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Ramsey suggested that ceding companies should also be worried about the results of consolidation on counterparty risk. A less diversified pool of reinsurers means more concentrated counterparty risk. On the other hand, reinsurers are using their newfound leverage to push back on recapture triggers. [In December, Swiss Re announced a new global corporate policy against ratings triggers in their reinsurance agreements.] Reinsurers are also obviously less comfortable with change of control provisions. Finally, ceding companies are also concerned that the reinsurers will offer less support for underwriting manuals and intercompany mortality studies as they continue to squeeze their expenses.

Mr. Ramsey sees some hope for increased supply of reinsurance in the future. The increased capacity may come from traditional sources, as P&C reinsurers look to expand their operations, or it may come from unexpected sources. For example, investment bankers are aggressively seeking new securitization transactions, which could add significantly to the capital capacity of life reinsurers. However, securitization transactions to date have had some significant downsides. They are generally more expensive than the more traditional Letter of Credit approach, and they are only appropri-

ate for very large transactions.

Paul Schuster, executive vice president at RGA Re, said that the market today is “all about profitability and capacity.” The result of the price war in term reinsurance in recent years is that all of the profits have been “squeezed out.” One response by reinsurers has been tighter contract terms. Another response is a hesitation to accept new kinds of risks. He views universal life policies with secondary guarantees as “flawed products.” Ceding companies will either pay more to reinsure these products or will have to do business with second-tier reinsurers. Reinsurers are also requiring a higher standard of financial reporting. He suggested that for ceding companies fast and accurate reporting of reinsurance transactions may be a competitive advantage in the future.

Mr. Schuster sees the industry’s need to fund XXX and AXXX reserves as the biggest challenge. He estimated that the need will be \$100 billion in seven years, but the bank Letters of Credit total only about \$25 billion today. He asked how we will meet the \$75 million gap. He sees securitization transactions as the most likely factor to expand the market in the future. But Mr. Clark suggested that the growth in securitization transactions will be slow. “Investors don’t like risks they don’t understand,” he said. ☞

International Financial Reporting Standards and Insurance

by Sam Gutterman

Background

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued “The Norwalk Agreement” in October 2002, a memorandum of understanding that reaffirmed their commitment to develop a single set of high-quality accounting standards. At that meeting the two standard setters agreed to place a high priority on three steps toward achieving that goal:

1. Reduce, through a joint short-term project, (which is now mostly completed) the differences between U.S. GAAP and IASB standards in certain areas not already being addressed by major projects.
2. Remove other differences through the coordination of future work programs and continued progress on the joint projects already underway.
3. Encourage further coordination of the separate activities of their two interpretive bodies.

Of the projects being led by the IASB and monitored by the FASB, the most relevant to readers of this article is the development of a new international financial reporting standard (IFRS) for insurance contracts. This effort is the culmination of work by the Insurance Steering Committee of the IASB's predecessor, the International Accounting Standards Committee (IASC), which began its deliberations in 1997¹. Extensive discussions have been held with many industry stakeholders, including the actuarial profession (led by the International Actuarial Association, along with many national actuarial organizations such as the AAA and the CIA). You may recognize various aspects of this discussion held from various papers and presentations made on fair value accounting over the last couple of years.

The current set of IFRSs does not contain specific accounting guidance for insurance contracts. In fact, insurance contracts are explicitly scoped out of a number of them entirely. Meanwhile, current U.S. GAAP insurance standards have primarily been developed over the past several decades under a matching (revenue and costs) framework which tends to be income statement driven, although the specific approach taken varies by type of contract. This is inconsistent in several ways from that being pioneered by the IASB's revised accounting framework, which is moving more toward a balance sheet orientation.

Due to the complexity of the issues involved (principally whether "fair value" should be used to measure liabilities for insurance contracts, and if so how to measure such a value), the fact that the EU and Australia issued directives that IAS standards would apply for all listed companies by 2005, and the resulting lengthy timeline needed to agree on the standards needed for implementation, the project was divided into two parts:

- Phase I – to provide initial guidance and facilitate consistent compliance with IFRS for European and other countries adopting IFRS in 2005 and
- Phase II – to incorporate in a comprehensive manner the more difficult recognition and

measurement concepts a couple of years later.

