

top issues

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Insurance modernization

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The insurance industry in 2015



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Developments in insurance contracts accounting and reserving

Certain proposed regulatory and standard setting changes pertaining to insurance contracts accounting and reserving are becoming more defined, and formal implementation of them is looking increasingly certain. Some of these changes will have a profound impact on insurers' business and are likely to drive strategic change. Insurers should not wait to assess the impacts of these proposals, and when performing their evaluations of them, should take an enterprise-wide view of their potential impacts.¹

FASB and IASB Insurance Contracts Project

Since February 2014, the FASB's focus on accounting for insurance contracts has been on exploring potential targeted improvements to existing US GAAP. The project is divided into two components, short-duration and long-duration insurance contracts.

For short-duration contracts (principally property/casualty and health insurance contracts), the FASB is limiting its proposals to enhancing disclosures. The disclosures proposed by FASB include annual disaggregated incurred and paid claims development tables that need not exceed ten years, claims counts and incurred but not reported claim liabilities for each accident year included within the incurred claim development tables, and interim (as well as year-end) roll forwards of claim liabilities. The FASB is expected to issue a final standard in the second quarter of 2015.

For long-duration contracts (principally life and annuity contracts), the FASB is focusing on enhancements to both valuation and disclosures. These include the potential updating of assumptions used in calculating various insurance liabilities, simplifications to deferred acquisition cost amortization models, and reconsideration of the measurement model for minimum benefits associated with variable annuities, such as minimum death benefits, income benefits, accumulation benefits and withdrawal benefits.

The impact of updated assumptions, including discount rate changes, would be recognized in net income.

The FASB has also proposed that the discount rates used to present value certain long-duration contract cash flows should be changed from the expected investment yield to the rates of return on reference portfolios of high-quality fixed income investments, as a proxy for a liability rate. Long-duration contracts deliberations are in the early stages. Although not yet discussed, a formal public comment process on any proposed targeted improvements would seem likely.

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The project's revised objective in 2014 was a dramatic change from the FASB's former comprehensive joint project with the IASB. The objective of that project, still in process at the IASB, was to develop common, high-quality guidance that would address recognition, measurement, presentation, and disclosure requirements for insurance contracts. Joint deliberations with the IASB from 2008 through 2013 ultimately led to the issuance of exposure drafts by the respective Boards in June 2013; however, the two boards reached different conclusions on several key areas. The FASB's decision to narrow its focus was in large part due to feedback from US investors and preparers who favored targeted improvements to existing US GAAP in the event that substantial convergence with the IASB's proposed insurance model became unlikely.

The IASB optimistically projects completion of its insurance project around the end of 2015. The IASB has been struggling during the re-deliberation phase to arrive at an acceptable approach for the accounting for participating insurance and investment contracts, which are quite common in Europe and other territories abroad.

¹ For insight into how insurers can develop an effective metrics and communications framework under new regulations and standards, please see the section of this report titled "Managing the metrics: Unlocking the potential of better business decisions through insurance modernization."

Under the IASB's proposal, an insurer would measure its net obligation to pay claims and benefits and its right to future premiums using an expected value discounted cash flow approach, inclusive of a risk adjustment, and remeasure each period (referred to as the building block approach). Changes in expected cash flows related to future services would be recognized over time while cash flows related to past services (i.e., changes between expected and actual) will be recognized immediately. At inception, there would be no immediate gain recognition for the expected excess of premiums over cash outflows.

A modified approach has been proposed under IFRS for certain short-duration contracts that meet specified criteria. Like the unearned premium approach used today for short-duration contracts, the premium allocation approach would recognize premiums as revenue over the coverage period. However, incurred losses would be measured in a manner consistent with the building block approach, including discounting of expected cash flows and a risk adjustment. A non-discounting practical expedient would be available for claims or the portion of claims expected to be paid within twelve months of the claim occurrence date.

Statutory accounting: Move to principles-based reserving

When applied, the additional changes in statutory accounting that are on the horizon for most life insurance contracts will dramatically change statutory profit profiles.

A new method for calculating life insurance policy reserves, referred to as Principles-Based Reserving ("PBR"), is a paradigm shift in the determination of statutory life insurance reserves with far-reaching business implications. The current formulaic approach to determining policy reserves would be replaced by an approach that more closely reflects the risks of products. Once at least 42 states representing at least 75% of total 2008 US direct premium adopt the revisions, PBR will be adopted for new business and implemented over approximately three years.

