Amortized over coverage period
 - Accretes interest
- Modified approach, *aka* premium allocation
 - Mandatory alternative to four building block approach, for pre-claims liability of contracts whose coverage period is at most 12 months
 - Analogous to an unearned premium reserve (P&C, not health) but accretes interest and premiums are discounted



IASB Exposure Draft (cont'd.)

- For contracts valued under main model, income statement would use a *margin approach*
 - Revenues and expenses not shown on income statement
 - Income statement line items would include:
 - Change in risk adjustment margin
 - Change in residual margin
 - Experience adjustment
 - Change in estimates
 - Accretion of interest
- A more traditional *premium approach* would be used for contracts valued using the modified approach



FASB Discussion Paper

- In their “joint” deliberations, FASB majority not always aligned with IASB majority
- FASB prefers a one-margin approach (composite margin) over the IASB’s two-margin approach (risk adjustment + residual margin)
 - Composite margin would not accrete interest and would be amortized over coverage and claims handling periods
- FASB has not taken a position on the modified approach



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Academy's Response to IASB and FASB

William Hines, FSA, MAAA

Incoming Chair, Financial Reporting Committee



Academy Response to IASB ED & FASB DP

The Academy's International Financial Reporting Standard (IFRS) Task Force sent comment letters to the IASB and FASB on November 30, 2010. The Academy responses referred to in the following slides refer to the IFRS Task Force letters. The letters are available on the Academy website:

<http://www.actuary.org/financial.asp>



Academy Response to IASB ED & FASB DP

- Interaction with Financial Instrument standard
- Estimates of future cash flows
- Discount rate
- Risk adjustment
- Residual margin
- Acquisition costs
- Modified measurement approach
- Contract boundary



Academy Response to IASB (cont'd.)

- Unbundling
- Ceded reinsurance
- Transition requirements



Interaction with Financial Instrument Standard

- Financial statements that faithfully reflect the economics of a business must measure assets and associated liabilities on a consistent basis
- Accounting mismatches can cause:
 - Income to be more volatile than economic reality
 - Reported equity amounts that significantly under or overstate the true economic level of capital
- Academy Position: Insurance contracts and associated assets need to be measured on a consistent basis in order to produce relevant financial statements.



Estimates of Future Cash Flows

- ED & DP limit cash flows to those that are incremental
 - At the contract level for acquisition expenses,
 - At the portfolio level for everything else
- How distribution and underwriting costs are incurred will impact valuation
 - Liabilities for contracts sold by salaried agents will be higher than liabilities for contracts sold by agents compensated entirely through commissions
- Academy Position: Measurement of insurance contracts should include all relevant future cash outflows less inflows that will arise as the insurer fulfills the contract



Estimates of Future Cash Flows (continued)

- Application guidance focuses on stochastic analysis when defining statistical mean values
- Concern that wording overemphasizes the term “probability-weighted” and may imply that identification of and assigning probabilities to every scenario of commercial substance may be required
- Academy Position: The objective should be to estimate the mean value. There are many techniques that can be used to estimate the mean of a distribution and preparers should not be restricted in their approach



Estimates of Future Cash Flows (continued)

- Many long duration insurance contracts have liability cash flows that depend on the performance of the underlying asset portfolio
- Academy Position: Estimates of future cash flows and interest rate used to discount those cash flows should reflect the dependence within each scenario



Discount Rates

- ED & DP state that discount rate should reflect the characteristics of the contract being measured
- ED & DP require starting with risk-free rate and adjusting for differences in characteristics between risk-free instruments and insurance contracts
- ED & DP note only one difference: liquidity



Discount Rates (continued)

Academy Position:

- Discount rate should reflect all characteristics of the contract being measured
- There are multiple ways to arrive at an appropriately risk-adjusted expected present value of cash flows – the ED identifies only one method
- Could start with expected earned rate and adjust downward to arrive at the same theoretical discount rate
- The methods should not be limited



Risk Adjustment - Objective

- ED defines risk adjustment as the maximum amount the insurer would rationally pay to be relieved of the risk the ultimate cash flows exceed the expected cash flows
- Academy Concerns:
 - Objective does not fully reflect the uncertainty in the future cash flows
 - Objective does not appear to capture timing risk
 - The term “maximum” may be misinterpreted



Risk Adjustment – Objective (continued)

- Academy Position: Restate objective as:

The risk adjustment should depict an amount the insurer would rationally pay to eliminate the uncertainty about the timing and amount of the ultimate cash flows, where the insurer is indifferent between paying such an amount that is certain versus paying the uncertain cash flows.



