

Market Value Accounting for Insurance Liabilities

AFTER YEARS OF LURKING IN RELATIVE OBSCURITY, the issue of market value accounting for insurers is beginning to get some attention. In December 1999, the Financial Accounting Standards Board (FASB) endorsed the idea that all financial instruments should be reported at market value. The FASB report quotes the following excerpt from the basis for conclusions of Statement 133:

“The Board is committed to work diligently toward resolving, in a timely manner, the conceptual and practical issues related to determining the fair values of financial instruments and portfolios of financial instruments. Techniques for refining the measurement of the fair values of all financial instruments continue to develop at a rapid pace, and the Board believes that all financial instruments should be carried in the statement of financial position at fair value when the conceptual and measurement issues are resolved. [paragraph 334]”

Having stated its position, FASB prudently declined to get mired in a project to resolve “the conceptual and measurement issues” as they related to insurance contracts and moved on to other more tractable projects.

However, the international accounting community continued to pursue the issue. In November of 2001, the International Accounting Standards Committee (IASC) published a Draft Statement of Principles (the DSOP) on the subject of market-value-based accounting for insurance contracts. The International Accounting Standards Board (IASB—successor to the IASC) continues to move this project forward with an originally proposed implementation date of 2005 (recently postponed to 2007 for insurance products).

Why Another Accounting Convention?

In the United States we already have Generally Accepted Accounting Principles (GAAP), Statutory Accounting Principles (SAP), and various internal company reporting standards, and some companies are experimenting with embedded value measures. And, after all, we’re only talking about measures of the incidence of reported profits, not lifetime profitability. Why do we need a new standard?

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GAAP arose because of deficiencies in SAP. SAP tends to report losses when products are sold, since acquisition costs are charged in full to the income statement as they’re incurred. GAAP allows those expenses to be capitalized (deferred) and charged off over the life of the product in proportion to revenues (matched) and thus avoids delivering bad news (financial loss) from good events (high sales).

Both GAAP and SAP are rooted in historical estimates of profitability. Embedded values are a forward-looking attempt to go GAAP one better by measuring the future profitability of new business at issue (rather than flooring profit on sale at zero as GAAP does) as well as measuring success at managing the future profitability of in-



force business. None of these accounting conventions, however, does a very good job of measuring the options embedded in insurance liabilities or in measuring changes in the value of the enterprise from changes in the economic environment.

The historical-based systems (GAAP and SAP) are focused on reported income. The income statement drives the balance sheet re-

sults. The philosophy of both systems is to report stable income levels from year to year from existing business. Through its deferral and matching techniques, GAAP also extends that objective to the year of issue. Liabilities are reported at historical costs (unless loss recognition is triggered), as are some assets. This philosophy tends to submerge the financial measurement of recent management decisions in a sea of renewal results. The current accounting convention can actually be counterproductive in its influence on management actions.

If an asset gets downgraded, for example, should you sell it or hold it? If you sell, you’ll have to report (and admit to) a loss. If you can continue to hold it at amortized cost, and keep your fingers crossed that it doesn’t default,

then maybe no one will ever know that you mismanaged the credit risk.

Another example: You hold a \$1,000,000 bond while your competitor holds \$1,000,000 in cash. You're both in the same economic position. Either of you could exchange his position for that of the other without either income statement or balance sheet implications. But suppose rates fall. Your bond is now worth \$1,100,000 while his cash is still worth \$1,000,000. But neither of you will report a change in either your balance sheet or income statement. Why should you have to sell your bond to get credit for your sound investment decision?

If all assets were held at market value, in both of these situations your decision could be made on the merits. An accounting convention shouldn't influence these kinds of decisions.

If all liabilities were held at market value, more timely measurement of management decisions (to reinsure or not reinsure, to hedge or not to hedge) would similarly be available.

Criticisms of Market Value Accounting

While the information provided by market value accounting will clearly be helpful to users of financial statements, there's still a lot of resistance to implementing it. The arguments against the system generally fall into the following categories:

Volatility of reported earnings. This concern is somewhat exaggerated. To the extent that many assets are already reported at market value in financial statements, volatility could actually be reduced if liabilities were, too. If assets and liabilities are well matched, changes in the economic environment should have little effect on surplus or income under a market value system. If they're not well matched, the current accounting system, which hides this fact, doesn't serve the users of financial statements well.

We don't know how to calculate market values of insurance liabilities. There will be a large degree of management discretion in setting assumptions. Results will be subject to manipulation, and results between com-

panies will not be comparable. This argument arises any time innovative solutions to problems inherent in accepted procedures are proposed. There are certainly many very basic unresolved issues. They're especially difficult because there's no active secondary market against which the calculation of liability market values can be calibrated.

