Future GAAP

Doug Van Dam, FSA, MAAA
Principal Consultant
msg global solutions, Inc.

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BACKGROUND

IASB

- International Accounting Standards Board formed in 2000 (FASB 1973)
- IFRS adopted by EU in 2004
- Until EU adopted IFRS, US GAAP was the de facto global standard – needed to report using US GAAP to access US capital markets

Breadth of IFRS

Afghanistan	Bulgaria	Ghana	Liechtenstein	Palestine	Sweden
Albania	Cambodia	Greece	Lithuania	Panama	Switzerland
Angola	Canada	Grenada	Luxembourg	Paraguay	Syria
Anguilla	Cayman Islands	Guatemala	Macao	Peru	Taiwan
Antigua and Barbuda	Chile	Guinea-Bissau	Macedonia	Philippines	Tanzania
Argentina	China	Guyana	Madagascar	Poland	Thailand
Armenia	Colombia	Honduras	Malaysia	Portugal	Trinidad and Tobago
Australia	Costa Rica	Hong Kong	Maldives	Romania	Turkey
Austria	Croatia	Hungary	Malta	Russia	Uganda
Azerbaijan	Cyprus	Iceland	Mauritius	Rwanda	Ukraine
Bahamas	Czech Republic	India	Mexico	Saint Lucia	United Arab Emirates
Bahrain	Denmark	Indonesia	Moldova	Saudi Arabia	United Kingdom
Bangladesh	Dominica	Iraq	Mongolia	Serbia	United States
Barbados	Dominican Republic	Ireland	Montserrat	Sierra Leone	Uruguay
Belgium	Ecuador	Israel	Myanmar	Singapore	Uzbekistan
Belarus	Egypt	Italy	Nepal	Slovakia	Venezuela
Belize	El Salvador	Jamaica	Netherlands	Slovenia	Vietnam
Bermuda	Estonia	Japan	New Zealand	South Africa	Yemen
Bhutan	European Union	Jordan	Nicaragua	Spain	Zambia
Bolivia	Fiji	Kenya	Niger	Sri Lanka	Zimbabwe
Bosnia and Herzegovina	Finland	Korea (South)	Nigeria	St Kitts and Nevis	
Botswana	France	Kosovo	Norway	St Vincent and the Grenadines	
Brazil	Georgia	Latvia	Oman	Suriname	
Brunei	Germany	Lesotho	Pakistan	Swaziland	

IASB Insurance Project Objectives

- Reduce diversity of accounting practices that currently exist for insurance contracts
- Align insurance accounting with other business sectors, where possible
- Increase users' understanding of insurance financial statements
- IFRS 4, the current insurance standard adopted in 2004, accomplished little of the above
  - IFRS 4 gave companies permission to continue current accounting with some additional disclosure

FASB

- 2006 Memorandum of Understanding with IASB
  - 11 original joint projects, 4 have been completed
  - Insurance added later
- 2008 global financial crisis
- G20 pushing for global accounting standards
- FASB was concerned in 2008 that SEC would allow even US companies to file IFRS

SEC Role in permitting IFRS

- Since 2007 U.S.-listed foreign firms have been allowed to file IFRS compliant financial reports with the SEC.
- In 2008 SEC proposed a "road map" to have U.S. firms use IFRS as soon as 2014
- In 2012 the SEC no longer supported full and complete adoption of IFRS in U.S.
- In 2014 "…will consider … whether a single set of high-quality global accounting standards is achievable."

FASB Question 1

- Is there a need for a comprehensive project to redo U.S. GAAP for insurance?
  - Yes – 25
  - No – 4
- In 2008 the FASB decides to work jointly with IASB on insurance

Perceived Problems in US GAAP

- Too many models (FAS60, 97, 120)
- Current models don’t reflect embedded options and guarantees
- DAC is a funny number
- FAS60 change in reserve is hard to explain
- FAS60 assumptions are locked in at issue
- Revenue inconsistent with non-insurance revenue

US GAAP

- From 2008 to 2013 FASB worked with International Accounting Standards Board (IASB) to come up with a global standard on insurance
- In 2014 FASB decided to only make “targeted improvements” in US GAAP

