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Insurance accounting: a new era?

Abstract of the Edinburgh discussion

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This abstract relates to the following paper: Foroughi, K., Barnard, C.R., Bennett, R.W., Clay, D.K., Conway, E.L., Corfield, S.R., Coughlan, A.J., Harrison, J.S., Hibbett, G.J., Kendix, I.V., Lanari-Boisclair, M., O'Brien, C.D. and Straker, J.S.K. Insurance accounting: a new era? *British Actuarial Journal*, doi: 10.1017/S1357321712000189

The Chair (Mr G. C. Wood, F.F.A.): This evening's business is a presentation on: 'Insurance Accounting: a New Era?' I have Darren Clay and Kamran Foroughi with me. They are going to do the introduction and positioning of the paper produced by the IFRS working party, before we open to the floor for comments and questions from the audience.

Darren is currently with group finance at Standard Life. He is the actuarial manager for IFRS and EEV. He has been involved with financial reporting throughout his career, and since joining the group finance function in 2006 he has been heavily involved with both embedded value and IFRS reporting. He is a member of the Actuarial Profession's Working Party on IFRS.

Kamran is a senior consultant with Towers Watson in London, and has been with the firm and its predecessor, Tillinghast Towers Perrin, for over 13 years. For the last eight years Kamran has held a number of financial reporting responsibilities in his firm and he was appointed Global Life Financial and Regulatory Reporting Leader from the start of this year.

[Mr K. Foroughi, F.I.A. and Mr. D. K. Clay, F.I.A. introduced the paper in the same manner as the paper was introduced at the sessional research meeting in London on 11 April 2011. The following discussion then took place.]

Mr M. G. Kerr, F.F.A.: I should like to congratulate the authors on a very comprehensive paper, which I am sure will be a very good reference source for all of us who have read it.

I have just a couple of questions for the authors.

I think Mr Foroughi mentioned the FASB developments. I am interested to know how important he thought getting a common approach for both IASB and FASB, which would bring the US offices in, was to the success of this project.

My second question is with regard to annuity cash flows: I was wondering whether you had any thoughts on what the commercial impact might be on the annuity market. Do you think companies will find the annuity market less attractive or do you think they will just maintain their existing strategy and pricing for annuities?

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Mr K. W. McGaughey, F.I.A.: I should like to ask the authors about mismatches given by the measurement in the exposure draft – the economic or accounting mis-match. I wonder whether you would like to give any comments of what you think are the implications. What sort of behaviours the mismatch will drive, whether it is economic or accounting? Will it be driving different behaviours in the investment community, or in the actuarial community, or the wider life assurance industry?

The Chair: I have one question for the authors. I was interested in the terminology used for the residual margin. You were talking about similar time periods and similar periods of coverage. I am not very close to this area myself, but that almost sounds like the US GAAP approach, where you had locked in assumptions for different cohort years. Perhaps worse than that, it is within different products and perhaps different terms within different products and measurements.

I would be interested if that is the way we are going to have to capture the measurement of multiple generations of products in the future.

Mr R. S. Henderson, F.F.A.: I suppose I get slightly depressed with some of the material which comes out from the IASB. I do not know whether people are generally happy with what is proposed for IFRS II or whether the main achievement is simply getting a common standard that can apply globally.

From a UK or European perspective, I would like to see more practical consistency between what has been suggested in Solvency II and what we are seeing in IFRS II.

What I struggle with most are the concepts of residual margin and amortisation. I do not find these intuitive, or helpful, and I wonder if there is any possibility that the IASB will backtrack in this area.

On a minor point in the paper, which I know was written against a changing background: it states that there is no requirement in Solvency II for an analysis of movements. However, the variation of analysis template from EIOPA, VA-C2, looks very much like the EEV income statement and does constitute such an analysis of movements.

I would also have thought that the VA-C2 template was a good starting point for supplementary information in the statutory accounts with, hopefully, relatively few adjustments so there is not a requirement to calculate numbers on multiple bases to satisfy different purposes. You mentioned one such adjustment in the paper, namely the 6% cost of capital rate. I would welcome the views of the authors on how many others there might be.

The Chair: One more issue I would like to enquire about. It is coming back to the residual margin point and also coming back to the basic definition under what is now IAS 39 and the fact that there seems to be this prohibition on recognising any profit on day one.