The IASB Exposure Draft 5 *Insurance Contracts* (ED 5) was issued in June 2003 as part of phase I and was available for public comment until October. The IASB received more than 130 comments on it. Then through January, the IASB Board discussed several important and controversial issues relating to it. The newly named International Financial Reporting Standard 4 (IFRS 4), expected to be made available in mid-March 2004 is the outcome of these discussions. It is intended to serve as a bridge to phase II that will allow insurers to continue most of their current accounting for insurance contract liabilities until the difficult issues in this area involved are more fully addressed. At the same time, it eliminates certain "low-hanging accounting fruit" that shouldn't require significant resources to change, such as European stabilization and Japanese catastrophe reserves that are inconsistent with the *IASB* framework, which contains the basic concept under which the IASB's standards are based, while at the same time attempting to minimize other significant deviations from the framework. The IASB Board is expected to begin discussion of phase II issues in June of 2004.

The objective of this article is to provide the reader a basic understanding of what has happened to date on phase I of this project, with a brief introduction to some of the key issues that will be addressed in phase II. Please note that because some of the rules are necessarily complex and this article was written prior to publication and implementation of these standards, the description provided may not be completely consistent with practice as will be applied. In addition, it does not cover actuarial standards that are currently being developed by the IAA.

IFRS 4

IFRS 4 (phase I) is the result of a series of compromises, adopted now primarily to satisfy the European Union (EU)'s requirement to move to IASB's standards in 2005, while at the same time not creating the need for expensive systems changes that might have to be

¹IFRS is the name for International Financial Reporting Standards, issued by the IASB. Under its predecessor these were referred to as IAS, or International Accounting Standards.

changed again when phase II is adopted. As a result, several issues addressed here will likely be revisited in the next year or year and a half until phase II is completed.

The following are some of the most significant issues addressed during the process of developing IFRS 4 and some of its key current requirements:

Insurance contract focus. The new insurance contract standard primarily addresses financial reporting for *insurance contracts* rather than for *insurance companies*, although it does incorporate certain requirements for company disclosures as well. In addition, phase I of the project also includes certain changes to other financial reporting standards, including IAS 32 and 39 (the two standards dealing with financial instruments as both assets and liabilities) and IAS 18 (the standard dealing with revenue, including those for service contracts).

Product classification. The insurance accounting approaches used in U.S. GAAP differ depending on what type of product is involved. These categories include short-duration FASB Statement No. 60 (FAS 60), long-duration FAS 60, limited pay FAS 97, universal life-type FAS 97, investment contract FAS 97 and mutual company FAS 120 contracts. Similarly, at least through IFRS 4, the product category in which a contract is classified will determine what measurement method should be used, although all are subject to a liability adequacy test (see below). These categories are:

1. Insurance contracts. These are primarily accounted for by local GAAP rules (that is, if U.S. GAAP is currently used, then it will be able to continue to be applied through the life of phase I), with some exceptions indicated below.

2. Investment contracts (i.e., financial liabilities measured according to IAS 32 / IAS 39). A company is given a choice between the use of an amortized cost or fair value method,

although limited guidance is currently available regarding these methods.

3. Investment contracts with discretionary participation features. This is a new category consisting of various participating contracts. Local GAAP can be used, though they are subject to a minimum value which is based on the investment only (type 2) contract. These are not particularly common in the United States, but can constitute a significant percent of business in force of insurers in countries such as France and Germany.

4. Service features. In accordance with IAS 18, if a class 2 or 3 contract has service features (e.g., variable or unit-linked products with respect to assets managed), then a deferred acquisition cost (DAC) asset can be established, but limited to incremental or marginal costs, then subject to amortization consistent with the revenue recognized.

The measurement methods used can be changed (although somewhat complex criteria must be met), but only if they represent an improvement, that is, a move toward a fair value-based system, e.g., a move from undiscounted to discounted liabilities.

Insurance definition. Due to potentially significant differences in values between the methods applicable to insurance contracts and investment type contracts, the definition of an insurance contract is quite important. The most important distinction is between a financial instrument (type 2 above) and an insurance contract (type 1 above). The IASB has attempted to categorize as many contracts as possible as insurance, in order to reduce the computational (systems) changes required in phase I.

