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Communicating Under Revised Insurance Accounting Proposals

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U.S. insurance company financial reporting will undergo an unprecedented level of change within the next several years. The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) are currently working on a number of joint projects with the goal of converging and improving both U.S. and international standards.

Perhaps most relevant to insurance companies is the insurance contract accounting standard, and, in this regard, convergence between U.S. GAAP and International Financial Reporting Standards (IFRS) presents a number of business challenges and opportunities. Although the target date for completion of the insurance contracts standard has been delayed, the timeline to implementation is still such that this should be high on the agenda for insurance companies.

While there will be significant implementation issues of both a practical and technical nature, one of the most fundamental issues to be dealt with is how the impact of the change will be communicated to investors, policyholders, rating agencies and other key stakeholders.

Communicating the value in life insurers represents a significant challenge, and there will be a short window of time in which to do this following conversion to a new accounting standard. Nevertheless, companies who get the message right are likely to reap the rewards.

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This article discusses some of the challenges that are likely to arise and which will need to be communicated effectively. The article will then cover potential approaches to deal with some of these challenges and what can be learned from the experiences of other territories where market-consistent techniques are already being used.

IMPACT OF INSURANCE ACCOUNTING CHANGES

To put the potential communication challenges in context, a brief description of the building-block approach set out in the IASB Exposure Draft is set out in the following insert.

- An unbiased probability-weighted best estimate of future cash flows in fulfilling the contract.
- Discounting at a risk-free rate appropriate to the nature of the liabilities, including the illiquidity of the liabilities.
- A risk margin reflecting the uncertainty of the amount and timing of the cash flows.
- A residual margin which removes a day-one gain.

Under the approach set out by the FASB in its discussion paper, the main difference is that the risk margin and residual margin are combined into a composite margin. The amortization of the composite margin is also different, and interest does not accrue. The IASB approach requires that the risk margin be reassessed each period, on current assumptions, and allows for interest accrual on the residual margin. The risk margin approach remains a key topic of debate in achieving a combined model.

As a result of adopting these measurement models, a number of potential challenges arise in the communication of GAAP results:

Earnings profile—The earnings profile, and hence generation of GAAP cash flow, will be substantially different than under current U.S. GAAP. The pattern of recognition of profits will be unfamiliar compared with existing GAAP measures. Combine this with additional volatility along with the impact of transitional measures (see below), and there will be a strong need to communicate not just the impact on conversion but the ongoing differences in likely earnings.

Volatility—The requirements that measurement be current (i.e., that the estimates of future cash flows will reflect all available information at the measurement date) and the use of a market-consistent valuation are likely to result in greater volatility of earnings.

Under both the FASB and IASB approaches, the liability cash flows would be based on current assumptions for non-market variables. If these assumptions change, the capitalized value of that change on all future cash flows would impact the liability value and current period income statement.

The use of a market-consistent valuation also introduces potential volatility. Volatility arises due to valuation mismatches between the market value of assets and the mark-to-model approach using a market-consistent calibration on the liability side. Differences arise from many sources; however, the discount rate used (discussed below), extrapolating market observations to the longer durations (required for insurance liabilities) and the calibration of volatility assumptions are amongst some of the most significant.

In particular, in distressed market conditions, such as those observed in the financial crisis at the end of 2008, the depth and liquidity of the market for certain instruments and durations can raise questions on whether there is a sufficiently robust market to calibrate the liability valuation model to. In such situations the mismatch between assets and liabilities can be particularly significant.

Under the IASB approach the risk margin would also be recalculated each period adding a further source of potential volatility. This would arise as management's view of risk changes over the life of the contracts.

In our 2009 survey of analysts' perspectives of current and future reporting in the insurance industry, a majority (60 percent) of U.S. analysts wanted changes in assumptions to be reflected in the income statement immediately. Typically this view was held by those who wanted the impact of management changes to be as visible as possible.

Only 15 percent of our survey participants felt that companies should treat changes in economic and non-economic assumptions in different ways.

