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## International Accounting Standards (IAS) on Top of Insurers' Minds

by S. Michael McLaughlin, Mark Freedman and Ludovic Antony

*Editor's Note: The section's GAAP List Serve would be an appropriate forum for discussing the concepts of this article.*

### BACKGROUND

The International Accounting Standards Board (IASB) is currently leading a significant effort to transform financial reporting requirements and promote the use of a "single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information." By 2005, all European Union (EU) companies listed on a regulated market and Australian companies will be required to prepare their consolidated accounts under International Financial Reporting Standards (IFRS). The IASB recently released Exposure Draft 5 (ED 5), which covers requirements specific to insurance companies. Ernst & Young and the Society of Actuaries recently co-sponsored a seminar to discuss the key accounting, actuarial and business management issues around IAS implementation. This article provides an overview of the status (as of November, 2003) of international accounting standards by summarizing selected contents of that seminar.

Attendees came from several countries, including the United States, Canada, the United Kingdom, the Netherlands, Italy, Sweden and Bermuda. Presenters included representatives from AEGON, Allianz, the IASB, Scotia Capital and Ernst & Young.

The strong interest manifested in the conference is most likely due to the fact that the implementation of IAS should be a major concern for many companies throughout the world, as it is likely to effect more countries and companies than those already mentioned. For example, the United Kingdom, the Netherlands and Germany have indicated that non-listed companies will be required or given the option to prepare their financial statements under IAS in 2005. Other countries,

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such as the United States, Canada and Hong Kong have committed to convergence to IAS. In particular, the IASB and the Financial Accounting Standards Board (FASB) have entered into the "Norwalk Agreement" to identify and remove any major differences between IAS and U.S. GAAP. Additional information about the Norwalk Agreement can be found at <http://www.iasb.org.uk/docs/press/2002pr15.pdf>.

**A "TWO-PHASED" APPROACH FOR INSURANCE CONTRACTS**

The IASB planned to develop standards based on the Draft Statement of Principles ("DSOP"), which required a fair value measurement for insurance contract liabilities. Due to a lack of time and fierce industry opposition, the IASB conceded that a fair value standard could not be ready for 2005. Consequently, the Board introduced a two-phased approach for the insurance project, with a delay in implementation of the final insurance standard, which will potentially require fair value. Peter Clark, the IASB insurance project's senior manager, mentioned that Phase II might not be implemented before 2008.

In 2005, the two major standards that will apply to insurance companies are IAS 39 and the final standard, which will be based on ED 5. IAS 39 is relevant for financial assets, derivatives and investment contract liabilities, and ED 5 is relevant for insurance contracts.

**INSURANCE CONTRACTS UNDER ED 5**

Under ED 5, insurance contracts are defined as those including significant insurance risk, namely a plausible event that adversely affects the policyholder or beneficiary. If a contract has both significant insurance risk and financial risk, it will be classified as insurance.

Mike McLaughlin of Ernst & Young pointed out that for some products, such as traditional whole life, term life and most property/casualty insurance contracts, classification will be straightforward. But, uncertainties remain for other contracts, such as Single Premium Deferred Annuities (SPDA) sold in the United States.

For insurance contracts, companies will be allowed to use their existing accounting with some key modifications, including the exclusion of catastrophe and equalization reserves and the obligation to perform loss recognition tests on existing liabilities. Other requirements include the unbundling of investment components that are part of insurance contracts and accounting for them under IAS 39. Some existing practices may continue until companies move to fair value accounting, but are not allowed to start. These include, for example, holding undiscounted P/C claim reserves.

Ruurd van den Berg, senior vice president, finance and information at Aegon N.V., explained that the disclosure requirements in ED 5 will lead to a significant increase in the length and complexity of current disclosure processes.

**COMPLYING WITH IAS 39**

The classification of invested assets under IAS 39 will resemble that of US GAAP with categories including Held-to-Maturity, Trading and Available-For-Sale (AFS). Dave Sandberg, corporate actuary at Allianz Life, said that the International Actuarial Association (IAA) was concerned with the potential disconnects that could arise, if for example, insurance liabilities are measured on a cost basis and assets on a fair value basis. Mr. Sandberg presented research done jointly by the IAA and the American Council of Life Insurers (ACLI), which showed disturbing patterns of profit

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and / or surplus that could emerge.