IFRS 4 defines *an insurance contract* as a "contract under which one party (the insurer) accepts *significant insurance risk* from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder or other

If a contract is determined to be an insurance contract, insurers will apply their current accounting standards ...

beneficiary.”

To qualify as insurance, at least one of the following uncertainties must be present: (1) whether an insured event will occur, (2) when it will occur or (3) how much will be paid. Insurance thus includes retroactive reinsurance, in which the insured event would be the insurance payment and not the original loss, but would not include most forms of financial reinsurance, even though the timing of payment is not certain. A key distinction is between insurance and financial risk, the former of which requires some adverse consequences to the insured. However, the key concept underlying this definition is whether a contract has significant insurance risk, in which an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding any scenarios with no discernible effect on the economics of the transaction. Many annuities will contain such risk if they include a minimum guaranteed annuitization benefit, although they will be an investment contract during their accumulate phase if there is no guarantee of rates on annuitization and no significant minimum death benefit. If a contract is determined to be an insurance contract at issue, it will continue to be considered an insurance contract; conversely, if a contract is determined to not have sufficient insurance risk at issue, it can be reclassified as an insurance contract at a later time.

While this definition will most likely result in limited categorization differences from U.S. GAAP for U.S. products, some insurance company contracts will certainly not contain sufficiently “significant insurance risk” under the above definition (particularly many pension contracts and group contracts with a complete experience refund, as well as financial reinsurance), and will be subject to the IASB financial instrument / investment contract standards, IAS 32 and 39.

Like U.S. GAAP, no formula will be provided to measure “significant,” but doubtless some ad hoc benchmark(s) may be developed in practice, although it is highly doubtful that it will be like the informal 10 percent chance of a 10 percent loss rule.

What to do with insurance contracts. If a contract is determined to be an insurance contract, insurers will apply their current accounting standards to insurance contracts until phase II is adopted. Some of the practices specifically allowed in IFRS 4 but expected to be eliminated in phase II that are currently followed by U.S. insurers are:

- Measuring insurance property/casualty loss reserves on an undiscounted basis. In phase II, it is likely that these liabilities will be discounted, with an as yet undefined adjustment for risk (often referred to as a “market value margin,” reflecting the market’s current appetite for risk)

- Reflecting future investments margins in the measurement of insurance liabilities by i) using the estimated return on assets expected to be held as a discount rate or ii) projecting the yield on those assets at an assumed rate of return, discounting the projected returns at a different rate and incorporating the result in the measurement of the liability. This primarily affects non-variable life insurance contracts with a savings element. The inability to reflect such margins, without other offsetting approaches, could lead in some cases to recognition of a loss at issue.

Liability adequacy test. Many of the temporary compromises were made by the IASB assuming that a rigorous liability adequacy test would be applied (this is a new term, but in concept it is similar to a loss recognition test). This test must consider current estimates of all future cash flows from a contract, including embedded options and guarantees. If it fails, then an additional liability is required with the resultant loss recognized as a loss on the income statement. If current accounting policies do not include a liability adequacy test that meets the requirements, then an IASB test, given in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, has to be applied.

Unbundling. If a contract is classified as an insurance contract, unbundling could be required; that is, different accounting approaches could apply to its components if sufficiently different. If both an insurance and a deposit component is present and the deposit element can be measured separately and regu-

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lar accounting policies (in the United States, U.S. GAAP) do not require it to be recognized, unbundling should occur. An example is if a cedant receives compensation for losses from a reinsurer, but the contract obliges the cedant to repay that compensation in future years, the obligation would be deemed to have arisen from a deposit component. Also, if the accounting policies used permit compensation to be recognized as income without recognizing a liability, unbundling is required.

What to do with an investment contract. If an insurer's contract does not have significant insurance risk, it is then subject to the requirements of the recently revised IAS 32 and 39. Under these standards, such a contract will be carried at either its fair value or its amortized cost, as elected by the insurer prior to issue. Although a complete description of these standards is far beyond the scope of this article, the following briefly describes some of their key provisions.

- **Amortized cost.** The interest method is basically used, which solves for the interest rate needed to mature the contract.

