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**Hospitality Suite at the
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Coming Soon... IFRS Exposure Draft

—Douglas S. Van Dam, FSA, MAAA, CLU, ChFC, Manager, Actuarial Services

The wait is nearly over! The Exposure Draft I have been referring to for years – the document that will outline a single standard for insurance accounting – is expected to be published by the end of July 2010.

Before the release date, I wanted to bring you up-to-speed on the discussions of the IASB and FASB over the past few months. The document will be a joint product of both the IASB and the FASB. Where the two boards have different views, both will be included; and questions will be asked of the readers who wish to comment. I expect the comment period to last through November.

The FASB may decide to call this document a discussion paper, not an exposure draft, because of the number of unsettled items. On the other hand, recent progress has been made in getting the two boards to agree.

The IASB is in a greater hurry than the FASB as they do not currently have an insurance standard. The IASB will label the document an Exposure Draft, and their time line still points to a final standard to be published in June 2011. The effective date would be 2013, at the earliest, and it will likely be even later.

Following is a high level summary of four of the big topics: Measurement, Universal Life, Presentation, and Transition. If you are interested in more detail on any of the topics below, I can direct you to some of the IASB staff papers.

Measurement

IFRS is supposed to be a principle-based standard, and the boards have tried to come up with a name to describe the measurement of liabilities. In the 2007 discussion paper, the measurement attribute was called “Exit Value.” By September 2009, the boards were talking about “Modified IAS37” and then “Fulfillment Value.” Now the boards are referring to the “Cash Flow Value.” In truth, there are aspects of all four proposed measurement attributes in the final standard. Changing the name from “Fulfillment Value” to “Cash Flow Value” allowed FASB to agree with the insurance industry and the IASB on how to measure acquisition costs and certain other cash flows.

The use of building blocks to measure insurance liabilities has been consistent since the 2007 discussion paper. The first building block is the weighted average of cash flows. The second building block is discount for the time value of money. The FASB calls the third building block the composite margin – the amount necessary to avoid a gain at issue.

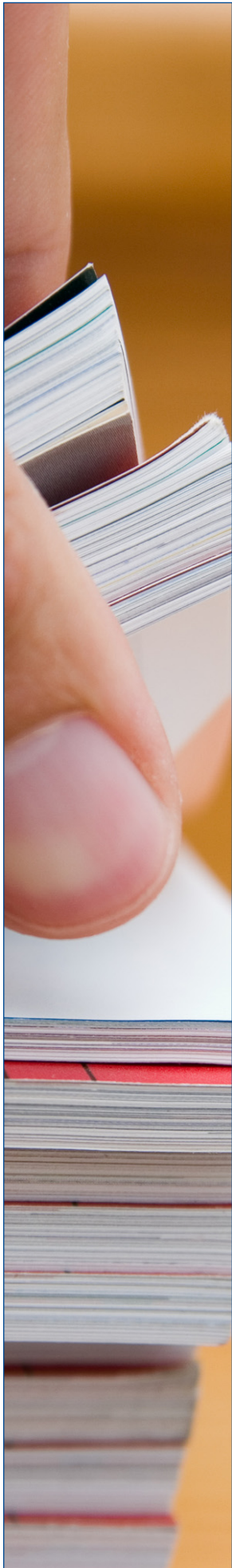
The FASB only recognizes three building blocks, while the IASB recognizes four building blocks. The divergence concerns the third and fourth building blocks, and the IASB presents four building blocks by splitting the composite margin into a risk adjustment and a residual margin. The residual margin is the amount necessary to avoid a gain at issue after taking the risk adjustment into account.

The votes on each board were close. There are FASB members that support the IASB method and IASB members that support the FASB method. All of the building blocks except the composite margin or the residual margin are based on current measurements as of the valuation date.

As long as the composite margin is greater than the risk adjustment, the FASB and IASB measurement is the same on day one. Neither the composite nor the residual margin can be less than zero, so if there is a loss at issue, the amount of the loss will be bigger under the IASB method by up to the amount of the risk adjustment. After day one, the income under FASB and IASB may differ to the extent the amortization of the margins and adjustments are different. In practice, though, they may be similar.

The risk adjustment in the IASB method is determined as “the maximum amount that an insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows may exceed those expected.” The guidance material included with the Exposure Draft is expected to mention three possible techniques: confidence levels (or Value at Risk), Conditional Tail Expectation (or Tail VAR), and Cost of Capital.

