

What Is Insurance?

A DECADE AGO, WHEN I WAS FIRST GOT INVOLVED in international accounting discussions, I organized a daylong session with actuaries from around the world to identify what was sufficiently unique about insurance to justify a special accounting standard for insurance contracts.

We started with the obvious—insurance responds to the financial effect of future contingent events. But there are many other arrangements that also do that. Although the specific type of contingent event might be unique, it didn't seem that this, by itself, it would warrant separate accounting treatment.

Someone brought up the long-term nature of insurance contracts. This seemed to be a possibility as the estimation and allocation of profits and risk to a period can be challenging. But it's not unique—there are 30-year mortgages while many whole life insurance contracts lapse after one year.

What about uncertainty? When compared with credit, market, operational, and interest-rate risks, insurance doesn't seem uniquely uncertain. Insurable interest or the adverse consequences to a person or entity were mentioned as a defining characteristic. But that, too, was discarded, as it can evaporate on the day after a contract is sold without changing the agreement itself, and it isn't relevant to expected cash flows.

Other defining characteristics considered and rejected included recurring premiums, the savings element, the fiduciary function

involved, the relatively large upfront marketing expense to be recovered by expected future profits, and the rigorous regulatory system. (In many places, insurance is what a regulator—or tax authority—declares it to be. But this certainly isn't principle-based, and it's unlikely that international consistency could be achieved.)

Finally, we decided that the unique characteristic of each insurance product type was the particular bundle of rights, obligations, promises, and time frames in its interlinked package. But this has proved difficult to communicate.

This reminded me of an insurance law course I took at Michigan in which we considered the question: What is insurance? After extensive discussion, the one conclusion that we could all agree on was that insurance was whatever a particular law or regulation defined it to be.

So, why do we need to find such a unique characteristic? The search has been driven by current international efforts to determine future accounting standards for insurance contracts, an issue of growing relevance to the U.S. insurance industry as it's likely that our generally accepted accounting principles will either converge with international financial reporting standards or go away entirely in about five years.

There are now two major interna-

tional accounting standard (IAS) models that most closely resemble an insurance contract—a service contract (IAS 18) and a financial instrument (IAS 39). A case could be made to apply either one to insurance. If the former is used, the revenue for providing insurance would be recognized as the service is delivered. If the latter, amortized cost or fair value would be used.

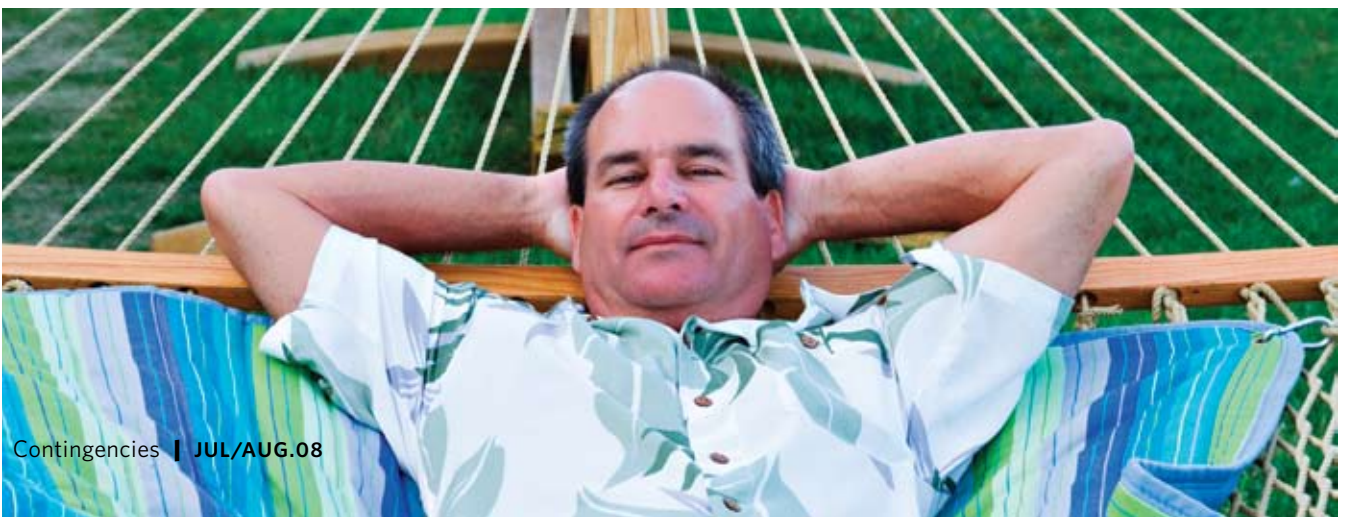
It's tempting to argue that insurance contracts deserve special accounting treatment. But if we can't convince decision-makers of the qualities that justify different treatment, this will not happen. There are elements of both a service and a financial instrument in an insurance contract. For pricing, it doesn't matter, as long as all the risks are reflected appropriately. But for financial reporting, where cross-entity comparisons are important, it can matter a great deal.

While it's tempting to try to determine what accounting approach makes most sense and work backward to determine what set of principles fits, consistent principles are worth using. We should help to establish a system that produces meaningful benchmarks for internal and external purposes.

What makes more sense would be to have a common measurement objective for all these products (insurance, financial instruments, and service contracts), so that it wouldn't matter which component is dominant in a contract. But I've been accused of being overoptimistic before!

At the end of the day, we need to remember that the true value of insurance is the peace of mind that it provides. ●

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