Rick Lynch of Ernst & Young also pointed out that the banking industry is strongly opposed to the current IAS 39 proposal in that it only enables companies to account for hedges on exposures from individual assets or liabilities. Reacting to strong lobbying led by large European banks, the IASB has issued a proposal to revise the current standard to allow macro-hedging accounting in some circumstances. The recent proposal issued by the IASB to update IAS 39 and permit macro-hedging accounting can be found at <http://www.iasb.org.uk/docs/ed-ias39mh/ed-ias39mh.pdf>.

Mark Freedman of Ernst & Young discussed the application of IAS 39 to investment contract liabilities. Companies will have the choice between two valuation options, fair value or amortized cost, with the separation and fair valuation of embedded derivatives. Currently, under IAS 39, there is no requirement for companies to apply one option or the other to all investment contract liabilities, but it is unlikely that insurers will differentiate the option they choose by product. Moreover, the choice is purely elective and will likely be irrevocable. Given that the profit emergence patterns under the two options will be signifi-

cantly different, insurers will therefore need to consider the implications of the two alternatives very carefully before picking one option.

At a contract's inception, the measurement basis for liabilities under fair value and amortized cost is the initial value, which is the difference between the gross premium and the transaction costs. Transaction costs are incremental and directly attributable acquisition costs. IAS 39 does not currently allow the inclusion of any internal acquisition costs, such as bonuses paid to internal agents, in the definition of transaction costs. The IASB may, however, decide to remove this exclusion. Under the amortized cost method, the contract's carrying amount will be equal to the initial value accumulated at the effective interest rate, i.e. the rate that discounts all future contractual cash flows, back to the initial value of the contract.

Ludovic Antony of Ernst & Young presented a case study on a European investment product. Assets were considered AFS and the yield curve was assumed to be flat. This resulted in a stable profit emergence pattern across the projection, since the difference between the earned rate and the effective interest rate was level across the projection.

This was in contrast to another case study presented by Mark Freedman on a U.S. SPDA with a steep forward yield curve. Since the book yields increased and the effective interest rate was level, there was a disturbing profit emergence pattern displaying losses during the first years and gains afterwards. Such results should be quite difficult to explain to management!

Although IAS 39 is currently silent about how the amortized cost reserve calculation should reflect changes in the estimate of future cash flows, the IASB is currently exploring various methods and intends to issue further guidance. The first method, called the "retrospective" approach, involves calculating the reserves using future revised best estimate cash flows and an effective interest rate, recalculated at inception with actual cash flows at the date of change in assumptions and revised estimates for the remaining life of the contract. This approach shows a volatility of results comparable to that created by DAC (deferred acquisition cost) unlocking under U.S. GAAP. The second approach, toward which the IASB seems to be leaning, called a "cumulative catch-up" approach, involves calculating reserves at the



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time of change using the effective interest rate determined at inception and future revised estimates. Although this approach would not require companies to keep track of historical cash flows and re-estimate the effective interest rate yield, results will likely be more volatile under this approach than under the “retrospective” one. This was illustrated in a case study presented by Ludovic Antony.

The other option under IAS 39 is fair value. IAS 39 does not provide any guidance on the calculation of fair value although it states that it would allow a “...valuation technique commonly used by market participants” when market prices are not available. Although this seems to qualify methods, such as embedded value, as a basis for measuring the fair value of liabilities, the IASB might not allow such a technique, as it has made public its dislike of embedded value. The board also stated its intention to revise IAS 39 to introduce a minimum floor to the fair value of liabilities equal to the amount payable on demand by policyholders, a view that the IAA strongly opposes due to its lack of consistency with general fair value principles.

## EMBEDDED DERIVATIVES

Under ED 5 and the IAS 39 amortized cost option, companies will be required to separate embedded derivatives and value them at fair value, if they are not insurance contracts and are not closely related to the host contract. As a result of making exceptions for insurance contracts, as well as options and guarantees that do not meet the definition of embedded derivatives, many product features will not be measured at fair value under IAS, a situation over which the IAA has expressed its concern. Gary Finkelstein of Ernst & Young also noted that, although the IAS requirements are close to U.S. GAAP requirements, there are still some differences. Under U.S. GAAP, guarantees must be net settled, whereas under IAS they could be settled in the future. In addition, grandfathering will not be allowed under IAS, as opposed to U.S. GAAP.

## PRACTICAL CONCERNS AND SUCCESS FACTORS FOR PHASE I IMPLEMENTATION

Ruurd van den Berg provided the audience

with a taste of AEGON’s Phase I conversion plans. According to him, key threats to the plan include a tight deadline for first time implementation, coupled with current uncertainties around IAS 39 and ED 5, limited skilled resources and other time consuming parallel projects, such as compliance with Sarbanes-Oxley, embedded value reporting and Dutch Accounting Principles reporting. The key success factors for implementation include (1) full support at the executive level and (2) efficient communication through the organization, coordinated by a project management team at the corporate group level and assisted by dedicated teams at the local level.

