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IAA SPECIAL NEWSLETTER

Development of Potential IAA Standards for Application with IASB Standards

The February newsletter of the Society of Actuaries has the following editorial opening: *“For those of you who worry about the slackening demand for actuaries, fear not. The Accountants and Actuaries Full Employment Act of 2005, better known as IAS phase I, will be here soon.”* The editorial refers to the fact that the International Accounting Standards Board (the IASB) is publishing an International Financial Reporting Standard (IFRS 4) for insurance contract liabilities at the end of March after seven years of study.

Recently, actuarial magazines and newsletters have increasingly addressed this new insurance accounting standard that is intended to serve as an interim step to the IASB’s ultimate phase II. While the phase II project has been delayed for a considerable period already, this imminent standard, as well as other current and future IASB standards, will indeed generate a lot of work for actuaries involved in the accounting for contracts offered by insurers.

This IAA Special Newsletter does not discuss the technical specifics involved. Rather, it discusses the work of a (increasing) group of actuaries that has been intensively engaged in developing guidance for actuaries who will be performing the actuarial work necessary to implement the new IASB standards.

This IASB standard sets forth the principles (and some rules) for accounting for insurance contracts. In addition, many insurers have issued contracts that do not qualify as insurance. These financial instruments or service contracts are subject to other standards of the IASB, in particular, IAS 39 and IAS 18, respectively.

None of these standards include much detailed guidance to the actuary on how to actually perform the needed calculations or on how to assess the appropriateness of the measurement of the liability for these balance sheet obligations. The needed detailed guidance has been left to the actuarial profession to provide. Since a key objective of the IASB is to achieve a set of high quality globally consistent standards, the development of associated actuarial guidance is also best served by high quality globally consistent actuarial standards and guidance that the IAA has undertaken to provide.

This article discusses the activities of the IAA, and particularly of its Subcommittee on Actuarial Standards, regarding the development of actuarial standards related to the contract liabilities of insurers, i.e., those contracts that are subject to the new standard for insurance contracts (IFRS 4) as well as contracts issued by insurers that are in the scope of IAS 39 or IAS 18.

The IAA Subcommittee on Actuarial Standards

The IAA Subcommittee on Actuarial Standards (the “Subcommittee”) was created by the IAA Council in March 2002, with the following Terms of Reference:

- *to develop recommendations regarding international actuarial standards of practice for preparing or reviewing values or information relative to IASB financial reporting standards for insurance contracts and for certain financial instruments, provisions, contingent liabilities and contingent assets;*

- *to work closely with the IAA Professionalism Committee to ensure the appropriateness of any international actuarial standard of practice in the light of the structure of the IAA and to ensure that IAA due process is followed;*
- *to maintain regular communication with IAA Member Associations during the course of its activities;*
- *to oversee the introduction of the standards to IAA Member Associations, including development of educational materials, as deemed appropriate, that could be provided to assist practising actuaries; and*
- *to recommend how the IAA should implement the standards after adoption by the IAA Council and monitor compliance with them.*

While it might seem more appropriate to start this article by discussing the content of our standards, given that the IAA has never produced a widely applied standard of practice (note that it has produced *Guidelines of Actuarial Practice for Social Security Programs* directed to a fairly narrow audience in comparison to our current effort), the most useful starting point is to understand how the project is intended to proceed.

IAA Due Process for Standards

The development of standards of practice by the IAA is a relatively new process with which few are familiar. At its May 2000 meeting, the IAA Council approved a due process procedure established by the IAA's Professionalism Committee. Based on recent experience with the development of our Social Security Guidelines, certain amendments to that procedure will be discussed at the Council's June meeting in Stockholm. In respect of the development of an International Actuarial Standard of Practice ("IASP") for an insurer's contract liabilities measured under IFRS 4, IAS 39 and IAS 18, the proposed due process includes:

- The preparation of an IASP by the Subcommittee. Upon approval by the President of the IAA, the Subcommittee will promulgate a preliminary exposure draft of a proposed IASP for a minimum period of four months of exposure and consultation. This will be made available for comment by a wide variety of audiences. The Subcommittee will look particularly to the national actuarial associations for input. At the end of this exposure period, the Subcommittee will report to the IAA Council on the comments received and its response to them.
- In case of substantial changes or if significant differences of opinion arise, a second round of consultation will be required.
- After this (or a second round of) consultation, the Subcommittee will develop a final exposure draft and seek Council's approval to expose this final version for four months, or for a shorter or longer period as determined by Council.
- The IASP becomes effective following approval by a vote of the Full Member associations after the final exposure period.