- **Fair value.** What constitutes a fair value for these contracts is not yet clearly defined. Concepts such as deposit floor (the net liability cannot be valued for less than amount that the policyholders can demand), own credit standing (reduction in the liability to reflect the credit risk of the company), and treatment of possible future premiums in a flexible premium contract may require IAA guidance.

Measurement inconsistency. One of the most controversial issues in the run-up to IFRS 4 has been the potentially misleading financial information that can be generated by assets and liabilities measured on inconsistent bases. Consistency of measurement has been a long-standing principle of the IAA in the seven-year-long discussion regarding the development of international accounting standards. In addition, it was the topic of a recent joint research project between the IAA and the American Council of Life Insurance (ACLI), showing that income statements would be inconsistent with economic reality when inconsistent measurement is followed as interest rates vary.

Volatile results and results inconsistent

with true underlying performance and economic reality will be reported for many life insurance companies that apply IFRS 4 in 2005, as they continue to follow what can be viewed as primarily an amortized cost approach (in other words, not being fully responsive to changes in the interest rate environment) in the measurement of their liabilities, combined with fair value for most of their assets in accordance with IAS 39 (in the "available for sale" (AFS) category in which changes in fair value are reflected as an equity adjustment; at the January IASB Board meeting, the IASB agreed to expose for comment the possibility of having changes in the fair value of certain AFS assets flow through the income statement, but this may prove to have limited value).

This mismatch in approach (i.e., particularly regarding the sensitivity to changes in the interest rate environment) currently occurs under U.S. GAAP due to the prevalence of the use of the AFS asset category, used to avoid the strict tainting rules associated with classifying these assets as "held-to-maturity," but the impact is reduced by having asset value changes go through other comprehensive income (OCI) and the effect of shadow DAC reported separately. IFRS does not provide for booking of fair value changes through OCI.

This concern arises particularly because of possible artificial losses that will be reported in an increasing interest rate environment that might occur over the next few years, where the value of liabilities will remain relatively stable with a corresponding decline in asset values. Several possible solutions have been raised in the course of the IASB discussions over the past few months, including the possibility of 1) relaxing the tainting rules in IAS 39 (which are generally consistent with FAS 115) to allow for easier classification of assets as "held-to-maturity" which then can be held at amortized cost, being potentially more consistent with changes in some U.S. GAAP net liability values, 2) permitting the use of a separate asset category, "assets backing insurance liabilities," that would permit assets to be held at amortized cost consistent with liability measurement, 3) allowing for the unlocking of

the discount rate used to calculate insurance liabilities by block of business, or 4) providing for some type of shadow accounting to reflect unrealized gains, similar to shadow accounting in U.S. GAAP.

In IFRS 4, the IASB will not permit any asset-based solution to this problem, although the possible changes in reporting for AFS assets in IAS 39 can be viewed as a solution as long as liability measurement is based on current interest rates. However, the IASB will permit a liability-based solution (no. 3 or no. 4 above). The problem with no. 3 is that in many cases, it would require a significantly revised valuation method which could be quite costly to implement. To accommodate this difficult interest-sensitive liability approach which few will utilize, the IASB Board may make the AFS change mentioned above. A few European insurers are exploring the shadow-accounting approach, but it is too early to tell how popular this method might become.

Embedded derivatives. IAS 39 already requires that some embedded derivatives should be separately valued from their host contract, with the effect of a change in fair values flowing through income. IFRS 4 exempts both an embedded derivative that would be an insurance contract if offered separately and surrender options in investment contracts with discretionary features and insurance contracts. Nevertheless, expected cash flows from these embedded derivatives should be reflected in the liability adequacy tests.

Disclosure. An insurer will be required to provide information to understand the amounts in the financial statements that arise from insurance contracts and the amount, timing and uncertainty of their future cash flows. This will include information regarding the effect on profit and loss from sensitivity tests involving material risk variables, claim reserve development, major assumptions, risk

management objectives, and on major risks and their concentration.

Reinsurance-specific items. In general, reinsurance accounting under ED5 applies U.S. GAAP FAS 113 concepts. The following specific rules are included:

- No netting permitted. Gross and net of ceded reinsurance values will have to be reported separately.

- Profit/loss at issue disclosure. Although earlier drafts would not have permitted a profit at issue, IFRS 4 allows a profit to be recorded at treaty issue, as long as this amount is disclosed in the financial statement footnotes. In addition, if the profit/loss is deferred, the amortization of this amount and outstanding balance are also to be disclosed.