## FAIR VALUE ACCOUNTING

Fair value would potentially apply to insurance contracts under Phase II, and it will apply beginning in 2005 to investment contracts, for companies that choose the fair value option. Peter Clark presented the key features of the IASB’s current thinking about the fair value model for Phase II. The fair value of insurance liabilities should be equal to the expected present value of all future liability cash flows, discounted at a risk free discount rate with a spread corresponding to the organization’s own credit standing and market value margins that enable the valuation to fully reflect the market price of risks in the cash flows. Cash flows should be projected using economic assumptions. Some economic assumptions, however, may not be observable in the market. In this case, companies may use their own estimates as proxies for economic assumptions, unless there is specific evidence that this is inappropriate. Finally, in the fair value model, options and guarantees should be valued using option pricing techniques.

Furthermore, the IASB has stated that it may not allow any profit at issue, unless this is supported by strong market evidence. This would probably significantly change the profit emergence patterns of many products, as was illustrated by a case study presented by Maria Torres-Jorda of Ernst & Young. Ms. Torres-Jorda also illustrated that profit emergence for an SPDA would be volatile in changing interest rate environments, even if assets and liabilities



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were approximately matched.

The board has also stated that renewal premiums would be included in future cash flows only if policyholders had rights that significantly restrain a company's ability to re-price contracts, and are forfeited upon lapse. In particular, the exclusion of renewal premiums in the measurement of liabilities, for many types of flexible premium policies, such as universal life and variable universal life, as well as "unit-linked" products in Europe, is inconsistent with how contracts are currently being priced, and would probably cause companies to incur losses at issue, as was illustrated by Mark Freedman in a case study about a regular premium variable contract in the Netherlands.

The board also made it clear that it would not allow the capitalization of future investment spreads in reported results, thus rejecting traditional embedded value approaches as the basis for measuring fair value. However, Ruurd van den Berg emphasized the fact that embedded value has all the qualities that make it a suitable framework for measuring the fair value of liabilities. It was later shown by Mike McLaughlin, based on the work of Luke Girard, that embed-

ded value reconciles to fair value, if a consistent set of assumptions was used. In addition, "stochastic embedded value" would allow for the valuation of the embedded options and guarantees that are often neglected in traditional embedded value calculations, and it would provide useful risk management insights.

Tom MacKinnon, senior stock analyst at Scotia Capital, said that although there are still some major concerns and uncertainties about fair value implementation, the move to fair value represents an important step toward the harmonization of financial reporting among countries that is increasingly needed, as the insurance sector is becoming increasingly global. He stated that fair value implementation would be even more meaningful, if regulators used the fair value framework to perform the calculation of minimum capital requirements. Moreover, Mr. MacKinnon indicated that a key concern for analysts following the implementation of fair value would be the disclosure of sensitivity analyses and the disclosures and detailed explanation of sources of earnings.

#### WIDER LINKS AND APPLICATIONS

The IAS seminar was also an opportunity to provide participants with a perspective on wider risk and capital management issues. As insurers become more convinced that fair value concepts are the most suitable to assess performance on an economic basis and evaluate complex risks, such as those arising from guarantees and options, some insurers have already started implementing such frameworks. These frameworks will also support wider risk management initiatives needed to manage insurance operations in today's environment.

#### ECONOMIC VALUE MEASUREMENT

Mike McLaughlin gave an overview of the Economic Value Measurement (EVM) framework, under which companies measure assets and liabilities using market value or economic value. The concepts used to value the liabilities in these frameworks are very similar to those currently outlined in the IAS Phase II fair value model. In an EVM framework, the main components of the balance sheet are the market value of assets, the economic value of liabilities and the economic net worth. The economic net worth is composed of economic



capital and any additional amount over economic capital needed to comply with regulatory or rating agency capital requirements. The value of economic liabilities is equal to the value of a portfolio of marketable instruments that replicates liability cash flows and frictional costs. Frictional capital costs are inefficiency costs that reflect the price of risks in insurance cash flows, such as market value margins would under IAS.

Mr. McLaughlin showed that the analysis of movement of an economic balance sheet between two reporting dates enables companies to derive economic return measures and attribute performance to different functions across the organization, namely the insurance function, the risk and capital management function and the proprietary asset management function. This has helped companies gain new insights about the value creation process in their different businesses and illustrates why the move to fair value accounting is strategically important for the industry.