Risk Adjustment – Techniques

- ED proposes to limit the techniques used to calculate the risk adjustment
- Academy concerns:
 - Other techniques are available and used in practice
 - The three allowable techniques may not work in all situations
 - Applying multiple methods may be desirable (generally required for US casualty actuaries via ASOP 43)
 - Comparability will not be achieved by limiting techniques; confidence level and underlying assumptions not specified
- Academy Position: Do not limit techniques



Risk Adjustment – Level of Aggregation

- ED proposes to measure risk adjustment at a portfolio level of aggregation (i.e., a group of contracts that are subject to similar risks and managed together as a pool)
- ED prohibits reflecting diversification across portfolios in risk adjustment



Risk Adjustment – Level of Aggregation (continued)

- Academy Position:
 - Insurers should be allowed to reflect the impact of diversification across portfolios when it has a discernable impact on the risk adjustment included in the measurement of the insurance liabilities and that company reflects that diversification in product pricing
 - Diversification across portfolios is reflected in pricing of many products
 - If diversification is not reflected in measurement of risk adjustment, liabilities may be overstated in aggregate



Risk Adjustment – Application Guidance

- ED defines criteria that risk adjustment must satisfy in order to meet objective
- Academy Position: The specified criteria are appropriate and should be considered, but they are not sufficient to meet the objective



Residual Margin

- ED requires calibration of residual margin such that no gain is recognized at issue at a portfolio level
- Academy Position:
 - We agree that calibration should be at the portfolio level provided that incremental acquisition expense is defined at the portfolio level as well
 - This is consistent with how products are priced and managed
 - Prices reflect recovery of acquisition costs for contracts not taken
 - Amortization should be over the coverage period



Acquisition Costs

- ED & DP define incremental acquisition costs at the contract level – anything that would not be paid if that contract were not issued
- Academy Position:
 - Measurement should reflect all relevant cash flows
 - Defining incremental at the contract level ignores pooling concept – i.e., pricing at a portfolio level
 - Pooling is referenced in ED to support portions of valuation model – but not for treatment of acquisition costs
 - Companies with different distribution systems will hold different liabilities for the same contract



Modified Measurement Approach

- ED & DP require use of modified measurement approach for short duration contracts
- Academy Position:
 - Modified approach should be allowed but not required
 - Modified approach as specified is overly complex; should allow use of traditional unearned premium methods



Contract Boundary

- ED & DP propose contract boundary principle linked to when the company has the practical ability to re-price a product based on the individual policyholder
- Academy Position:
 - Proposed principle works well for most life and annuity contracts
 - Principle may cause difficulties for rate regulated business (e.g., non-renewal and premium rate restrictions)
 - Reference to portfolio of contracts priced together is better than reference to individual policyholder
 - Issues may still exist with the proposed definition



Unbundling

- ED & DP propose to require unbundling for certain contracts including any contract with an explicit account value where investment earnings are fully passed through to the account value
- Academy Position:
 - Support unbundling for presentation if it would produce meaningful information
 - Support unbundling for measurement in cases where two otherwise independent contract were put together for non-economic reasons
 - Support unbundling if it achieves better accounting match



Ceded Reinsurance

- ED & DP require use of expected loss model
- Academy Position:
 - We support expected loss model as it closely aligns with current fulfillment value
 - Concerns regarding valuation of reinsurance asset:
 - Treatment not specified for modified measurement model
 - Presentation should not be in a single income statement item, but should show impact on each income statement line item
 - Valuation needs to be consistent with valuation of underlying contracts