However, these issues are being addressed and resolved. While the resolutions may not be perfect initially, in the short term good disclosure can mitigate these problems. In the longer term, standards will evolve and assumptions and techniques will improve. The actuarial profession has dealt with these kinds of issues in the past and is well positioned to take the lead resolving them here also.

Gains and losses on new sales shouldn't be capitalized up front when the future experience of very long duration contracts is uncertain. Actually, this shouldn't be an issue. The calculation described in the DSOP requires that market estimates of risk be included in the liability market value calculation. These market value margins will flow into future profits as the issuer is released from risk. Any significant gain or loss at issue either misestimates these margins or is a temporary market advantage that will be reduced as competitors see and capitalize on the same opportunity.

Current Proposals

As noted above, the principles of market value accounting as they apply to insurers are still evolving. While the goals of the project are well defined, there are problems with some of the definitions and proposed solutions.

The DSOP describes two approaches for determining the market value of insurance liabilities—"fair value" and "entity-specific value." Both involve projections of liability cash flows and discounting of those flows to the statement date. Both would base projections on expected values adjusted for market-value risk margins. Both would require estimates of the value of the options embedded in insurance liabilities, deter-

mined using either stochastic processes or option pricing techniques. The primary differences between the two approaches are described in DSOP paragraphs 3.3 and 3.4. Paragraph 3.4 states:

"*Fair value* is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction. In particular, the fair value of a liability is the amount that the enterprise would have to pay a third party at the balance sheet date to take over the liability."

Fair value is an exit value. Fair value would estimate market prices by discounting the *market's expectation* for insurance cash flows at the risk-free rate *adjusted for the credit standing of the liability issuer.*

While fair value may work well for many enterprises, it represents a serious problem for financial intermediaries. A financial intermediary's whole purpose for existing is to acquire cash cheaply and deploy it profitably. To distinguish itself from competitors it must exhibit superior skill in designing and managing the liabilities it issues to raise cash or in managing the assets it acquires with the cash it raises, or preferably, both.

Fair value would measure the present value of each of these activities using market expectations for cash flows. Valuing all market participants' assets and liabilities using consistent assumptions will make it difficult for financial intermediaries to distinguish themselves from their competitors. Also, using the insurer's credit rating in determining the discount rate for its liability cash flows creates the anomalous result that a credit downgrade reduces liability values and increases surplus. This makes little sense for most insurance liabilities given their super senior priority in the insurer's capital structure and, in many cases, the security provided by guarantee funds.

Paragraph 3.3 of the DSOP proposes the use of "entity-specific value" as an alternative: "*Entity-specific value* represents the value of an asset or liability to the enterprise that holds it, and may reflect factors that are not available (or not relevant)

to other market participants. In particular, the entity-specific value of an insurance liability is the present value of the costs that the enterprise will incur in settling the liability with policyholders or other beneficiaries in accordance with its contractual terms over the life of the liability.”

Entity-specific value is analogous to the concept of “value in use” in measuring the value of assets. This measure would allow adjustment of liability cash flows to account for the *issuer’s expectations* based on its skill in liability management and would discount liability cash flows at the risk-free rate *without adjustment for the insurer’s credit standing*.

The definition of the term “risk-free rate” is an illustration of the kinds of technical issues that remain to be resolved. The risk-free rate is probably a set of spot rates rather than a single rate. It may be based on Treasury rates, but the liquidity premium inherent in Treasury market

rates may not be appropriate for this purpose. Some advocate using a high-quality corporate rate instead.

An apparent problem that can arise using this measure is that discounting at the risk-free rate (however defined) can produce an initial market value loss from the sale of profitable products unless appropriate market value margins are used. If the discounted liability cash flows are higher than the secondary market price for the liability, then the market value margin has been overstated—it must be reduced.

For general account liabilities that derive a significant portion of their profitability from asset spreads (e.g., interest-sensitive life and annuity products), calibrating liability values to market prices can lead to negative market value margins. While this is the correct result, some may find it offensive. The perceived problem can be fixed by adjusting the discount rate to be consistent with the estimates of

liability cash flows. This should produce a positive residual market value margin.

Conclusion

While many issues remain to be resolved, it’s clear that market value accounting for insurers is coming and it would be prudent to begin preparing for implementation. Many of the concerns with moving to this measure are overblown since it won’t, in the short term, replace current accounting measures (regardless of what the IASB dictates).

While market valuation may become the official standard for financial statement preparation in 2005 (or 2007), GAAP and SAP and other measures will certainly continue to be available to supplement the market value results, at least until standards and procedures stabilize and the users of financial statements become comfortable with the new measure. ●

1/3
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Page 42