#### VALUING EMBEDDED OPTIONS AND GUARANTEES

Implicit in the valuation of economic liabilities in a fair value framework is the valuation of options and guarantees embedded in insurance and investment contracts, a key concern for many life insurers recently suffering from the costs of such guarantees and for those implementing IAS Phase I requirements under IAS 39. Gary Finkelstein provided a thorough description of leading-edge valuation techniques, from simulation and lattice to replicating methods. Mr. Finkelstein illustrated, with two case studies, how powerful replicating techniques could be in practice. In the first case study, he showed that put options provided a very efficient replicating strategy for the costs of fixed maturity guarantees. In the second case study, although the replicating strategy did not prove to be as efficient, costs of guaranteed annuity options were reasonably well replicated using receiver swaptions. According to Mr. Finkelstein, insurers that are able to identify, measure and implement strategies that hedge the costs of these guarantees and manage their balance-sheet volatility, will be ahead of their competitors in the current volatile financial environment.

#### IMPLEMENTING AN OVERALL RISK FRAMEWORK: VALUE TO THE COMPANY AND SYNERGIES WITH IAS AND UPCOMING REGULATORY REQUIREMENTS

Finally, Doug French of Ernst & Young reviewed how the events in the last two years, with more economic, business and cultural shocks than any time in recent memory, have affected the insurance industry and highlighted the need for the development of enhanced overall risk frameworks. These frameworks would also help meet the need for enhanced disclosure required by IAS. According to Mr. French, an overall risk framework's objectives are to (1) enhance business performance by providing decision makers with a holistic and complete view of their operations, (2) improve the level of confidence by providing management with better assurance that the business is being directed and controlled effectively, ensuring "no bad surprises" and (3) improve the ability to respond to sudden and unpredictable changes. The frameworks that need to be implemented in order to fulfill these goals are (1) a risk measurement framework, (2) a risk management framework and (3) a risk governance framework.

A risk measurement framework will provide executives with the vital information needed to make fact-based decisions, with the increasing use of value-based concepts such as embedded value, risk-adjusted performance measurement and fair value, to provide companies with a realistic view of the risks and performance of their businesses. Companies already implementing leading-edge risk measurement frameworks will likely jumpstart their IAS conversion efforts, as well as those implied by other upcoming regulatory requirements, such as Solvency II, which will set forth the basis for measuring regulatory capital requirements in Europe in the near future.

A realistic risk measurement framework alone is not sufficient to conduct business operations successfully. A risk management framework is also needed to drive the establishment of committees, including product pricing and design, ALM and enterprise risk committees, in order to ensure that risks are realistically

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... enhanced overall risk frameworks. ...would also help meet the need for enhanced disclosure required by IAS.

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the IASB finalizes the Phase II standard for insurance contracts, in which insurance liabilities will likely be measured at fair value. The IASB re-emphasized its commitment to Phase II in a recent meeting held in November 2003, and is planning to resume discussing Phase II in May 2004. The aim is to complete an exposure draft by 2005, in order to provide companies with time to get ready for the implementation of Phase II requirements for insurance contracts, at the earliest by 2008. As the move to fair value for insurance contracts appears to be inevitable, companies that are already putting significant efforts into the implementation of Phase I requirements will also need to continue exploring the many business implications related to Phase II. These include (1) an expected increased volatility of earnings, (2) the need to develop a proactive approach to asset and liability management, with closer matching of assets and liabilities to reduce volatility, (3) changes in product design, especially in the areas of guarantees, options, and embedded derivatives, which are likely to be scaled-back, (4) system challenges, such as any need to develop sophisticated option pricing models to measure liabilities at fair value and (5) the challenges arising from the need to communicate and explain results to analysts, shareholders and policyholders. Some insurers already managing their operations based on frameworks similar to fair value will certainly be best prepared to face these challenges. ☒

measured, monitored and efficiently managed.

Finally, for an institution's risk management and measurement frameworks to be driven in the right direction, appropriate roles, responsibilities and hand-offs must be agreed upon to ensure that a working governance process is in place.

Although there seems to be an urgency for companies to implement an enhanced overall risk framework, according to the results of a recent survey conducted by Ernst & Young, companies admitted that they were less than halfway toward their ideal risk framework and are still facing many implementation challenges, ranging from a lack of skilled resources and management support to technical issues. Fortunately, many companies in the survey recognized the importance of the matter in the current environment.



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## CONCLUSION

Beginning in 2005, all European Union listed and Australian insurance companies will need to implement IAS Phase I requirements, based on ED 5 for insurance contracts and IAS 39 for investment contracts. This will change when