New International Accounting Standards and Insurance

Gérard de La Martinière

Comité Européen des Assurances, Chairman of CEA, 3 bis rue chaussée d'Antin, 75005 Paris, France
Fédération Française des Sociétés d'Assurance (FFSA), Chairman of FFSA, 26, bd Haussman, 75311 Paris, Cedex 09, France.
E-mail: gerard.delamartiniere@ffsa.fr

This paper focuses on the new international accounting standards and their impact on the insurance industry.

The Geneva Papers (2005) 30, 108–113. doi:10.1057/palgrave.gpp.2510015

Keywords: accounting; solvency; Europe; insurance; asset-liability management

First, I will describe what insurers want with regard to the new International Accounting Standards. Then, I will detail where we are coming from. Afterwards, I will examine where we stand. Lastly, I will consider where we are going before making concluding remarks.

What do insurers want?

As a result of the variety of concerns expressed by European insurers about the new international accounting standards, it has sometimes been argued that these standards are not understandable. This is a misperception, probably biased by ignorance of insurance basics. What insurers want is relatively clear and well shared around Europe.

As main investors in European markets, insurers are fully supportive of the move toward international accounting standards. This move is important for them because it will promote the transparency and comparability they need, all the more when competing to attract capital. At the same time, insurers, as investors, are concerned about the way the process is managed within Europe. Because of late and disputed preparation, they fear significant disturbances for investors before any noticeable improvements.

When turning to their own insurance business, insurers are even more supportive, as they appreciate the diversity of solutions provided by current national GAAPs. They feel an urgent need for international standardization first inside Europe, and also between Europe, the United States and the rest of the world. At the same time, they are anxious about making sure that the basics of their business are sufficiently considered and assimilated by standard setters so as to enable them to provide adequate solutions that refer correctly to their services and performances. They were rather disappointed by the painful experience of last year's process when the IAS board made clear that it was not interested in understanding the insurance business.

Where are we coming from?

The current accounting landscape is particularly diverse for the insurance industry. The set of standards applied in the United States is largely specific to insurance. Because of substantial differences in business practices, these standards are not immediately usable in Europe, as experienced by European listed companies in the United States. Current European standards are probably better adapted to European insurance practices, but at the cost of a large range of diverging technical solutions (especially in life insurance), which range from fair value accounting to historical cost or amortized cost accounting.

One may have thought that it would have been easy to design more functional standards while at the same time unifying the European babel of accounting rules. Unfortunately, but not unpredictably, the IAS board emerged as totally unable to bring about such standards. More surprisingly, it spent many years going back and forth, without any visible rationality. The first ambitious attempt to design a brand new standard based on a full fair value approach was a total failure for the former IAS Committee: the draft standard, known as DSOP, proposed by the steering group chaired by Warren McGregor, was thrown out after having been heavily criticized for its ignorance of insurance basics.

Despite such difficulties and against the unanimous request of the profession expressed by the CEA, the European insurance companies' association, the European Union took the hasty decision to go forward quickly and make IFRS compulsory starting in 2005. Moreover, it took this decision without having checked what was ready to be implemented and what would be available only in due time. Keeping in mind the deadline of 2005, the industry urged the board to provide a standard for July 2003 at the latest. This proved impossible. The only way out, then, was to introduce an interim period for insurance. But the board wasted another 2 years by refusing to simply leave things as they stood and by trying to design an interim standard that would anticipate some changes (credit insurance, reinsurance and life insurance considered as investment).

As a consequence, the insurance standard IFRS 4 was issued only at the end of March 2004 and the financial standard IFRS 39 that was supposed to be amended and completed is still under discussion. Unanimous proposals of the insurance industry, such as the special category of assets covering insurance liabilities, have been rejected without any real discussion on them.

Where do we stand?

What is the content of IFRS 4 and IFRS 39, keeping in mind the concerns of the insurance industry? IFRS 4 handles the interim period for insurance, that is, Phase I. It imposes accounting for insurance liabilities at current GAAPs and insurance assets at fair value, with due application of IAS 39. In order to smooth the transition, IFRS 4 has taken on a number of amendments provided by the insurance industry. Therefore, the glass is half empty and half full:

- no “sunset” clause or fair value disclosure is imposed;
- participating investment contracts are excluded from the application of IAS 39;

- reinsurance remains the same;
- large windows (i.e. options) are open in order to mitigate the mismatch introduced by the differing philosophies applied to assets vs. liabilities accounting during the interim period.

This last point, which refers to the combined application of IFRS 4 and IFRS 39, raises two big issues that have been emphasized by EFRAG in the comments annexed to its position paper on the endorsement of IFRS 4 and IFRS 39:

- the equity mismatch: because of differing accounting standards for assets and liabilities, the net equity value will give no coherent financial information;
- the deposit floor: as such, it will remove any significance to the fair value option of life insurance liabilities; more generally, it will impair the content of Phase II.

One has to add that the large options opened by the board introduce a lot of flexibility but at the expense of comparability not only between countries or industries but also (and this is new for us) inside the national insurance industry.

It is therefore not difficult to understand why the European insurance industry, which is solely concerned with the interim period, is clearly and unanimously not satisfied with the content of IFRS 4. Counter-proposals for temporary exemption or special insurance category have been set aside by the board without discussion. But, because it needs a standard for 2005, the majority favours a quick endorsement of IFRS 4, even if certain identifiable issues are not yet resolved. The point is that the industry wants the board to solve these controversial issues as soon as possible, as a matter of priority.

