

International Accounting Standards: Some Pain, Much Gain for Insurers

THE GLOBAL EFFORT to transform financial reporting has far-reaching implications for insurance companies worldwide. Spearheaded by the International Accounting Standards Board (IASB), this undertaking seeks to develop a single set of global accounting standards to provide a common financial language for the world's capital markets, which would make it easier for financial statement users to understand and compare financial information.

The IASB initiatives have been endorsed by the International Organization of Securities Commissions (IOSCO), which supports the use of international accounting standards (IAS) as an alternative to national GAAP in local capital markets, including the United States. The U.S. Securities and Exchange Commission (SEC), a member of IOSCO, has not clearly stated its position on whether and how it will recognize IAS as an acceptable basis of reporting for U.S. purposes of foreign securities filings. Instead, the SEC has preferred to participate in the dialogue and monitor developments, withholding its ultimate decision.

The proposed IASB reporting framework would be radically different from current national reporting practices in many countries and would thus pose serious challenges for insurers and other participants in the capital markets. At the heart of the proposed standards is the concept of fair value—or a “fair value like”—measurement of financial assets and liabilities. Some observers believe the movement of global cap-

ital markets to a fair-value standard will eventually force U.S. GAAP to follow.

Accounting for insurance is a top IASB priority because at present there is no international financial reporting standard covering insurance contracts. To address this issue, the IASB is currently reviewing a Draft State-

ment of Principles—Insurance Contracts (DSOP) that will likely form the basis of an International Financial Reporting Standard (IFRS) for insurance contracts. The DSOP would apply to all forms of insurance (life, property/casualty, reinsurance, and health) and presents a set of princi-



ples upon which an IFRS can be built.

With its requirement for fair-value (or “fair value like”) accounting, the DSOP represents a major departure from current accounting practices. As a result, putting the new reporting framework in place will be a tremendous challenge for insurers, surpassed in difficulty only by the need to explain reported earnings after the new principles have been implemented.

The global business community is responding quickly to the IASB's efforts to develop uniform global accounting standards. In Europe, many non-insurance companies already report under international standards. Furthermore, the European Commission (EC) has man-

PETER DURAN (NEW YORK) AND **MARK FREEDMAN** (PHILADELPHIA) ARE PARTNERS IN ERNST & YOUNG'S ACTUARIAL SERVICES GROUP. **EMMA McWILLIAM** IS A U.K. ACTUARY LOCATED IN NEW YORK.

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dated that by 2005, all companies with shares trading on stock markets within the European Union (EU) must report using IASB standards.

In addition, it's expected that companies with listed debt in the EU will be required to report IAS results by 2007. This requirement may be extended to all companies operating in the EU, even those not listed. The tight timeframes stipulated for IAS implementation compound the challenges facing insurance company management.

Key Challenges Raised

IAS 39 and proposed changes. The DSOP, scheduled for completion in late 2003, will fill a gaping hole in the current international financial reporting framework. At this point, under IAS, the majority of an insurer's assets (as well as some of its liabilities—specifically, “investment contracts”) are governed by IAS 39, Financial Instruments, Recognition, and Measurement. However, insurance contracts are excluded from the scope of this standard.

IAS 39 permits certain securities (those classified as trading and available-for-sale) to be carried at market value, with changes in unrealized gains and losses reported through income. As an alternative, a company may elect to report unrealized gains and losses for the available-for-sale securities through equity. Financial liabilities that aren't insurance contracts and aren't held as trading must be measured at amortized cost.

Unless these IAS 39 requirements are modified, insurers will find themselves in a quandary. On the one hand, most of their invested assets will be carried on their balance sheets at fair value. On the other hand, investment contract liabilities would be carried at amortized cost, and insurance contract liabilities would be carried at fair value or something similar to fair value (i.e., entity-specific value). In this situation, the classification of contracts as “insurance” would have a significant impact on the level and volatility of reported earnings.

To address these potential problems, the IASB is considering a number of

changes to IAS 39. One proposal would permit companies to measure any financial instrument at fair value, with changes in value reported through income. If this revision were made, most insurers would likely opt to use fair value for both assets and liabilities in order to make the accounting consistent with insurance contracts reported at either fair value or entity-specific value.

Contract classification. The DSOP applies to insurance contracts, not to insurance companies. Moreover, the definition of insurance contract requires the presence of “insurance risk.” This definition is similar to that for U.S. GAAP in FAS 97 and 113.

