IFRS Task Force presentation to NAIC

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Agenda

- The U.S. actuarial profession's international activities
- Initial reaction to IASB Discussion Paper (DP)
- Initial reaction to FASB invitation to comment

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International Activities

– The Academy has formed a task force that will comment on both IASB and FASB documents.
– The Society of Actuaries has a project underway to measure the effect of the proposals on U.S. L&H products.
– U.S. actuaries are working with the International Actuarial Association on their response.
  - Also developing a paper on current estimates and risk margins (Appendix E and F of DP)

Problems with the Building Blocks - 1

- Explicit, unbiased, market-consistent, probability-weighted, and current estimates of the contractual cash flows
  - Not possible to do all “possible” scenarios
    - Even mathematical models exclude certain alternatives at the ends
  - Need to be able to use approximations, particularly for quarterly statements
  - Not clear what an entity - specific vs. portfolio - specific expense is (e.g., impact of health insurer provider discounts on incurred claims)
  - Probability-weighted doesn’t apply for many well-accepted non-life claim liability estimation methods

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Problems with the Building Blocks – 1 (Cont.)

- Explicit, unbiased, market-consistent, probability-weighted, and current estimates of the contractual cash flows
  - Market-consistent may not exist or be reliable or relevant
    - For non-life, important variation between:
      - settlement strategies,
      - processing systems
      - claim estimation approaches
      - claim incurral dating practices
      - underwriting criteria
      - markets
      - etc.
    - Makes use of industry and/or external data typically suboptimum

- Goal should be to use best estimates of future cash flows for the company – stochastic when needed to value options, etc.

- We think we know what is needed and want to avoid auditor conflicts over unclear guidance.

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Problems with the Building Blocks - 2

- **Current market discount rates that adjust the estimated future cash flows for the time value of money**
  - Does using “market” discount rates mean risk-free?
    - If so, many products may show non-economic losses at issue
  - Need to be able to discount at expected rates when benefits reflect returns (every life product except non-par traditional products)
  - Need to be able to use scenario-based rates, not a set of rates at date of valuation

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Problems with the Building Blocks - 3

- **An explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)**
  - No market information in general after initial issue
  - No agreed- upon methodology
    - Casualty Actuarial Society study (*Fair Value of P&C Liabilities: Practical Implications)* showed determining one methodology can lead to very different results.
  - Should not specify one methodology
    - Cost of capital as defined in Solvency II may not be appropriate for accounting – concern with gains at issue
    - Quantile methods more consistent with U.S. L&H historical practice
  - We need to discuss service margin further, but our initial reaction is that it's not necessary except, perhaps, in limited circumstances.

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Eliminate Measurement Restrictions

- Should include all future cash flows from current contracts
- Eliminating certain flows changes objective of measurement – not market consistent or true exit value
- Applies to premiums, policyholder dividends, non-guaranteed elements

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Measurement Attribute

- Current exit value can be okay, although the words can cause confusion – needs better definition
  - Not a run-off situation – must be a going concern
  - Not really a transaction to another insurer, too many individual issues in each transaction
  - Not a reinsurance agreement since such agreements don't transfer the total liability

Valuation Guidance

- Appendices E and F are too detailed.
- Should rely more on actuarial profession to set standards
  - IAA high level for use in countries without developed actuarial professional organizations
  - Individual countries set what is appropriate guidance for their markets.
    - Different markets and products require different guidance.
    - Actuarial Standards Board and American Academy of Actuaries should provide needed guidance.
    - Need to coordinate with auditor guidance.

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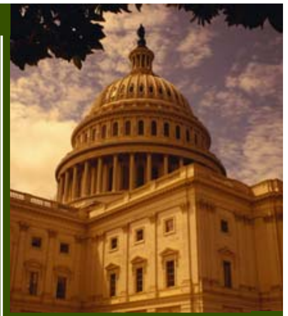
Gains and Losses at Issue



- DP can cause both non-economic gains and non-economic losses due to:
  - Limitations on cash flows
  - Limitations on discount rates.
- Even assuming these are eliminated, margin guidance allows significant gains that may not be appropriate
  - Transfers are not based on statutory minimum capital but on company economic capital requirement.
  - Generally, “profit” on transfer is due to reimbursement of acquisition expenses or expense savings being shared.
    - Other reasons not always involved (e.g., more reliable assumptions or lower margins)
  - Pricing assumes company’s own target capital return and own economic capital – not minimum statutory requirements.
  - CFO Forum estimates over $7 billion in gains are at issue, if margins are based on cost of capital, as in Solvency II (as some are proposing).

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Gains and Losses at Issue (Cont.)

- Will put unhealthy pressure on the estimate to generate gains at issue – reduce reserves and generate increasing sales
- It has been observed that insolvencies generally follow efforts to rapidly grow sales
- We prefer that margins be calibrated to premium as rebuttable presumption – expect that differences will be very rare

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Unbundling

- We see no added value in the IASB's proposal.
- Requirement to show deposit element separately and balance into the total liability would not add useful information.
- We prefer to unbundle only clearly independent cash flows.

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Summary

- An initial reaction is that there are a number of problems that need to be fixed.
- Implementation will not be easy.
- Appropriate guidance is needed to achieve comparability and transparency.

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The FASB ITC – The U.S. Gets Involved

- Some parts of U.S. GAAP, particularly for life, are flawed and need replacement:
  - Problems created by SOP 05-1,
  - Consistent accounting basis without numerous special adjustments
  - Better language to avoid auditor conflicts.
- Start with IASB Paper, but fix it.
- Treat Health Insurance in a cohesive manner.
- Treat policyholder accounting separately.
- Be sure that the insurance contracts project doesn't disagree with other projects – Work in accord.

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