For financial instruments a standard does exist, the IFRS 39. One has to emphasize that this standard, which has been described as the flagship of the IAS revolution, is not a conceptual revolution at all. It is, more modestly, an innovativeless translation from U.S. GAAPs. Not exactly in line with the framework (rule-based rather than principle-based) it has been a real deception for those who, from the beginning, have supported the new approach initially sold by the board.

The endorsement of IFRS 39 by the European Union has been delayed for two main reasons:

- the European Central Bank requested deleting or limiting the fair value option for financial liabilities,
- criticism of the banking industry *à propos* the right hedge accounting.

Curiously, the European Commission seems to have deliberately decided to ignore the insurance industry's concerns and to concentrate for the short term on banking critics. The insurance industry has not been involved in the last discussions on IFRS 39 despite the fact that insurance industry concerns are not substantially different from banking industry concerns. Concerns of the two industries point to the recognition of portfolios and hedging when accounting for assets and liabilities at fair value. In fact, IFRS 39 seems to be very controversial as shown by the positions of EFRAG and the European Banking Federation, and by the proposition of the European Commission to carve out the provisions of IFRS 39 on the use of the fair value option and those relating to hedge accounting.

In this context, the European insurance industry will have to preserve a position that has to be balanced between the urgent need for a standard and the need to improve the adequacy of the current IFRS 4 and 39.

Where do we go?

Perspectives are not rosy. The 1 January 2005 is approaching and the final drafts are not yet available. At the time of the writing of this paper, endorsement is not planned before the end of 2004. One has to add that, if the above mentioned provisions are effectively carved out from the endorsement, they will probably not be amended before mid-2005. How is it possible to manage correctly so many significant changes in such a constrained time frame?

Moreover, a number of issues contained in IFRS 4 and 39 are not well addressed and we are progressively discovering the magnitude of these latent unsolved problems. How many issues are concerned? We do not even know. Moreover, the implementation of IFRS has become a lot more complex because of European securities regulators. They have adopted a lot of recommendations that are largely impossible to apply correctly.

The consequence is that we are far from an orderly implementation process and that we run the risk of being confronted with huge market frustrations – if not with short-term financial instability. This will make things even more difficult to manage for insurance companies.

But, as mentioned above, we are not at the end of the game. For the insurance industry, the 1 January 2005, is only a first step corresponding to Phase I. A second revolution is already being foreseen with Phase II that will define the standard for insurance liabilities and for investment liabilities with participating features. The board of IAS has set up a working party that includes industry participants (mainly CFO profiles proposed by the industry) and supervisors, a strategic “input” in view of the insurance solvency reform considered by the European Commission.

Considering the current difficulty of opening a constructive dialogue with the board of IAS and the complexity of the problems to be solved for Phase II, one has to fear the consequence of the decision of the board to work at the same time in common with the American FASB. This will probably make things more difficult and will delay the delivery of the future insurance standard for Phase II. We are therefore facing the risk of recurrent confrontation with the board and of an endless interim period.

On the other hand, it will be very difficult to get a constructive and objective technical contribution from EFRAG because of the strong resistance from auditors and accountants. At the same time, ARC, the European accounting regulatory body, even if it has improved the quality of its work, spends a lot of time in political negotiations between national regulators. In the end, it is the Commission that seems to have understood what is really at stake. However, its growing unsatisfaction has been caught in the deadline it has set for itself.

As far as the insurance industry is concerned, the main requests for a satisfactory Phase II standard are largely consensual:

- the standard should allow the consideration of the strong asset–liability linkage that characterizes the insurance balance sheet;

- it should also take into account portfolios of assets or liabilities and allow for assets to hedge insurance liabilities, depending on their respective durations;
- it should not neglect prudential concerns whose solvency rules play a huge role in the financial strategy of insurance companies;
- required information should be in line with management information systems and easily readable.

Conclusion

Far from reducing financial risks, IFRS 4 and 39 will constitute a source of major risks for the coming years:

- Phase I, far from being a transition, will move insurance balance sheets dramatically away from Phase II as illustrated by the graphic below, which presents the effect of higher interest rates on the French life insurance companies under different accounting scenarios;

- the combination of Phase I and Phase II will impose two successive costly transitions that will disturb the market and have a counterproductive impact on the image of IFRS and on its track record;
- uncertainty about final time frame raises the overall level of risk of the transition period.

This diagnosis is not made by an industry that wants to jeopardize IFRS or that can be suspected of being reluctant to deliver market-friendly reporting. The European insurance industry has a high level of interest in a successful implementation of the new international accounting standards. It has demonstrated without respite its clear willingness to be constructive, by unanimously supporting the endorsement of IFRS 4 and 39 by the European Commission. Now, it needs a strong coordination of its views and to build a common proposal for Phase II if it wants to be heard.

IFRS 4 and 39, as they stand, might well change the current insurance business model from customer-driven products and services to accounting-compatible ones. Such an evolution could have huge potential consequences on the overall financial and macroeconomic system. We have to make sure that this evolution does not threaten to transform insurers and bankers from shock and volatility absorbers to shock and volatility transmitters, if not amplifiers. This is why we have to correct the abovementioned defects of IFRS as quickly as possible.

About the author

Mr. Gérard de La Martinière is a graduate of the “Ecole Polytechnique” and the “Ecole Nationale d’Administration” (ENA). He was appointed Chairman of the FFSA Economic and Financial Committee from 1993 until 2003, and has been Chairman of the Economics and Finance Committee of the CEA (Comité Européen des Assurances) from 2000 to 2003. On 13 May 2003, he was elected Chairman of the French Insurance Association (Fédération Française des Sociétés d’Assurances). He was elected incoming President of the CEA at its 19 June 2003 General Assembly and took up his functions as President in June 2004.