The intent is for similar contracts to be recorded at similar values on the balance sheet, but this may be difficult with the DSOP and IAS 39 in their current forms. For many contracts with large investment elements, judgment will be required as to whether they should be classified as insurance or as investment contracts. This decision will significantly affect their carrying value and the pattern of earnings recognition (in the absence of the proposed changes to IAS 39 described above).

Furthermore, the DSOP requires that contracts be reclassified from non-insurance to insurance (but not vice versa) under certain conditions. For example, deferred annuity products in some countries might be reclassified from investment to insurance contracts as they approach the annuitization date, and the mortality risk rises to significant levels.

Basic measurement principles. Under the DSOP, a single approach to measurement applies to all insurance contracts. This differs from some current practices, such as U.S. GAAP, for which accounting varies by product type. The DSOP specifies that invested assets deemed to support liabilities shouldn't be taken into account when valuing insurance liabilities, except where the liability cash flows directly depend on the assets, such as in a variable annuity, unit-linked, or other performance-linked contracts.

Two possible ways to measure insurance contract liabilities outlined in the

DSOP are fair value and entity-specific value. If IAS 39 is amended to require fair-value treatment for the “substantial majority” of financial assets and financial liabilities, then insurance assets and insurance liabilities would have to be measured at fair value. Fair value is defined as the amount an insurer would need to pay a third party to assume the liability in an arm's-length transaction. Without this amendment, insurance assets and insurance liabilities would be measured at entity-specific value. The DSOP is silent on the insurance liability measurement approach to be used if fair value is permitted but not required under IAS 39 for financial assets and financial liabilities other than insurance, as is likely to be the case.

Entity-specific value differs from fair value in that the cash flows under the contract are estimated using the company's best estimates for noneconomic assumptions (mortality, expenses) rather than the market estimates used in fair-value calculation. In addition, entity-specific value doesn't consider a company's own credit risk, whereas fair value does, according to the DSOP. However, the DSOP doesn't provide guidance on how to account for credit risk, and the question of whether it should be taken into account is controversial.

Valuing options and guarantees. The DSOP requires that options and guarantees contained in contracts—such as minimum interest-rate guarantees, guaranteed annuity rates, and guaranteed death benefits on variable or unit-linked products—be valued. In such cases, option-pricing or stochastic valuation techniques will be required, forcing many companies to undertake costly upgrades to their existing financial measurement and modeling systems.

Estimating cash flows and adjusting for risk and uncertainty. Liability valuation begins with projections of expected cash flows under an insurance contract. The present value of those cash flows, discounted at the risk-free rate, is the liability value before any adjustment for risk and uncertainty. Both fair value and entity-specific value should always contain a

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market-based adjustment for risk. Under the DSOP, that risk adjustment is made by adjusting the cash flows (the preferable approach), adjusting the discount rate, or both, without double counting.

The risk adjustments are referred to as “market value margins” and should be consistent with market-risk preferences. The market-based adjustment for risk and uncertainty effectively acts as a market mechanism for pricing uncertainty and will have an impact on liability valuation levels. However, there’s no guidance in the DSOP on how these margins should be determined.

Inconsistencies with pricing. Market transactions and product pricing typically employ embedded-value techniques. Embedded-value calculations include asset returns in excess of risk-free rates and typically adjust for risk by means of allocated capital. They use a discount rate based on the cost of capital.

If the rules for setting market-risk adjustments aren’t consistent with established product-pricing techniques, there is the possibility of reporting material gains or losses when products are issued. Furthermore, the DSOP sets limits on the projection of some income anticipated in pricing, which may lead to losses at issue, even for products that are priced profitably. Specifically, returns in excess of risk-free rates on assets backing insurance contracts may not be taken into account. In other words, the standards for calculating fair value aren’t necessarily consistent with actual market pricing.

Financial statement disclosures. The proposed DSOP disclosure requirements are voluminous and burdensome. Companies will be required to disclose expected earnings based on prior-period valuation assumptions, together with the effects on current earnings of new business written, release of margins, deviations due to differences between actual and expected experience by source, and changes in assumptions.

Major Implications for Insurers

The timetable for converting to IAS is extremely tight. For companies reporting in multiple territories, it will take years to

implement a full conversion, and all companies will need to apply the standards for several years before they’ll be able to comprehend and explain their results. Therefore, IAS adoption and analysis are recommended well before 2005.