Transition Requirements

- ED specifies that existing business at transition will be measured without a residual margin
- Academy Position
 - Not including a residual margin will unfairly portray existing business as having no expected profit other than release of risk adjustment
 - Expected future profits will be much higher on new business than on existing business
 - Existing business must include residual margin
 - No consensus on method to derive residual margin for EB



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Comment Letters to IASB

Tom Herget, FSA, MAAA, CERA

Chair, Solvency Committee

Member, Financial Reporting Committee



Comment Letters to IASB

- 234 comment letters
- Selected from the most recognizable and most active names
- The letters themselves are 20 to 30 pages long; what follows are highlights from executive summaries
- The concerns identified are not all issues listed in each letter; I have attempted to extract the concerns that are identified by many parties



Deloitte

- Coordinate with IFRS 9 (assets at either AC or FV)
- Whatever is used to value assets won't align with rates used to discount liabilities
- RM – unlock
- Discount rate – used asset-based, allowing for defaults
- Unbundling – modify, clarify
- RA – restate its objective
- RA – allow calculation at portfolio level to accommodate diversification
- Do more field testing



Ernst & Young

- Be sure to converge with FASB
- Discount at high-quality corporate bond rate rather than risk-free rate
- Allow option to use volume-based items (premiums, claims) in income
- Simplify onerous contract test if short-term modified measurement model is used
- RM – unlock
- Transition – future profitability will not be fairly represented



KPMG

- Volatility – unlocking assumptions for CE and RA without unlocking for RM
- Volatility – discounting at rates less than those used for pricing
- Volatility – discounting at fluctuating current rates
- Transition – no RM
- Presentation – is summarized margin really relevant?
- RA – don't limit (to three) the techniques
- Timing – OK to delay introduction of final standard
- Conduct further field testing



PwC

- Artificial day one losses caused where insurer priced products using rate of return greater than risk-free rate
- Allow option for locked-in liability discount rate (to align with AC feature of IFRS 9)
- RM – amortization
- RA methodology freedom causes incomparability between companies
- RM – not remeasured
- Unbundling – needs clarification
- Transition – need RM on existing business
- Field testing – do more; OK to push back timeline



AICPA

- IASB and FASB should work together to issue identical standards
- Discount rates within IASB initiatives are inconsistent
 - Insurance – risk free plus illiquidity
 - Pensions – high-quality corporate bonds
 - Leasing – incremental borrowing rate
- RA definition is unclear which will result in inconsistent presentation and lack of comparability
- Unbundling definition is unclear
- Need volume indicators (premiums, claims) in the presentation statement, not as footnote
- Transition: allow future profits on existing business



MetLife

- Assets and Liabilities at Amortized Cost
- Lock in CE assumptions at issue with subsequent loss recognition tests
- Discount rate – use pricing rate
- Presentation – use premiums and claims
- RM & RA – combine into Composite Margin
- Two models – short term (P&C) and long term (life insurers) have different business models; let there be two accounting models



RGA

- Discount rate – using (lower) rates not linked to policyholder pricing will lead to product withdrawal
- Discount rate – use of current curves with amortized cost assets will lead to volatility in earnings
- Discount rate – too much inconsistency in selection of illiquidity adjustment. 2008 MCEV disclosures showed companies varied illiquidity premiums from 0 to 300 basis points
- RA definition – The “maximum amount the insurer would rationally pay to be relieved of the risk” is somewhat nebulous
- Unbundling – not well-defined; costly to account; little value to users
- Presentation – wants premiums, claims
- Disclosures – complexity and extensiveness reduces usefulness. Readers will be overwhelmed with these disclosures. Disclosures will be expensive to prepare. Should pare back.
- Transition – need RM on all business. Otherwise inconsistent results will appear for many years



GNAIE

- Need separate models for long-term (life) and short-term (P&C) business
- Long-term – long duration, asset/liability relationship, known payment, single loss, reliance on investment income
- Short-term – short duration, payment not known, multiple chances for loss, investment income not as relevant
- Different capital requirements, RBC and regulatory reporting forms
- Modified approach for short term products isn't materially simpler, distracts from key measurement of claim rates and shouldn't use interest discounting
- Coordinate financial instruments (IFRS 9) and this project.
- Use a risk-adjusted asset portfolio rate for discounting since performance of life and annuity contracts are inextricably linked to earnings on assets; ignoring asset returns will cause distorted earnings and potentially cause withdrawal of products
- Prefer CM, not the RA plus RM
- If RA is used, allow more than three methods
- At transition, do allow RMs on existing business
- Retain key indicators (premium, claims) in income statement
- No unbundling except for derivatives and other items not closely related to the insurance policy