Next Steps for IFRS

- The IASB completed discussions in January, 2016, and is currently drafting IFRS on insurance
- Final standard anywhere from late 2016 to mid-2017
- The final standard will be based on the building block model of the 2013 exposure draft:
  - Current cash flows
  - Discount at a rate consistent with the cash flows
  - Explicit risk margin
  - Contractual Service Margin is the plug so that there is no profit at issue. It is written off over life of contract.
- Targeted effective date is 2020 or 2021

US GAAP P&C DISCLOSURE

FASB Short Duration Disclosures

- The FASB release ASU 2015-09, May 2015
- http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176166047247
- Effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016.
- For non-public entities the amendments are effective one year later

Purpose

- Provide users with more useful information about an entity's claim liability estimates, including:
  - Initial claim estimates and subsequent adjustment
  - Methodologies and assumptions used when calculating the liabilities
  - Timing, frequency, severity, and uncertainty of cash flows
- Increase comparability between reporting entities

The key disclosures required under the ASU are:

- Quarterly reserve roll-forwards
- Annual paid loss and allocated loss adjustment expense (ALAE), and ultimate incurred loss and ALAE development triangles by accident year, for up to 10 accident years, net of reinsurance and reconciled to the carried reserves in the current reporting period
- Current reported claims frequency by accident year including descriptions of methodologies used to determine the claim frequency

Disclosures (continued)

- Current loss and loss adjustment expense (LAE) incurred but not reported (IBNR) by accident year, net of reinsurance, including descriptions of methodologies used to determine the IBNR estimates;
- Explanations of significant changes in methods and assumptions used to calculate reserves and derive reported claim frequency and IBNR; and
- Average annual percentage payout of incurred claims by age of accident year.

Quarterly roll-forwards

- Beginning unpaid claim liability balance, gross of reinsurance, amounts ceded to reinsurance and then the net of reinsurance amounts
- Incurred claims in the period, net of reinsurance, with current accident year and changes to prior accident year liabilities shown separately
- Paid claims in the period, net of reinsurance, also having current year and prior year shown separately
- Ending unpaid claim liability, net of reinsurance, amounts ceded to reinsurance and then gross of reinsurance

Interim Period Reporting

The key changes from the annual table are:

- The roll-forward will have a year-to-date presentation, with the beginning balance being the prior year-end unpaid claim liability and the paid and incurred amounts being the year-to-date amounts.
- For health insurance claims only, the new guidance further requires that such roll-forwards be presented in a disaggregated manner; with the guidance for disaggregation the same as that used for the triangle disclosures.

Level of disaggregation

- The ASU provides a principle on how the loss triangles should be disaggregated:
- An entity shall aggregate or disaggreate the disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have significantly different characteristics
- Look at how loss reserves presented to investors or company senior management

Academy white paper

- Not a practice note since it is dealing with anticipated changes

http://www.actuary.org/content/white-paper-exposure-draft-released-issues-implementing-fasb-short-duration-contract-disclos

US GAAP LONG TERM CONTRACTS

FASB Long Duration Targeted Improvements

- Discussed Long Duration in 12 meetings between Feb 2014 and March 2016
- In February, 2014, the FASB decided to limit changes to "targeted improvements"
  - The US responses to the June, 2013, Exposure Draft didn't fully support the proposed IFRS model
  - While the FASB agreed in principle with much of the IFRS draft, they didn't agree on some of the details

Assumptions

- FAS60, FAS97 limited pay, and FAS120 contracts will update assumptions annually in consistent quarter
- The effect of the change in assumptions will be included in net income
- No margin in the estimate
- Eliminate loss recognition
- Increased disclosure

Discount Rate

- All contracts which currently use “expected yield” will use interest rate based on portfolio of high-quality fixed-income investments
  - FAS60
  - Language similar to pensions
  - Change quarterly
- DAC does not accrue interest

Change in assumptions

- Unlock the net premium annually for changes in assumptions
- The net premium is based on experience from the issue date to the valuation date and current assumptions going forward (retrospective)
- Presumably the net premium would change quarterly to reflect actual experience
- Net premium capped at 100%

Change in interest rate

- Interest rate assumption changed quarterly in line with market interest rates
- The net premium is locked in for changes in interest rates -- the change in reserve for changes in discount rate runs through OCI, similar to assets at FV-OCI.