The business implications of the DSOP reporting framework are far-reaching. Among the most significant are:

Increased financial statement volatility. Reported financial results will be more volatile under IAS, making it more difficult to understand results and explain them to senior management, boards of directors, investors, and other stakeholders.

Investment management. In the effort to reduce earnings volatility, assets and liabilities may become more tightly matched. Assets backing surplus may be invested in less risky instruments, causing policyholders and investors to lose the potential upside gain. For countries such as the United States, there will be fewer constraints on managing asset portfolios on a total-return basis, because current disincentives to realize gains will be diminished.

The credit quality of the fixed-income portfolio will become more transparent, because changing credit spreads may materially affect reported income. These changes may not be offset by corresponding changes in liability values, due to the separation of liability discount rates and asset yield rates. To some extent, however, a fair-value system that provides for the recognition of a company’s own credit risk in the liability discount rate would alleviate this problem. As invested asset-quality spreads increase or decrease, the company’s own credit-quality spread related to valuing liabilities would also tend to increase or decrease.

Pricing and product design. Products may be designed to take advantage of the

new accounting environment. Performance-linked contracts, for example, appear to receive more favorable accounting treatment than other life insurance contracts. Companies also may be reluctant to readily offer guarantees and options in contracts as their true economic costs become known. If they do offer such guarantees, they may choose to hedge the risk to more effectively manage the volatility of results.

In addition, back-end guarantees and loyalty bonuses may be introduced to demonstrate that a product contains valuable options. This would allow companies to consider future premium renewals when valuing the contract, which would tend to reduce the liability.

System challenges. To meet the new reporting requirements, insurance companies will have to undertake a massive re-tooling of existing systems and may have to introduce new global modeling platforms. In particular, systems and tools will be required to

- Value insurance liabilities and guarantees and options embedded in contracts. Where stochastic models are used in these valuations, the timeliness of results may become an issue.

- Analyze the components of earnings.
- Forecast insurance liabilities in future time periods, including showing the effects on earnings if the economic environment changes.

It will become nearly impossible to forecast results accurately, since they’ll depend so completely on the future economic environment. Stakeholders may require multiple forecasts based on differing future economic assumptions. As a result, companies will need to develop techniques quickly to estimate the impacts of changing economic scenarios.

New-business and valuation pressures. With the introduction of IAS, analysts are expected to focus on the value of new business, which will add new pressure to company valuation assumptions. This will place additional pressure on actuaries to select assumptions that optimize reported results when new contracts are issued. In addition, the disclosures of changes in

provisions for risk and uncertainty, assumption changes, and experience gains and losses will draw attention to all judgments being made in valuing the insurance contracts, including the setting of valuation assumptions.

Performance measurement will likely shift to an emphasis on the increase in value of new and in-force business. This will prompt many companies to restructure performance pay and executive compensation.

Skilled expertise, knowledge, and training. A diversion of skilled human resources, especially in actuarial and accounting, will be required to implement IAS. This will consume a potentially critical mass of strategic and technical resources.

In addition, global project management is crucial for multinationals. Knowledge acquisition and dissemination through knowledge-sharing platforms and training programs will be key to successful implementation.

Disclosure and external relations. The new, more onerous IAS disclosure requirements will require insurance companies to adopt a completely new way of communicating with the public. The balance sheet, for example, may change materially from the valuation date to the date earnings are released and then to the date of the stockholder meetings. Also, companies will have to carefully explain the differences between actual and expected earnings, especially since earnings are a function of the economic environment.

Capital management. In the long term, global solvency standards for insurers may evolve more quickly, and IAS may replace current local regulatory standards. This may cause companies to restructure their capital to maximize their returns on capital employed. Furthermore, earnings volatility may create a perception that insurance companies should be more strongly capitalized than at present.

A Strategic Opportunity

Along with the challenges it presents to insurance companies worldwide, however, conversion to IAS does offer a silver lining; it will push insurers to enhance

operations in several areas. For example, they will have opportunities to

- Reshape and reengineer internal management reporting systems.
- Evaluate internal performance measures and executive compensation.
- Improve external communications with analysts, investors, financial markets, and other users of financial information.
- Access international capital markets at the lowest cost of capital.
- Increase understanding of a company's

position relative to its global competitors.

■ Better integrate pricing, financial reporting, earnings analysis, forecasting, and risk management.

Thus, while IAS implementation will involve some pain, insurers stand to realize substantial gains from their efforts as well. Ultimately, the adoption of international accounting standards should help insurers adapt to, and succeed in, the more demanding business environment of the 21st century.

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