US Managed Care companies

- Joint letter from Aetna, Cigna, Humana, United & WellPoint
- Please converge with FASB
- Slow down; no need to rush to complete; field test
- Current (US GAAP) short-term model is working; don't change it
- Use actuarially-determined mean rather than probability-weighted cash flows for CE
- Combine RA and RM; RA itself implies false precision
- Margin information should be in footnotes, not performance statement
- Transition – alarmed that all profits on existing business would be in the past



Manulife

- Discount rate – generates false positives and false negatives
- Discount rate – use of risk-free rate plus illiquidity won't let users judge if company can fulfill its obligations
- Discount rate – investment portfolios will gravitate to mirror assets used for discount rate, significantly narrowing the diversity of the portfolio and creating unnatural demand
- Unbundling – limit to separate account products
- Expenses – expand includable acquisition and maintenance costs
- Presentation – let margins be an analytic; replace with premiums and claims
- RM – eliminate; OK for day one gain
- Transition – include RM for existing business



Canadian Life & Health Assn.

- Discount Rate problems
 - Not tied to asset earnings capacity
 - Different discount rates for assets and liabilities
 - No yield curve for longer periods
 - Lack of guidance for illiquidity adjustment
 - Failure to reflect reinvestment risk
- Discount rate consequences
 - Volatility, volatility, volatility
 - Results: unreliable, irrelevant and difficult to explain
 - Leads to unintended consequences to consumers and economy
- RA – allow more than three
- Don't limit expenses – both acquisition and ongoing
- Transition – where is RM?
- Need second exposure draft with quantitative impact studies



UK actuarial profession

- Institute and Faculty of Actuaries
- Add liability for undistributed par earnings (90/10)
- RA – why advocate method such as CoC if you have to do a CI (which may be unrealistic) anyway?
- Undesirable to exclude general overhead from CE – will exacerbate future losses for companies closed to new business
- Transition – require RM for existing business



Four European reinsurers

- Munich, Hannover, Swiss Re, Mapfre
- Presentation – put changes in financial assumptions in OCI
- Diversification – don't restrict RA to the portfolio level
- Measurement – short term market movements that are not representative of long term performance should neither be mixed with nor presented as key performance indicators; this introduces artificial volatility



CEIOPS

- Unbundling – do only if it produces more relevant information
- Illiquidity premium – not needed, as illiquidity has already been baked in by use of all possible scenarios
- Make clear under which circumstances (e.g., exact matching in all scenarios) replicating portfolio techniques may be used
- Incremental costs – make them at the portfolio, not contract, level
- Presentation – will need explanation; any way to include volume indicators (premium, claims)?
- Transitional provision – don't set RM to zero on existing business
- Income statement volatility – needs both assets and liabilities discounted on a market consistent basis



CFO Forum

- Need another ED; June 2011 is too soon to address all issues
- Need field testing
- Need to reflect insurer's business models; IFRS 9 did this for banks (e.g., if assets are at AC, then liability discount rate should be locked in)
- Unbundling – needs clarification
- Transition – lack of profits on in-force portrays insurance as a start-up business
- Presentation – not suitable for short-term contracts



Institute of Actuaries of Japan

- Discount rate – illiquidity adjustment is inadequate to measure longer-term risks
- Include non-incremental overhead costs in CE
- RA as defined is confusing
- RM should be re-measured
- Transition – need RM for existing business
- Presentation needs to include premiums and claims
- RA methods – why do CofC or CTE if you have to do CI anyway?