DAC Amortization

- DAC for contracts not using effective yield method should be amortized over the expected life in proportion to insurance in force
- Straight line in proportion to number of contracts in force if insurance amount is variable or difficult to predict
- Totally eliminate EGP and EGM?

GMxB for non-traditional products

- GMxB will be calculated as fair value
- Change in “own credit” will go through OCI
- Goal for all similar benefits to use similar methods

Par contracts

- Projected dividends included in future cash flows
- Use same discount rate as non-par contracts

Disclosures

- Difficult to summarize in slides all the decisions on disclosure
- See FASB notes from Feb 24, 2016, board meeting on the FASB website (www.fasb.org)

Transition

- Liabilities for future policyholder benefits should be calculated retrospectively using actual historical experience
- If full retrospective impractical then use current carrying amount
- For market risk benefits transitioning to fair value, the difference at transition date goes to retained earnings
- DAC should use existing balance at transition date

What's next?

- Exposure Draft perhaps as soon as September
- The proposed "targeted improvements", if adopted, will have a significant effect on US GAAP
- When effective, which will not be for several years, the standard will change accounting for all in force policies as well as new business

Perceived Problems in US GAAP

- Too many models (FAS60, 97, 120)
- Current models don’t reflect embedded options and guarantees
- DAC is a funny number
- FAS60 change in reserve is hard to explain
- FAS60 assumptions are locked in at issue
- Revenue inconsistent with non-insurance revenue

Implementation

- Big Bang
- All of your in force
- Every company

Steps to get ready

- Throw nothing away
- Gross premium valuation of FAS 60 products
- Do you want to model possible impact on projected result of proposed changes?

Q&A

Appendix – IFRS 4 Phase II

History of New Insurance Standard

- 1997 predecessor to IASB starts project on insurance contracts
- March 2004 IFRS 4 – temporary solutions prior to EU adopting IFRS
- Mid-2004 Phase II work begins
- May 2007 Discussion Paper
- July 2010 Exposure Draft
- June 2013 Second Exposure Draft
- January 2016 Finish internal IASB discussion
- Late 2016 to Mid-2017 Final Standard

Perceived Problems Addressed

- Variety of accounting treatments
- Estimates not updated
- Discount rate not based on liability cash flows
- Cost of options and guarantees not always considered

Four Building Blocks

- Current estimate of future cash flows
- Time value of money
- Risk adjustment
- Contractual Service Margin (CSM)

Current Estimate of Future Cash Flows

- Current, use all relevant information
- Unbiased
- Explicit
- Probability weighted
  - Expected value (mean), not "best estimate"
  - Number of scenarios depend on product
- Exclude non-performance risk for insurer but may include non-performance risk for ceded reinsurance

Time Value of Money

- Consistent with current observable market prices
- Exclude factors not present in the insurance liability
  - Independent of assets held unless obligation is a direct function of a set of assets
  - Do not consider non-performance risk of insurer
- Arrive at discount rate either by adding an illiquidity adjustment to risk free rates (bottom up) or adjusting the yields of financial assets which are similar to liabilities (top down)

IASB - Risk Adjustment

- Compensation the insurer requires for bearing the uncertainty inherent in cash flows that arise as the insurer fulfills the insurance contract
- Designed to take into account that insurers/investors have a preference for an expected cash flow of 10 with a standard deviation of 1 versus an expected cash flow of 10 with an standard deviation of 12
- Re-measured at each period
- Not a PAD
- Entity specific depending on risk aversion and diversification

IASB – Contractual Service Margin

- At contract inception Contractual Service Margin (CSM) is the plug so that there is no profit at issue
- Cannot be less than zero

Remeasurement – Cash Flows

- Changes in cash flows related to past and current services are reflected in profit and loss (actuals)
- Changes related to future services go into CSM (estimates)

