International Accounting Issues

Rob Esson, NAIC & Chair of the IAIS Insurance Contracts Subcommittee

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Overview of presentation

- Outline of the International Accounting Standards Board (IASB) process and development of International Financial Reporting Standards (IFRS)
- What happening in the US
- What the International Association of Insurance Supervisors (IAIS) is doing

The IASB process

- The process has already lasted 10 years!
- IASB has issued a temporary insurance contracts standard, IFRS4, as Phase I. It did not deal with the measurement of insurance liabilities!
- Phase II has started which will result in a final comprehensive IFRS standard.
- A Discussion Paper has been issued with a comment deadline of November 16

Activity in the US

- The US Financial Accounting Standards Board (FASB) has issued an Invitation to Comment (ITC) with the same deadline of November 16
- The ITC asks whether the FASB should join with the IASB in a full joint project
- A joint project would result in a common, or at minimum similar, standard both internationally and for US GAAP

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What the SEC is doing

- The US Securities and Exchange Commission (SEC) has issued a proposed rule to remove the reconciliation requirement from IFRS to US GAAP for foreign registrants from next year
- It has also issued a concept release asking whether US domestic registrants should be permitted to file IFRS statements

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SEC/FASB/IASB

- Imagine if the FASB were to consider NOT joining in a joint project …
- Non-US SEC registrants would be able to file radically different financial statements to US registrants without reconciliation
- This will likely increase the political pressure that a full joint project **will** be undertaken resulting in a global GAAP

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What the IAIS is doing

- The Insurance Contracts Subcommittee (ICSC) has drafted a response to the IASB DP
- At the Zurich meeting of the ICSC 2 weeks ago, the Subcommittee came to an IAIS position on many issues
- But Profit on Inception, Service Margins, and cash flow constraints remain open and a further meeting will be held

IASB DP – main features

- Liabilities measured at "Current Exit Value" or CEV
- While CEV is observable (e.g. market prices) for many securities, stocks etc., it is rarely observable for insurance, and hence a proxy methodology is used instead with three building blocks

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The Three Building Blocks

- "Explicit, unbiased, market consistent, probability weighted and current estimates of contractual cash flows
- Current market discount rates to adjust the cash flows for the time value of money
- Explicit and unbiased estimate of the margin that market participants would require for bearing risk and other services"

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The big issues

- Building block one ought not to be very controversial, but is not necessarily used for life business
- Building block two (discounting) is not used for P&C business in the US – but vote is 21:0 at the two Boards on this issue as money **does** have a time value
- Building block three – no problem! [Joke!]

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Building block 3

- More than anything else, it is the two margins (risk margin and service margin) that are difficult and the reason that the project has already taken 10 years, and will probably take at least another 3 – 4.
- Unless one calibrates to the premium (entry value), the margins are not directly observable

IASB Questions & IAIS Answers

- Q: Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments?
- A: Theoretically yes, but interesting problems with bound but not incepted policies. Conclusion that the benefit is unlikely to outweigh costs. Onerous contracts however should be recognized.

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IASB Questions & IAIS Answers

- Q: Should an insurer use 3 building blocks?
- A: Yes, but … various practical problems: issue of company own expenses; actual probability weighting; service margin a particularly big problem (as it is only a recent ‘invention’ and people have not had time to consider it carefully)

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IASB Questions & IAIS Answers

- Q: What role should the premium play in calibrating the risk margin?
- A: This is basically a profit on inception question! "Exit model is preferable but profit on inception should be recognized only where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities" – IAIS second liabilities paper (missing service margin!)

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IASB Questions & IAIS Answers

- Q: How should beneficial policyholder behavior be handled?
- A: Many at the IAIS believe that it's the wrong question – if one really uses expected cash flows there is no need to consider it. However many would accept a commercial substance test while France & UK favor a guaranteed insurability test

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IASB Questions & IAIS Answers

- Q: Should acquisition costs be expensed?
- A: Yes, and recovery of them does not need to be considered separately if building block 1 is not constrained to any greater extent than ultimately recommended in the previous answer (either commercial substance or guaranteed insurability)

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IASB Questions & IAIS Answers

- Q: Should risk margins be determined at the portfolio level? Should they reflect diversification benefits?
- A: Portfolio level: yes in practice
- A: Diversification: yes to the extent that the market reflects diversification. Any additional diversification should be reflected in capital

IASB Questions & IAIS Answers

- Q: Should reinsurance be measured in the same way
- A: Yes, except for impairment (assets can be impaired but the corresponding liabilities should not be). The IAIS raises the same cost/benefit issues with reinsurance as with the recognition question

IASB Questions & IAIS Answers

- Q: Should deposit and service components be unbundled?
- A: 3 situations – IAIS agrees with two of them, but believes that the IASB answer is wrong for interdependent but non-arbitrary unbundling & wants a more consistent answer for Phase II

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IASB Questions & IAIS Answers

- Q: Should credit characteristics be included in the measurement of liabilities?
- A: **No, no, no!** In the Fair Value Measurement project, the only justification (in FAS157) is a symmetry of assets and liabilities argument – IAIS disagrees very strongly.

IASB Questions & IAIS Answers

- Q: How should discretionary participation features be handled?
- A: “Amounts relating to future policyholder distributions in respect of both the guaranteed and discretionary elements of participating contracts should be treated as liabilities based upon the expected future cash flows” (IASB has problems with this)

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IASB Questions & IAIS Answers

- Q: How should results be displayed in the financial statements?
- A: The answer to this question should be coordinated with the IASB/FASB joint project on financial statement presentation. Additionally, information on relative reliability should be disclosed similar to ‘level 3 of the fair value measurement hierarchy’.

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Other issues

- Differences between deposit floor in IAS39 and a surrender value
- IAIS position is that a surrender value floor is not necessary, but companies should have sufficient financial resources to handle all surrenders

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Questions?

Rob Esson
resson@naic.org
+1 (816) 783 8131