For those of you young enough to qualify for the Sloan Prize, you probably will not remember the achieved profit methodology to which the industry tried to find agreement. I have to say, philosophically, I liked the concept of matching the amount of profit with the amount of work done.

I have never quite understood the prohibition of this recognition of any form of profit on day one. I am not sure if the authors or anybody in the audience could shed some light on that for me. Perhaps, the authors can pick up on that point at the end of the discussion.

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Perhaps there could be some practical feedback from the audience. Mr Henderson already touched on some aspects, but what about things like allowance for illiquidity premium? We must all have had many practical difficulties setting the valuation rate of interest for our regulatory returns. There have been all sorts of theoretical papers about ways that can be done, and all sorts of interaction with the FSA on appropriate ranges. I would ask for contributions on such practical matters, and whether the folk in the room see it as problematic or not.

Ms C. M. Stewart Roper, F.F.A.: As there is little prescription in terms of discount rates and illiquidity premium, it is going to be hard to get comparability – which must be a focus for any accounting standard. There does not seem to be much that would lead to a very similar view being taken by different companies and different markets. Although possibly in the European market there will be more comparability as companies may use Solvency II as a base.

Turning to participating business: section 6.8 outlines the Profession's comments on the treatment of the estate in the exposure draft including that it "needs clarification". Do you have any feeling whether this is going to move and how it is going to move? It is important to a lot of companies, both mutuals and also former mutuals.

Mr A. T. Pfaff, F.F.A.: As an actuary who is very much steeped in the shifting sands of Solvency II at the moment, there certainly seems to be a growing divergence on certain issues like illiquidity premium and contract boundaries within Solvency II and what is proposed here. This leads to the question: how is that going to impact firms in the context of comparability between figures?

It seems to me that we are creating a mass of figures that are going to be harder and harder to interpret or compare.

Mr D. Gott, F.F.A.: To what extent do you expect there to be a mismatch between assets and accounting liabilities and a mismatch between assets and Solvency II technical provisions?

Following the implementation of both regimes, do you expect there to be a greater focus for companies' risk management functions? Do you think the Solvency II internal models will be fit-for-purpose in order to assess potential accounting mismatches as well? If they are not, does it present problems with the 'use test'?

The Chair: Just for clarification for myself, I picked up from the paper that there was no floor any more. I wonder how that squares with what I thought of as a standard accounting concept of prudence. If the reserve is less than any guaranteed surrender values at any point in time, it does seem as though we do not have to reserve for that shortfall. I would be interested to know if my reading is correct.

If there are no more questions, I should like to ask the authors to respond to quite a number of interesting technical issues. Thereafter we will move to the summing up and closing.

Mr Clay *(responding)*: I can respond to your residual margins question about cohort years. That is exactly where we view it as being – that, because of having to set the residual margin by similar dates of issue and similar contract durations, you will have to bring the residual margin down to a very small cohort of business that may well be a year of issue or even below that for certain contract types. In the paper we say that this can require quite a lot of additional work because you will have

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to do your risk margins and your best estimates at that level in order to be able to set your residual margin, and then you are going to have to track those cohorts of business over the period your residual margins are expected to run off.

There was also a question around how recognition may affect the sale of business in the UK. It is possible that there are certain contract types (e.g., a whole life contract) where the residual margin could cause significant issues, with the way it is currently defined as expected benefits incurred.

How would you actually look at benefits incurred on that basis? Would you defer your residual margin far out into the future, not recognising any profit until well into the expected duration of the contract? There are other contracts, obviously, where that would have a similar approach.

I am not so sure annuities would be one of them in that circumstance because you would have benefits coming throughout the lifetime of the contract. So there you may still get a reasonably swift residual margin release.

Where you have back-ended benefits, you will have back-ended residual margin releases and back-ended profit recognition.

Mr Foroughi (***also responding***): *[What follows is an abridged version of Mr. Foroughi's responding comments. Additional comments were made similar to the responder's comments at the Staple Inn sessional research meeting on 11 April 2011 (see earlier).]* Mr Kerr asked whether a common approach for both IASB and FASB was critical to the success of the project. Getting IFRS and US GAAP to move much closer together would do no harm in the long run to help engage with investor communities, which are increasingly global in nature. However, today within current accounting, US-based investors and European-based investors are used to receiving very different financial results, in a form very different to the proposals for future accounting. During the changes in the coming years, we should take care not to alienate one or both investor groups.

