

# International Accounting

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## Background to Phase II

- IASB promulgated IFRS4 in 2004 as an interim step prior to the EU adoption of IFRS
- IFRS4 does not alter accounting for insurance liabilities significantly: generally one uses one's local GAAP – so for US would be US GAAP
- Phase II will be a comprehensive solution to insurance accounting
- 10 years in the making ... and counting!

## What's happening now?

- IASB is moving ahead with Insurance Contracts Project with a 2011 completion date
- Exposure draft October 2009
- Comments February 2010
- Standard May 2011
- US might aim to adopt IFRS in 2014 with a stable platform from 2011 – 2014: decision in 2011

## Why is the NAIC interested?

- NAIC is concerned with SAP & regulatory reporting – why should it bother with the IASB?
- US GAAP underlies SAP – if and when US GAAP converges with IFRS, we will need to be involved
- Also, the NAIC is a member of the IAIS, and participates in the IAIS process

## Why is the NAIC interested?

- “The IAIS believes that it is most desirable that the methodologies for calculating items in general purpose financial reports can be used for, or are substantially consistent with, the methodologies used for regulatory reporting purposes, with as few changes as possible to satisfy regulatory reporting requirements”

## IAIS Activities

- Insurance Contracts Subcommittee (ICSC) formed in 2005 specifically to provide input to the IASB on Phase II, Financial Instruments, and Revenue Recognition
- ICSC has provided three Phase II papers to the Board, colloquially known as the first and second liabilities papers, and a response to the IASB’s Insurance Discussion Paper

## IAIS Activities (cont'd)

- The ICSC has also provided input to the Board on Fair Value Measurement and the possibility of wider application of FAS157
- IAIS is an “Official Observer” at both the IASB’s Insurance Working Group (Rob Esson & Henning Göbel) and the IASB’s Financial Instruments Working Group (Rob Esson)

## IASB’s Insurance Discussion Paper (DP)

- IASB issued its DP in May 2007 for comment by November 2007
- 165 respondents – double sided the responses are about 30 inches thick!
- IAIS, including NAIC, responded (with, clearly, the most important and well thought-out response of all ...)
- So ... what did the DP suggest?

## Main Proposals in DP

- Insurance contract attribute “Current Exit Value” or CEV. CEV indistinguishable (as far as anyone knows) from a Level 3 Fair Value measurement
- CEV very rarely observable, so a proxy methodology using 3 building blocks used instead consisting of expected cash flows, a discount for time value of money, and a margin that would be demanded by a market participant

## DP Building Blocks

- explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,
- current market discount rates that adjust the estimated future cash flows for the time value of money, and
- 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)

## IAIS Views - General

- a common reference framework for modelling, until such time as insurance liabilities become directly observable in a deep liquid traded market. The lack of market observability for the vast majority of insurance liabilities causes many of the problems inherent in the project.
- Cash flows should be modelled for the entire contract: DPFs, future premiums – measurement vs. recognition

## IAIS Views – Policyholder Behaviour

- Policyholder behavior: Insurance policies are not treated like fungible financial instruments by policyholders, whether efficient markets theory dictates they should be or not. Consequently, a real world economic view of insurance contracts should take into account reasonable expectations of policyholder behaviour – true probability weighting.

## IAIS Views – Recognition & Measurement

- Recognition & IAS39: a theoretically pure approach to recognition along the lines of IAS39 *probably* not worth it from a cost/benefit standpoint.
- A practical approach to market assumptions and a company's own experience with a particular portfolio.

## IAIS views – Margin Calibration & POI

- "An exit model is preferable but profit on inception should be recognised only where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities." – 2LP
- While IAIS Members are unanimous that losses on inception should be recognised immediately, they differ regarding situations where a profit on inception might possibly arise.

## IAIS views – Margin Calibration & POI

- View 1: pure exit value – premium no more than a piece of evidence – and profit on inception possible
- View 2: exit value for the ‘insurance’ part of the liabilities and the remainder that would be otherwise be POI deferred and run-off in accordance with IAS18
- View 3 (U.S.): rebuttable presumption based on intrinsic measurement error

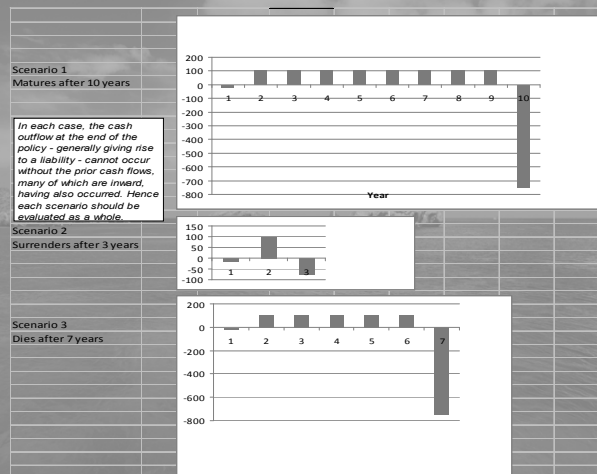
## IAIS Views – Settlement vs. Transfer

- Exit (transfer) value vs. settlement value debate – potentially very relevant
- “Transfers would need to be made to an entity capable of accepting the transfer which ... implies that the transferee would also need to be regulated and capable of **settling** the obligation to the claimant/beneficiary. Any transfer notion would be strongly influenced by the **settlement** obligations that the transferee would undertake” – 2LP

## IAIS Views – Future Premiums

- IASB in a right pickle about this – due partially in IAIS view to muddled thinking
- How do you measure the liability outflow in a long term policy? (Clue – think first building block)

## The reason why ...



## NAIC Views – Own Credit Standing

- Don't get me started! Oh, ok, do ...
- NUTS!, NUTS!, NUTS!
- So, does the NAIC support a reduction in liabilities for a reduction in credit standing of the insurer?
- Lend me a million dollars.
- My credit standing has dropped
- I now only owe you \$900,000. Yeah, right.
- ? Legal for an insurer?

## Other mildly relevant stuff

- Fair values – lots of controversy about these at the moment. Current IAIS view – economic balance sheet
- Revenue recognition – Board voted in a non-binding vote for a customer consideration model: effect on Insurance?
- Performance reporting project – relevance for financial institutions – FIAG: discussion paper just published

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**Questions and – maybe! – Answers**

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