Insurance and International Financial Reporting Standards

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The development of an international standard for the accounting of insurance contracts is a challenging project. The goal of this standard is to accomplish high transparency and decision usefulness for participants in the capital markets. The paper gives an overview on the actual development status of this accounting standard for insurance contracts. Beyond a description of the actual status, possible consequences and problems for the business model of insurance companies are elaborated. Furthermore, the article gives an outlook on phase II of the insurance project and outlines the possible relationship between IFRS and the Solvency II project.

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Introduction

Group financial reporting among German insurance companies is often characterized by a “mixed accounting model”. Although this expression describes the use of historical cost and fair value in IAS 32 and IAS 39, it also stands for the way group financial reporting of insurance companies is conducted. On the one hand, financial assets are accounted in accordance with IAS 39. On the other hand, there is no International Financial Reporting Standard (IFRS) for insurance contracts covering actuarial reserves. As best practice for missing standards on actuarial reserves, US-GAAP is used as a surrogate in accordance with IAS 1 par. 22.

Back in 1997, the International Accounting Standards Board (IASB) set up a project called “Insurance Contracts” to address this issue. Its objective was to standardize insurance-specific issues and, in particular, to enable consistency in accountancy tools for financial instruments. This objective was linked to the accounting of assets and liabilities arising from insurance contracts at fair value. It soon became apparent that fair value accounting would have significant consequences for insurance reporting, since there are no active markets for actuarial liabilities and hypothetical market values can only be arbitrary.

EU Commission guidelines require all EU companies using organized capital markets to prepare their accounts in accordance with IAS/IFRS from 2005 on. The project is split into two phases. The first phase will come into effect in 2005 as a transitional phase until the final standardization of an individual IFRS is accomplished. To this end, the IASB published an exposure draft in July 2003, which allows companies to maintain existing national accounting practices for the most part. At the same time, the IASB, which has positioned itself as an important globally acting

institution, is determined to pursue a full fair value concept in phase II, which will be driven by academic excellence. However, it remains to be seen whether this concept will meet the requirements of the users.

The IASB also has to deal with local supervisory agencies and governmental interests on a national and European level. The supervisory authorities are eager to protect consumers' interests and, therefore, demand ever higher risk capital.

Insurance companies are in a tricky position: They must deal with both financial requirements, especially set by rating agencies, and supervisory requirements. It remains to be seen how conflicting interests might affect the products and, indeed, the entire business concept of insurance companies.

IFRS 4 insurance contracts

The insurance industry awaited the first stage of accounting standardization of insurance contracts with some apprehension. IFRS 4 is a global standard for the accounting of insurance contracts, which enables the European insurance industry to comply with EU regulations requiring all companies using organized capital markets to prepare consolidated accounts in accordance with IAS/IFRS by 2005. One anticipates that the standard will be applied in other non-European countries, such as Japan or Australia. A further global extension might cause a convergence between the IFRS 4 and US-GAAP accounting regulations on insurance contracts in the years to follow. IFRS 4 and the future standard are limited to accounting for assets and liabilities relating to insurance contracts. The IASB defines insurance contracts as contracts where a significant insurance risk is transferred. There are no details concerning quantitative limits for recognition as an insurance contract and this, combined with the examples given in the draft, means that the future IFRS for insurance contracts can probably be applied to almost all insurance products in the German insurance industry. So far, IFRS 4 allows individual insurance contracts to be valued in accordance with existing local GAAP. Therefore, insurance companies already using international accountancy rules are expecting only a few changes to application and valuation principles.