Remeasurement – Discount

- Unwind of the discount (time value of money) in profit or loss
- There is an option to present the effect of change in interest rates in either Other Comprehensive Income (similar to assets carried at Fair Value – OCI) or through profit or loss

Remeasurement – Risk Margin

- Changes related to past and current services reflected in profit or loss as entity is "released from risk"
- Changes related to future services go into CSM

Remeasurement - CSM

- Recognize CMS in profit or loss as the entity provides coverage
- Coverage is based on the passage of time and the size and duration of contracts in force
- Take the CSM at the beginning of the period and amortize over remaining lifetime

Variations on General Model

- Simple products (P&C) – Premium Allocation Approach
- Par products – Variable Fee Approach
- Reinsurance ceded

Premium Allocation Approach

- For short duration contracts (P&C)
- The industry felt that using four building blocks for short duration contracts would be overkill
- The existing unearned premium accounting model for short duration contracts was currently used much more consistently than the diversity of practices in life insurance
- The IASB’s Premium Allocation Approach is similar to the existing unearned premium for short duration products

Premium Allocation Approach

- Viewed as a practical expedient and therefore optional
- Safe harbor if contracts are 12 months or less
- Also available for contracts for which
  - No significant change is likely prior to claim incurred
  - No significant judgement needed to allocate premium

Variable Fee Approach

- Applies to some participating contracts
  - Policyholder participates in share of clearly identified pool of underlying items
  - Entity expects to pay policyholder a substantial share of returns from underlying items
  - Cash flows expect to vary substantially with underlying items

Variable Fee Approach

- Fulfillment cash flow is calculated consistently with the general model
- Modify the general model so that change in estimate of variable fee are adjusted in CMS where variable fee is:
  - Fee equal to entities expected share of returns on underlying items MINUS
  - Any expected cash flows that do not vary with underlying items
- Discount accreted to CSM at current rate instead of locked in rate

Variable Fee Approach

- Unlike the general model, the entity can use hedge accounting if it hedges guarantees and meets the following requirements:
  - Entity holds the derivative instrument
  - Hedging is consistent with risk management strategy
  - Economic offset exists between guarantee and derivative
  - Credit risk does not dominate the economic offset

Reinsurance Ceded

- Viewed as an offset to the direct insurance
- Modeled separately from direct insurance
- Modeled similarly to direct insurance except:
  - A negative CSM (asset) is allowed
  - If the direct insurance has changes in future cash flow reported in the CSM, then the reinsurance changes in future cash flows must be reported as a change in CSM
  - If the direct insurance has changes in future cash flow reported in Profit or Loss, then the reinsurance changes in future cash flows must be reported in Profit or Loss

Presentation

- Insurers required to present premiums, claims, benefits and the gross underwriting margin in income statement
- BUT their definition of premium different from definitions commonly used today
- Other comprehensive income (OCI)
  - Changes in liability due to changes in discount rate will be reflected in OCI
  - Potential FVOCI asset category within IFRS 9

Presentation – Revenue

- Under building block approach earned premium (revenue) should be consistent with Revenue Recognition standard
- Revenue stream will look like YRT premiums
- Cannot be derived from collected and doesn’t affect bottom line
- When experience differs from assumed the EP is affected

Balance Sheet

Balance sheet	20XX
Assets	
Reinsurance assets	XX
Other assets	XX
Total assets	XXX
Liabilities	
Insurance contract liabilities	XX
Other liabilities	XX
Total liabilities	XX
Equity	XX
Total equity and liabilities	XXX

Income Statement

Statement of Comprehensive Income	20XX
Insurance contracts revenue	X
Incurred claims and expenses	(X)
Underwriting result	**X**
Investment income	X
Interest on insurance liability	(X)
Net interest and investment	**X**
Profit or loss	**X**
Effect of discount rate changes on insurance liability (optional)	(X)
Total comprehensive income	**XX**

Transition Hierarchy

- Retrospective application: when historical data exists and hindsight is not required
- Prescribed simplified approach: when not all historical data is available but information about historical cash flows is available or can be constructed
- Liability calibrated to fair value: when no historical information about cash flows is available to determine CSM