The entire due process followed by the Subcommittee, including the level of application of the standard as well as its format and general content, is monitored by the IAA's Professionalism Committee.

Organisation of Work in the Subcommittee

Another important issue in the development of a standard or guideline for the accounting of insurance contract liabilities is the standard setting process itself. The financial reporting standards of the IASB cover a wide range of issues that must be addressed by the actuary involved in the financial reporting of an insurer for which new actuarial guidance may need to be developed. It covers both general actuarial practice and the technical actuarial issues involved.

In starting its work over two years ago, the Subcommittee decided it would be most efficient to seek commitments from actuaries who would commit a considerable time to draft standards or guidelines. Initially the drafting group included eight persons (five drafters and the Committee leadership). Over time the number of persons involved in the details of drafting the standards has roughly doubled. This increase resulted from both the desire from certain national actuarial organisations to be more involved in the details of the drafting as well as the need to include expertise from various actuarial practice areas.

Initially the Drafting group developed a series of internal draft issue papers. From those and extensive subsequent discussion, the Drafting group proceeded to draft a set of draft IASPs. To accomplish this, and through subsequent future stages, it has used a private (IAA) listserver to circulate ideas on a daily basis and a long series of regular telephone calls to discuss drafts and issues raised in the course of their development. Furthermore, the entire Subcommittee has had several face-to-face meetings in addition to the normal semi-annual IAA committee meeting schedule.

As noted above, the development of actuarial standards is a new process for the IAA. As a result, limited experience is currently available within the IAA for the format or the wording to be used. The Subcommittee requested support from the Actuarial Standards Board (the "ASB"), the actuarial organization associated with the American Academy of Actuaries, that adopts actuarial standards for the U.S. actuarial profession. This assistance should prove beneficial because of the ASB's long experience in developing actuarial standards in a highly litigious country. As a result, the ASB is acting as a staff resource to the Subcommittee.

The Relation Between National and IAA Actuarial Standards

Two important objectives of the IAA are 1) to promote high standards of professionalism among actuarial associations and actuaries and 2) to represent Member Associations in discussion with international bodies.

An important principle under which the IAA operates is that of subsidiarity, whereby "the IAA will restrict its activities to strategies and programmes which require international co-ordination or direction, or can be handled more efficiently across national and regional boundaries. It will not become involved with actions at the level of the Member Associations or regional groups of actuarial associations, except at the express invitation of such an association or group."

An IASP adopted by the IAA would not automatically be binding on actuarial associations in relation to their own standard-setting activities in connection with local practice, except in cases where a client advised by the actuary is required, or decides, to comply with the relevant IASP.

A Member Association can decide whether to (1) endorse a particular IASP for use in connection with, say, a relevant International Financial Reporting Standard, (2) adopt it formally for use in relation to local accounting standards or other reporting requirements, (3) adapt it to produce a locally applicable standard or (4) do nothing. Where a Member Association decides to adopt a standard which would be applicable in the same or similar circumstances as would require compliance with an IASP or where an actuary might find himself or herself being required to comply with the IASP and the national standard simultaneously, the Member Association should ensure that its standard does not conflict with the IASP in regard to work which falls within the scope of the IASP. Unless a Member Association decides on course (3) above, the IAA IASP would apply to actuaries practicing in that country.

A serious problem could arise if an IASP is in conflict with the law of a particular jurisdiction. Such a potential problem, which would likely also be a problem between, say, the national bodies or legislatures and the IASB with regard to an IFRS, should be identified during the exposure process. If such a conflict persists, the application of the IASP might be limited in that jurisdiction, or subject to a disclosed deviation.

The Member Association, not the IAA, is expected to deal with discipline matters with respect to the application of IASPs.

Draft Standards under Development

Currently, several IASPs related to IFRSs affecting insurers are under development. At this time, it has been decided that they will take one of two forms:

- 1) A class 3 IASP or “recommended practice. Actuaries would be expected to follow a recommended practice unless there were sound and defensible reasons for not doing so. Actuaries who do not follow the recommended practice should be prepared to give good account as to why it was felt appropriate not to follow the standard and should disclose the material aspects where they have departed from it. A Member Association may choose to raise the recommended practice to a stronger type of standard in the local context.”
- 2) A class 4 IASP or “practice guidelines. These are educational in nature, representing a statement of good practice (or perhaps practice as generally accepted among actuaries) and intended, for example, to help the client audience to understand better what they should expect from the work product of actuaries in the area in question. They might also serve to show non-actuaries who carry out similar work how the actuarial profession expects to approach the subject matter.”