However, the disappearance of equalization reserves and catastrophe reserves that are allowed under German GAAP causes a major change in insurance accounting for German insurance companies. Owing to the smoothing effect of these reserves on the results, the IASB regards them as particularly non-transparent, and in the transition from German to International Accounting Standards, they must be dissolved and reassessed as equity capital. As a consequence, larger equity capital increases the cost of capital and an adequate shareholder return is harder to attain. From a risk perspective, the smoothing effect could theoretically also be accomplished by equity capital but because of the nature of the insurance business, portraying long-term risk equalization in this way leads to increased equity capital volatility. Indeed, absorbing the resulting volatility with equity capital is feasible, but equalization reserves as well as catastrophe reserves are based on untaxed parts of premiums, whereas equity is built up from after-tax profits. This results in the more expensive balancing of portfolio. In the future, risks pertaining to a catastrophe may only be overcome by

means of higher premiums. Although the definite provisions of a phase II standard cannot be foreseen, IFRS 4 does contain some “tentative conclusions” that give a hint of what is to be expected in a future standard. Within the concept of measuring insurance contracts at fair value a “margin for risk and uncertainty” is an explicit requirement. Allowing management subjective determinations of these margins would create areas of discretion in evaluating technical liabilities and thus in generating profits. In order to prevent negative consequences such as decreased transparency, consistency, and comparability, it is crucial to create approved and generally applied methods for calculating these margins. Furthermore, the applied approaches in the calculations have to be thoroughly revealed. Only with this standardization will one be able to determine whether giving up equalization and catastrophe reserves will be compensated by this margin.

In order to guarantee a minimum level of security concerning cover for actuarial liabilities, the phase I draft contains obligatory “loss recognition tests”. Existing requirements for prospective calculation of reserves and the establishment of potential loss reserves – or in the case of US-GAAP a premium deficiency – mean that the introduction of IFRS loss recognition tests will make no material difference to German insurance companies. However, if the test indicates a deficiency, it will have an immediate effect on the profit and loss account.

In the health and life insurance sectors, the risk component is often accompanied by an investment or savings component. In the case of unbundling, the insurance-related components would be covered by future IFRS Insurance Contracts, whereas the accounting of investment components would follow IAS 39. Additionally, some contractual elements could also be interpreted as derivatives from a financial point of view. In this case, we are dealing with embedded derivatives, for example, guaranteed interest and surrender values. Regulations for unbundling and for embedded derivatives are full of exceptions and are open to interpretation. Thus, IFRS 4 and the IASB phase I regulation do not expose insurance companies to any major challenges.

However, a key problem with IFRS 4 is the varying valuation principles applied to assets and liabilities (accounting mismatch). For example, a rise in interest rates causes a fall in value of bonds, which are subject to fair value accounting. On the other side, the actuarial reserves, which are subject to national regulations, are usually not discounted and are based on a reasonable commercial assessment. Therefore, a rise in interest rates does not change the book value of the reserves. This can lead to an accounting mismatch in assets and liabilities. Economic reality is distorted if the insurance company achieves a duration matching between assets and liabilities and, therefore, has taken steps to protect itself against the consequences of interest rate changes. The interest rate changes continue to have an effect on the balance sheet because these value fluctuations lead to highly volatile equity capital levels. This accounting mismatch problem could lead to a situation where rising interest rates mean that a financially sound life insurer has issues with the supervisory authorities because market value losses to their available for sale (afs) securities led to a severe reduction in equity capital. The IASB argues that inequalities in the treatment of financial assets and actuarial liabilities has also been an inherent feature of US-GAAP

for some time and has not led to major problems. Nevertheless, it can also be argued that the valuation of securities as available for sale (afs), which has been applied in the U.S. for more than 10 years, has indeed led to fluctuations in US-GAAP reporting. However, during this period, interest rates have been falling and thus the value of fixed-interest bonds has tended to rise, and equity capital has, therefore, risen too. In the case of rising interest rates, which is the more likely scenario in coming years, many life insurance companies would face massive problems concerning their equity capital base where this valuation problem would materialize. Additionally, changes to equity capital due to fluctuations in afs bond values are listed separately under US-GAAP, limiting its further disposition. This at least enables one to obtain a more objective view. Under IAS/IFRS, however, this is not necessarily the case.

Owing to the number of complaints about this, the IASB has allowed a voluntary discounting of actuarial liabilities at a rate based on the market interest rate. This would enable a reaction to interest rate changes equivalent to the asset side. However, discounting technical liabilities increases their volatility and does not reflect appropriately the long-term character of the insurance business. In addition, the substantial changes to IT systems necessary to achieve this discounting mean that this can hardly be implemented by 2005.