- Reinsurance ceded haircut. Less than full recognition of a ceded reinsurance asset could be required, reflecting the credit standing of the reinsurer used. At the time that this article was written, it was unclear what approach

would be taken to measure any such reduction in reinsurance credit.

This only touches the surface of a new system of financial reporting of insurance contracts. This article has not addressed many of what may be significant details that can affect a particular company's reserves. So, when IFRS 4 is published in mid-March, please look through the details. In addition, during the course of implementation, a number of issues will likely arise that were unanticipated when the standard was written.

The next stage

Many very difficult issues will be addressed over the next year and a half in the course of completion of phase II of this project. Because of the difficult conceptual issues involved, it is uncertain how long the development of phase II will take, although it will most likely not be adopted until at least late 2005, for possible

... some embedded derivatives should be separately valued from their host contract, with the effect of a change in fair values flowing through income.

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implementation in 2008. A primary reason for the long timeframe is the IASB has found that changes in accounting approaches for insurance contracts can have serious impacts on many other fields of accounting as well. For example, changes made in IFRS 4 in the definition of DAC for service contracts to include all marginal acquisition expenses may have an unexpected effect on certain bank products.

A brief overview of some of the most important and controversial issues for phase II include:

Fair value. What is the fair value of an insurance contract? A key aspect of this question is whether a “pure” fair value definition or a variation will be used (of which there are many possible ones). For example, should fair value be the entry value, (the original price charged) or the current estimated exit or purely prospective value? If it’s the latter, will a profit be allowed to be reported at issue? Many observers believe some form of fair value will be used in phase II, as the IASB is moving in that direction in many areas.

However, Tom Jones, vice-chairman of the IASB, indicated in September that a fair value approach was not a “fait accompli,” and that the Board would keep an open mind in its upcoming discussions regarding the best approach to take. In fact, if entry values are used, there may be little difference between fair value and a FAS 60 amortized cost approach, possibly even with a DAC and fair value. This debate will continue over the remainder of this IASB project.

Asset / liability measurement mismatch. Although there was a significant effort over the last several months to arrive at a consensus solution, no resolution equally acceptable to all was reached in IFRS 4. Because it is unlikely that all assets will be valued on a fair value basis with changes affecting the income statement by the time phase II is implemented, the effect of measuring assets and liabilities on an inconsistent basis will likely remain an issue for phase II discussions.

Unbundling. Certainly unbundling or bifurcation will be a topic that will be addressed, even whether a traditional whole life contract should somehow be split into its savings and risk elements. Many observers believe that this is needed to provide compara-

ble values with other financial services firms selling deposit or balance type financial products, and that premiums for the savings element should not be counted as revenue.

Embedded derivatives, options and guarantees. It is likely that more of these will be required to be valued through either stochastic methods or demonstrated equivalents. This may present a challenge to many actuaries who will have to be able to apply generally acceptable methodology for the measurement of the fair value of many of these benefits.

Loss reserves. Germane to P&C insurance, it seems that the use of discounted loss reserves is an almost foregone conclusion. However, probably more important is how the corresponding risk margins (generally referred to as market value margins = risk margins that reflect the market’s perception of the risk) are determined for these liabilities.

Renewal premiums. Because renewal premiums are not under the control of the insurer (i.e., policyholders aren’t obligated to pay them), they may not be acceptable to be reflected as an asset or anticipated before collected. A new approach may be required to avoid reflecting these in current measurement, although this might not provide a complete picture of the structure of many insurance contracts.

Future investment margins. When to reflect expected profits from future interest earnings will be addressed. Currently the IASB Board is opposed to reflecting these before the corresponding interest is earned. As a result, initial losses on contract sales may have to be recognized for several insurance products.

Minimum deposit floor. Many within the industry believe that it is inappropriate to incorporate a minimum floor (cash surrender value or zero if there is none) to a liability, particularly if a DAC asset is not allowed. This is currently a constraint on recognition of the otherwise determined liability requirement for investment contracts.

Discount rate. Many believe that the current risk-free rate should be used. However, difficulties can arise in certain cases, i.e., in countries in which there are no assets to match the liabilities involved. Alternatives



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