PBR's primary objectives are to have reserves that properly reflect the financial risks, benefits, and guarantees associated with policies and also reflect a company's own experience for assumptions such as mortality, lapses, and expenses. The reserves also would be determined by assessing the impact under a variety of future economic scenarios.

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PBR reserves can require up to three different calculations based on the risk profile of the products and supporting assets. Companies will hold the highest of the reserve using a formula based net premium reserve and two principle-based reserves – a Stochastic Reserve (SR) based on many scenarios and a Deterministic Reserve (DR) based on a single baseline scenario. The assumptions underlying principles-based reserves will be updated for changes in the economic environment, changes in company experience, and for changes in margins to reflect the changing nature of the risks. A provision called the "Exclusion Tests" allows companies the option of not calculating the stochastic or deterministic reserves if the appropriate exclusion test is passed. Reserves under PBR may increase or decrease depending on the risks inherent in the products.

PBR requirements call for explicit governance over the processes for experience studies, model inputs and outputs, and model development, changes and validation. In addition, regulators will be looking to perform a more holistic review of the reserves. Therefore it is critical that:

- The PBR reserve process is auditable, including the setting of margins and assumptions, performance of exclusion tests, sensitivity testing, computation of the reserves, and disclosures;

- Controls and governance are in place and documented, including assumption oversight, model validation, and model risk controls; and
- Experience studies are conducted with appropriate frequency and a structure for sharing results with regulators is developed.

The NAIC also has adopted Actuarial Guidance 48 (“AG 48”) which incorporates elements of the PBR model. This guideline is effective from January 1, 2015. The guidance is intended to harmonize the regulation of insurers using captives and special-purpose vehicles to offload the costs of reserving for term life and universal life with secondary guarantee products (often referred to as XXX/AXXX reserves). This will require insurers to post certain collateral requirements using the PBR valuation method and provide additional disclosure around both those transactions that follow and those that don’t follow AG48. The use of the PBR actuarial method is intended to produce a required level of primary security more aligned with insurers’ own economic view of what the PBR reserves for these products should be. So-called “redundant” statutory reserves that exceed the PBR level may be collateralized by “other securities” – that is, any asset that is acceptable to the commissioner of the ceding insurer’s domiciliary state.

Implications

- All of the changes we describe above will place additional demands on the financial reporting process and business, and increase:
 - Reliance on a company’s liability and cash flow models and data;
 - Demands on technology, computing and data resources to support stochastic models, and an increase in the number of times models are run (for example, sensitivity testing, and quantification of margins, changes in assumptions, validations, and analysis);
- Emphasis on company experience and assumption setting processes;
- Emphasis on governance (experience studies, inputs, models, outputs, processes) and disclosures;
- The need to secure staff resources and skill sets with the capability to understand, interpret, and to explain results;
- Demands on staff during the close process;
- The need to reconcile among all reporting bases in order to make effective business decisions; and
- Communication to key stakeholders on the results and any volatility related to changes in assumptions.
- Financial results will change and, more importantly, provide greater transparency into a company’s own experience, governance, and risk and capital management.
- Many functions within the organization will be impacted, especially actuarial and IT. Collaboration among all impacted areas will be a critical success factor for effective modernization.
- In addition to the Insurance Contracts Project and PBR, there are numerous other regulatory changes that impact insurers, including Solvency II, the ORSA, proposed changes from the FASB on consolidation and financial instruments, and the recently issued standard on revenue recognition.
- Legacy processes and systems will not be sufficient to address pending regulatory and reporting changes. Forming a holistic strategy and plan to address these changes will promote effective compliance, reduce cost and disruption, and increase operational efficiency, as well as help insurers create more timely, relevant, and reliable management information. Companies that do not plan effectively are likely to struggle with subpar operating models, higher capital costs, compliance challenges, and overall competitiveness.

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Denise Cutrone

Partner, Assurance and Business
Advisory Services
+1 678 419 1990
denise.cutrone@us.pwc.com

Chris Irwin

Partner, National Professional Services
Group
+1 973 236 4743
christopher.g.irwin@us.pwc.com

Mary Saslow

Managing Director, National Professional
Services Group
+1 860 241 7013
mary.saslow@us.pwc.com