In continental Europe, IFRS 4 allows for the existing national accounting practices to be maintained to a large extent. Neither the insurance product-related application field, nor the planned IASB phase I regulations concerning unbundling of risk and savings components, or embedded derivatives, represent major challenges to insurance companies. It is mainly the disclosure regulations that will represent a major additional challenge. At least an obligatory disclosure of fair values in the notes has been prevented by the insurance industry since there are no guidelines or regulations regarding the calculation of fair values and therefore no existing objective and comparable base. Insisting on fair value disclosure in the notes would have committed the IASB to undertaking extensive fair value accounting principles in phase II.

IAS 32/39

The revision of IAS 32/39 attracted the attention of the insurance industry as it saw the creation of a new category, “financial asset or financial liability at fair value through profit or loss”. This was the first major step towards fair value accounting since the withdrawal of fair value disclosure in the notes by IFRS 4. The new category allows companies to value every financial instrument at its fair value, be it asset or liability. (The term “financial instrument” relates primarily to equities, bonds, receivables, loans and derivatives.) Not included in IAS 32/39 are shares in affiliated and associated companies, joint ventures and any assets and liabilities arising from insurance contracts. The supervisory authorities countered by expressing concerns that the fair value option might be used inappropriately and disturb the stability of capital markets. As a result, this option can only be applied to those financial assets and liabilities whose fair value is verifiable. The new standard was reviewed only 3 weeks after being issued by the IASB and demonstrates the influence that supervisory authorities still have in this process.

The modification of the IAS 39 category “loans and receivables originated by the enterprise” ran contrary to the principles of fair value. Abandoning the requirement that a loan and receivable must be originated by the enterprise, and allowing loans and receivables that are bought from banks, IASB opened an amortized cost measurement for additional financial instruments. This was a move away from previous fair value orientation by the IASB and might be a window of opportunity for insurance companies attempting to stabilize their yearly results.

European insurance companies are waiting for the European Commission to endorse IAS 32/39. After clashing discussions with the banking sector, the IASB withdrew its first IAS 32/39 proposal. The European Commission proposed an intermediate solution. Issues relating to interest rate margin hedging would be carved out of the standard to be reintroduced as a compromise between the European banking sector and the IASB. The intermediate solution will omit the fair value option and will be ready when the complete endorsement of IAS for 2005 takes place.

Phase II outlook

Since the publication of a draft statement of principles (DSOP), phase II has hardly progressed. The IASB has made it clear, however, that the founding principles of fair value and asset liability measurement approach will be adhered to. Instead of calculating profits and losses on an accrual basis according to the deferral and matching principle, the asset liability measurement approach aims at estimating and discounting future cash flows. The consequence of a fair value measurement of insurance contracts is a net present value of all net cash flows from existing contracts. Since insurance contracts are not traded like financial assets in secondary markets, market values are not available. Therefore, accepted subjective measurement methods must be used. They require an estimate of all the cash flows arising from the insurance contract in the future as well as their valuation with regard to discounting. Thus, even at the time when the insurance contract is concluded, profits have to be collected so that they are reflected in the accounts; they must be brought forward to the beginning of the insurance period. Up to now, the IASB has discussed the “no gain at inception” concept. By this, IASB means that no value of an insurance contract is recognized in the balance sheet. Therefore, in the absence of market evidence to the contrary, the estimated fair value of an insurance liability shall not be less, but may be more, than the entity would charge to accept new contracts with identical terms. Thus, the risk margins especially gain importance in subsequent measurements realizing profits or losses accordingly to the realization of risk (revenue recognition scheme).

Thus, profits and losses will be influenced first and foremost by market fluctuations of financial assets (i.e. by items appearing on the asset side), or by changes and/or deviations in assumptions that were made (i.e. by items appearing on the liability side). Given current equity market volatility and increasing loss volatility due to randomly occurring catastrophic losses, profit fluctuations can reach considerable proportions. This means that insurance companies import fluctuations of the capital markets and economic cycles into their profit and loss accounts, in addition to the normal fluctuations which, owing to the stochastic nature of the business, are considerable at

the best of times. As a result, insurance shares become more volatile than shares in other business sectors.