The risk adjustment, residual margin, composite margin, and expenses other than acquisition are all determined at the portfolio level. The definition of portfolio is similar to US GAAP – a block of



similar policies managed together. Acquisition costs are determined at the issued policy level. Residual margins and composite margins are amortized using a cohort that is based on portfolio plus issue year plus length of contract. I don't know what they mean by length of contract. Would 10 year term and 20 year term be different cohorts, or would they both be considered long term contracts and in the same cohort? I think we can convince them that the math will work just fine if we combine all the term products, for example, into one cohort.

In regards to the first two building blocks (weighted average of cash flows and the discount for the time value of money), the issues will be the number of scenarios and the discount rate. It is pretty clear that a stochastic method will be needed to measure the option value of the guarantees on variable products. For products at the other end of the spectrum, will a single scenario be sufficient? P&C products will be allowed to use an unearned premium approach as an approximation of the building blocks. The three risk adjustment techniques do anticipate some sort of distribution, but the goal will be to keep it simple for simple products.

In most cases, the discount rate will be independent of the assets held by the insurance company. If the interest crediting rate is tied to a pool of assets, only then would the discount rate reflect the asset yields. Otherwise the discount rate would be based on market rates which reflect the characteristics of the liabilities. The expectation is that this will be the risk free rate plus an illiquidity margin. (These rules on discount rates may not apply to UL or SPDA. See the section on UL below.)

The illiquidity margin is not well defined. There has been some research on illiquidity margins in bonds, but that is not definitive and the illiquidity margin in an insurance liability is even less well defined. As a result of the financial crisis that began in 2008, European companies that reported market consistent embedded values used an illiquidity spread that ranged from zero to 300 basis points. Actuarial practice will need to evolve to give a better definition of illiquidity margins for different insurance products.

Universal Life

In the past couple of months, the boards have decided that the account value of UL and SPDA should be evaluated separately from the rest of the insurance contract. They have labeled this as "unbundling." Another word for it might be bifurcation. The account value would be measured using the financial instruments standard instead of the insurance standard. The current FASB rules in *ASC Topic 944-20-15* (formerly known as *SFAS 97*) would be used for determining what contracts have an account value.

Using two different standards for a single policy would complicate the measurement of UL, but it has the potential upside of tying the discount rate for the account value to the crediting rate. Many people will consider this a big improvement over limiting the discount rate to the risk free rate plus an illiquidity adjustment. Still, there is too much unknown here to say definitively what will happen.

FASB and IASB are even proposing different rules for how to measure financial instruments.

Presentation

The measurement described above focuses primarily on the balance sheet as of the valuation date. The income statement is then the reconciling item between the balance sheets on two different valuation dates. Several presentation models have been discussed and four different models were shown to the joint meeting of IASB and FASB on June 23, 2010. The boards decided on a "Summarized Margin" approach. This has been described as similar to source of earnings analysis or changes in embedded value. All premiums are treated as deposits and claim costs, claim handling expenses and other contract-related expenses are treated as repayments of deposits.

Transition

Transition is an important topic since it deals with what the opening balance sheet should look like when adopting the new IFRS standard. The FASB and IASB are in agreement with how the initial balance sheet should be calculated. The first three building blocks of the IASB measurement method will be used to calculate the liability – current probability weighted cash flows, current interest discount rates, and a current measure of the risk adjustment.

Even though FASB does not like using the risk adjustment for new business, they have decided a risk adjustment needs to be calculated for the initial balance sheet. Differences between the prior liability and the newly calculated liability would go into retained earnings as of the date of the initial IFRS balance sheet for the earliest period presented without going through earnings.

For future periods, the calculated risk adjustment would be re-measured under the IASB method and treated as a composite margin by the FASB method and amortized.

Next Steps

The IASB and FASB met on Monday, July 19, and the IASB determined that they were ready to proceed. The IASB will review a draft of the Exposure Draft starting this week with the goal of releasing the Exposure Draft close to the end of the month. The FASB will have a separate discussion on some P&C issues next week and then determine which direction they will go.

PolySystems will dive into the Exposure Draft as soon as it is released (it will make for great summer vacation reading). In the coming months, you can expect PolySystems to release summaries, suggested courses of action, necessary software modifications, and all of the latest updates.

We are ready for IFRS so you can be ready for IFRS. Plan on asking us your questions. We will have the answers. For more information on what you can do now to prepare, contact Bob Keating at BKeating@PolySystems.com or via phone at 312.332.5670.

If you have any questions about the imminent Exposure Draft, you can contact me at 312.332.5670 or via e-mail at DVanDam@PolySystems.com. 