These preliminary drafts relate to issues associated with actuarial practice and measurement that arise within the context of financial reporting, primarily that of insurers, in relation to IFRS for which the Subcommittee believes it is appropriate to develop guidance for actuaries. Most of the drafts under discussion are also expected to apply to the final standard that the IASB is to publish (phase II). In addition, they may involve educational papers that could serve as background for application of the IASPs. The final content of the preliminary exposure drafts have not yet been finalized.

The areas currently covered by the material being developed include the following:

1. Actuarial practice - to provide guidance concerning the role of the actuary and actuarial practice relating to work performed related to the IFRS for insurance contracts and related liabilities.
2. Contract classification – to provide guidance on the definition and classification of contracts issued primarily by insurers.
3. Embedded derivatives – to provide guidance regarding the types of embedded derivatives and related measurement techniques.
4. Discretionary participating features both within insurance contracts and financial instruments.
5. Reinsurance related issues.
6. Liability adequacy tests – to provide guidance regarding the application of testing required in the phase I IFRS.
7. Measurement of the liability for those contracts currently offered by insurance companies, but that do not meet the IASB definition of insurance contracts, such as investment contracts and service contracts.
8. Setting current best estimate assumptions.
9. Disclosures – to provide guidance regarding various information required or determined to be appropriate to be disclosed, including loss development and sensitivity of alternative assumptions.
10. Change of accounting policy – although the proposed phase I IFRS generally allows continuation of current accounting as applied to insurance contracts to continue, an insurer is permitted to change accounting policy if the change represents an improvement.
11. Stochastic models – identification of the appropriateness of models and their application.
12. Business combinations (acquisitions and mergers).
13. Unbundling (splitting investment from risk elements where practical).
14. Replicating portfolios – to provide guidance as to approaches that can be following in the construction of replicating portfolios.

Most recently the Subcommittee met in London on March 15 and 16 to discuss its latest drafts.

Expected Timetable and IAA Council Approval

The Subcommittee aims to prepare various informal discussion drafts that will be available in the near future. The objective of these drafts is to provide an opportunity to receive comments before the promulgation of Preliminary Exposure Drafts, currently anticipated in early June. Preliminary Exposure Drafts only need approval by the IAA President in order to be distributed. It is hoped that these due process stages will lead to the receipt of comments and suggestions that will enable final IASP Exposure Drafts to be brought to the IAA Council at its Washington meeting (November 13, 2004) for approval of their release for a final exposure period and vote by Member Associations.

This very tight schedule is necessary since the new IFRS phase I standard is expected to be in place for several jurisdictions (including the EU) for financial reporting starting in 2005. In order to accomplish this, the following preliminary time schedule has been established:

- March 31st 2004 – the IASB makes IFRS 4 (phase I of its *Insurance Contracts* project) available.
- April 2004 – distribution to IAA Member Associations of discussion drafts of key IASPs ready for initial comment for a 30-day discussion period.
- May 2004 – the Subcommittee reviews comments and prepares Preliminary Exposure Drafts.
- June 5th 2004 – discussion with IAA Council of process to be used and general content of standards; IAA President approves the promulgation and the dissemination of Preliminary Exposure Drafts.
- October 4th 2004 – deadline for comments on Preliminary Exposure Drafts (early comments greatly appreciated).
- October 5th to October 12th 2004 – Final Exposure Drafts and report on comments received and conclusions prepared for Council review (with early submission of comments appreciated). If changes to Preliminary Exposure Drafts are substantial, second Preliminary Exposure Drafts are produced instead of Final Exposure Drafts.
- November 13th 2004 – Council approves Final Exposure Drafts and the duration of the final exposure period before vote by Full Member Associations.
- XX, XX 2005 – Standard becomes effective after approval by the Full Member Associations.

IAA Member Associations' Approval

If and when the IAA Council approves one or more IASPs, it may recommend what action should be considered by its member associations. The recommendations may depend on the class of standards involved that, as indicated above, are anticipated to be either class 3 (recommended) or class 4 (practice guidelines). It is expected that the IAA Council will want to move cautiously with the maximum consensus, as it embarks on the IAA's new initiative of international actuarial standard setting.

The Subcommittee looks forward to continued two-way communication with IAA Member Associations throughout this process. Only through this cooperation will the process work effectively and a quality set of actuarial standards result.

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 Sam Gutterman, chair; Paul McCrossan and Francis Ruygt, vice-chairs, IAA Committee on Insurance Accounting
 Jean-Louis Massé, chair, Professionalism Committee