It is currently impossible to say what the content of the final IFRS on insurance contracts will be. It seems certain, however, that it will mean a complete reappraisal of accounting principles and accounting practices in insurance companies regarding the valuation of assets and liabilities in insurance contracts. It remains to be seen whether the new standard for insurance contracts by the DSOP will be able to provide investors with more and better information (decision usefulness). Besides transparent and comprehensible information on the annual results, the perceived quality of the information for investors is heavily influenced by the reliability of the data for planning investment decisions. The increased volatility of results caused by full fair value accounting might lead to misinterpretations of the insurance company's performance. Only if investors are explicitly aware of the volatility in the insurance business (as assumed by the DSOP) will they take more than 1 year into consideration when evaluating an insurance company. The increased annual volatility will be smoothed out over time.

Still, insurance managers have to reduce the volatility in their annual results caused by a full fair value accounting approach. As a consequence, changing over to IFRS for insurance contracts will have strategic and operative consequences. Insurance companies might be forced to reconsider and rework their strategies. This would mean changes for all operative areas – asset liability management and investment policy, IT, product, underwriting, portfolio, and reinsurance policy, sales, and of course corporate communications. In future, policyholders will have to get used to risk-related premium adjustments and more volatile policyholder's dividends.

Solvency II

The current discussions in the EU on the Solvency II project are aimed at establishing new and more appropriate capital requirements for insurance companies. So far, the current discussions have carved out the following structure: the model would be based on three pillars. Pillar 1 would set the minimum capital requirements. Pillar 2 would encourage proactive risk management by a possible reduction of capital needed. The idea of Pillar 2 is that internal risk management models established by the company might be more appropriate to reflect the individual risk situation of the insurance company than default models set by supervisors. Pillar 3 would emphasize the disclosure of the applied risk management practices, requiring the insurance company to reveal its approach to financial management of the company. One of the main issues within the discussions on Solvency II is the development of IFRS, since it has a major impact on all other areas important for solvency, such as the quantification of risks on the asset as well as on the liability side of the balance sheet. For the models to be applied in Solvency II, risk management is an integral and crucial part. It interacts with all business processes connecting pricing, underwriting, asset allocation, asset-liability management and controlling. The basis for sound risk management models will be market information on assets and liabilities.

The question is whether the data needed to establish the new supervisory model can be provided by the IFRS accounting model. So far, the Solvency II discussion would explicitly require the utilization of information coming from IFRS. Full fair value accounting is a convergence towards an economic capital concept. This might enable insurance companies to use one accounting model for the purpose of external accounting, internal accounting for risk management and capital adequacy modelling, and for statutory requirements. However, the development of Solvency II and of IFRS will show whether the desired convergence of models used in supervision, risk management, and accounting will be accomplished. This would assume that IFRS and the Solvency II capital measures are based on the same cash flows and on the same set of assumptions about the insurer's development. Theoretically, this might be achievable. In practice, it requires sophisticated systems and extensive data on which to base the projections. Furthermore, the latest proposals for IFRS for insurance business represent a mix of prospective and retrospective measurement and as such are not very suitable to reflect the risks in the business. If this convergence is not attained, the information needed for the supervisory models must be provided by a separate accounting system. This would lead to a statutory accounting for the only purpose of supervising insurance companies.

Summary

The anticipation of profits from insurance contracts at inception in terms of embedded value conflicts with the long-term and permanent nature of the insurance business. Instead, profit should continue to be realized periodically according to the risks incurred over time. Furthermore, unrealized gains and losses should not be disclosed in the operating result, because they do not have any effect on the actual cash flow of the company. Otherwise, the outcome would be a difference between the recorded result and the actual result situation.

Since insurance contracts are not tradeable financial instruments and, therefore, market values cannot objectively be deduced, any fair value of insurance liabilities can only lead to significantly more subjectivity in the declared results of the insurers. Therefore, financial assets covering actuarial liabilities should enter in the balance sheet at its amortized costs in the sense of held to maturity investments in order to avoid the aforementioned accounting mismatch.

Considering the immense importance of accounting for the functioning of capital markets and the economy as a whole, accounting rules should be there to portray the insurance business adequately, not to define how the business is run.