International Actuarial Association

- Doesn't produce transparency
- Magnifies accounting mismatches
- RA – provide an explicit objective
- Acquisition costs – include all
- RM – please revisit for dynamic and better amortization
- Unbundling – tighten definition
- Transition – lack of RM misrepresents economic reality



International Association of Insurance Supervisors

- Three-fold interest:
 - Methodologies for calculating items in general purpose financial reports can be used for, or are substantially consistent with, the methodologies used for supervisory reporting purposes
 - Accounting results drive management behavior and supervisors would be concerned about any accounting requirements that may potentially incent management not to act in the interests of policyholders
 - Accounting requirements which might lead to outcomes in general purpose financial reporting of insurers that could pose a threat to global financial stability
- Discount rate will cause constant, unwarranted gains/losses when not much has changed in the long-term perspective; non-economic volatility
- Need field testing



Corporate Reporting Users' Forum

- CRUF (buy and sell side analysts)
- ED is too balance-sheet focused
- Presentation – impacted by too many short-term events
- Principles-based is laudable but need more guidance (if not rules) so results between companies are comparable
- IF CE and RA are unlocked, so should RM
- Want a single method for RA, preferably CofC
- Transition – existing business should be accounted for the same way new business is
- Allow for more field testing



IASB outreach

- Needs: Most recognized need to reduce diversity allowed by IFRS4; US GAAP for life insurers can be confusing; US GAAP for P&C insurers continues to work
- Timetable: many say June 2011 is too soon and artificial; some say more field testing is needed, more deliberation and clarity needed
- Items for Redeliberation: on following slides



IASB outreach – Items for Redeliberation

- Volatility caused by:
 - Most report assets at FV; all its volatility goes through profit/loss, not OCI
 - Fluctuation in credit spreads on assets not matched with corresponding changes in insurance liability
 - Use of current risk-free plus illiquidity rates
 - If you use AC for assets as permitted by IFRS9, still get volatility



IASB outreach – Items for Redeliberation

- Risk Margin, Risk Adjustment, Composite Margin
 - Many want a CM
 - RA implies undue precision
 - RA definition implies an exit value but we are doing fulfillment value
- Presentation
 - Most are uncomfortable about eliminating premiums, claims and expenses
 - Few insurers would be in Fortune 500
 - Some users want more information about “free cash flow”



IASB outreach – Items for Redeliberation

- Non-life
 - Needs work
 - Most believe the non-life modified approach has been over-engineered
 - Many believe onerous test should be at higher level of aggregation
 - One-year cutoff for contracts is too short



IASB outreach – Items for Redeliberation

- This outreach summary document states participating business should not use investment portfolio rate
- RA methods – some say principles only so that new methods can be used; others say the wide variety will eliminate the ability to compare companies
- Unbundling: unclear; “closely related” needs to be better understood; it will be costly
- RM – amortization method and unlocking needs to be revisited
- Acquisition costs have been too narrowly defined
- Many concerns about volume and complexity of disclosures
- *No one* agreed with lack of RM for existing business at point of transition



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Recent Activities and Future Timetable

Presented by Marc Oberholtzer, FCAS, MAAA
Director, American Academy of Actuaries
Member, Financial Reporting Committee



Key Dates and Recent Activities

- July 2010 – IASB Exposure Draft
- September 2010 – FASB Discussion Paper
 - November 2010 – IASB Insurance Working Group
 - Discussion around interest rates issues, risk adjustments, margin amortizations, many other issues
- December 2010 – FASB/IASB Public Roundtables
 - Tokyo, London, Norwalk CT
 - Discussion of key topics, part of extensive outreach program



FASB/IASB Roundtable

- Participants include preparers and users, actuaries, auditors, regulators, trade groups
- Focus on:
 - Probability-weighted expected cash flows
 - Discount rate
 - Unbundling
 - Composite margin versus risk adjustment and residual margin
 - Modified approach for short duration contracts
 - Presentation



Expected Timetable for Project

- IASB – Steps in 2011 to finalize the standard
 - January – Discount rate education session
 - February – Unbundling education session, discussion re: risk adjustment, margins, presentation
 - March – Contract boundaries, margins, follow up other items
 - April – Scope/definition, short duration contracts, reinsurance
 - May – Transition and effective date
 - June – Final Standard
- Effective date – 2013? 2014? 2015?
- FASB Plans?



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Questions and Answers