Mr Kerr asked about the annuity market, noting the illustrative example we provide in Appendix B. I agree with Mr Clay's comments. I believe that the onset of EEV/MCEV and UK solvency developments has already challenged the 20th century annuity pricing model, and led to a hardening of the market during the 2000s. The market has survived this challenge and remains robust and innovative. I believe it will similarly survive IFRS ED proposals. But the Appendix B illustrative graph highlights the continuing need for supplementary reporting to communicate more realistic new business metrics to capital providers.

Mr McGaughey asks what behaviours may result from the issues raised by sections 5.4 to 5.8 of the paper. Whenever any accounting or regulatory framework introduces distortions or "accounting" mismatches, companies have a choice whether to manage to the framework or manage to a more realistic position. Managing to the framework leads to low reported volatilities over many periods, but at the extreme can lead to perverse management decisions (which could of course lead to extreme accounting results in the future). Managing to a more realistic position leads to companies needing to explain why reported volatility is accounting in nature and not economic. This tension exists today, and will I believe continue to exist in the future.

Mr Henderson and the Chair both question the merit of the residual margin. From my UK background, I understand their discomfort. However, many UK life insurance actuaries are

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comfortable with the ideas of producing a market-consistent balance sheet and linking the definition of profit to the movement in the balance sheet. We should recognise that around the world there are many investors, accountants and actuaries who are much more uncomfortable about these ideas, particularly recognising significant day one profits when these are uncertain and relate to long-term products. I think of the residual margin as a tool to allow both schools of thought to be represented in a single financial modelling framework, allowing users to apply their own views when analysing the disclosures.

I agree with Mr Henderson and Mr Pfaff's desire to see more consistency between Solvency II and IFRS developments. I do not think there is a chance that the IASB will backtrack on the residual margin concept, but at least it is a clearly identifiable difference that can be easily explained and adjusted for. The paper discusses a number of other potential differences in section 8.3 which do not have such an advantage. I believe that much of the responsibility with these differences lie with the Solvency II standard setters, and you may wish to use the points made in this section in your lobbying.

Ms Stewart Roper recognises the issue with the measurement of participating business. This was a hot topic of discussion at the December 2010 IASB London roundtable where a number of participants (including myself) expressed the need for change. This appears to be an issue faced by mutuals from a number of European countries, not just the UK; I believe this increases the chance of movement by the IASB.

Mr Gott asks whether Solvency II internal models can be used to assess potential accounting mismatches. Just to remind everyone that the internal model aspect of Pillar 1 does not affect the basic Solvency II measurement of assets and liabilities, instead affecting the capital requirements. Whether the Solvency II Pillar 1 measurement of assets and liabilities will be realistic remains to be seen – I personally have doubts and think companies should plan for otherwise. But, in my view, the 'use test' is unaffected, as it does not presuppose that the Solvency II Pillar 1 basis is realistic. There should be room for multiple metrics in management decision making, and of course Solvency II forms an important component.

The Chair raises the question of the deposit floor. The deposit floor is not currently a feature of existing standard IFRS 4 – it is instead a feature of existing standard IAS 39 which applies to contracts classified as investment contracts. Current IASB proposals mirror existing standards in this respect. IFRS 9 will keep the deposit floor, whereas the Insurance Contracts ED does not propose to introduce the deposit floor into insurance contracts measurement.

Finally, on the question of whether prudence is a standard accounting concept, it is interesting to note that the IASB's Conceptual Framework (discussed in sections 2.2.6 to 2.2.11 of our paper) makes clear that prudence is not one of the key characteristics of an accounting framework, given that the deliberate understatement of equity and profit can conflict with representational faithfulness, neutrality and comparability. Perhaps we, as a profession, should ensure our education reflects this recent development.

The Chair: Thank you both. And thanks not just to the presenters, but to everybody else involved in the working party that pulled the paper together. I would not underestimate the amount of work involved.

Thank you for a very useful reference document, a good summary, and a very good summing up at the end. And my thanks to everybody who contributed tonight.

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