These sources of potential volatility can make it difficult to understand how the profits in any period relate to the likely future emergence of profits, and therefore, the ultimate value inherent in the business.

Discount rate—The discount rate used in the liability valuation is a key assumption and will require careful communication for a number of reasons:

- Spread-based business such as U.S. fixed annuities can look uneconomic if the discount rate does not reflect the expected return on assets used to back the liabilities. In particular where there are guaranteed or minimum crediting rates to policyholders, the impact of using a risk-free rate can be onerous. Communicating the economic viability of such products despite the valuation requirement can be challenging.

- The allowance for any illiquidity premium in the liability discount rate can be a significant assumption. However, the inability to directly observe transaction prices for liquid and illiquid insurance liabilities makes it difficult to assess the appropriate adjustment to the risk-free rate. Furthermore, different liabilities display different liquidity characteristics making the determination of the appropriate assumption for any particular insurance portfolio more difficult. A number of potential approaches are evolving (including the use of more "top-down" approaches based on portfolio yields less adjustments for credit risk) as a result of investigations supporting the EU Solvency II implementation requirements; however, this is likely to be an area of interest and focus to users of the financial statements.

- The rate at which the liability cash flows are discounted becomes the rate that insurers need to outperform each year (to achieve a positive investment variance). This rate therefore becomes important in determining a benchmark or hurdle rate for measuring asset performance. This may create a need for careful communication, as it is unlikely that assets will be invested in this way. In particular, it will be difficult to replicate or hedge to a risk-free rate with an allowance for an illiquidity premium making matching difficult.

Link with risk management—If the IASB approach of identifying a separate risk margin is ultimately adopted by the boards, this is likely to stimulate questions on how the risk margin relates to other forms of capital such as regulatory, economic or rating agency capital levels.

> In our 2009 survey of analysts' perspectives of current and future reporting in the insurance industry, a majority (58 percent) of U.S. analysts wanted insurers to report a risk margin. Some respondents expressed the view that it is the disclosure around the risk margin that is important. However, others felt that risk margins were too subjective and a further sign of over complexity in insurance reporting.

One of the key criticisms of requiring a separate risk margin is the lack of a consistent method and approach to parameterization across the industry. This makes the resulting risk margins difficult to compare and understand. It is therefore highly likely that users of the financial statements will want to understand how the risk margin relates to other forms of capital.

Other capital measures are typically calculated at an insurance entity level, whereas risk margins would apply to insurance contracts. This may result in the need to subdivide other capital measures by accounting contract classification, and to reconcile these to the risk margin.

There are many reasons why the risk margin would be different than regulatory, economic or rating agency level capital for the same contracts. However, it is likely that analysts and other users of the financial statements will want to understand the relationship and reasons for the differences. They will also be keen to understand how the risk margin will be released over time to profit.

Transitional measures—The IASB Exposure Draft includes the intended approach to transition in-force contracts as at the date of conversion to the new standard. Under this approach, the measurement of the liability would not include a residual margin either on transition or subsequently. Existing deferred acquisi-

tion costs and any intangible assets associated with the contracts would be derecognized.

Although it is likely that this approach will see revision, this could result in the release of profit, which would not be recognized in period earnings. Subsequent earnings would be reduced compared to the existing GAAP profile. The quantification of the risk margin for the in-force contracts will therefore be important in determining the future earnings profile and increases the need to understand how this relates to other capital measures.

The impact of the transitional measures on in-force business, both at initial measurement and subsequently, will therefore be an important component in explaining the likely earnings profile. Insurance companies will need to explain the reason for lower expected returns on capital compared to current more familiar measures.

In its discussion paper, the FASB did not set out any intended transitional arrangements. As of the date of publication, this topic had not been addressed by the board.

Disclosure requirements—In addition to the above communication points, the Exposure Draft and discussion papers propose certain required disclosures. They are more detailed than currently required and may involve significant development of analytical processes and systems. In particular the presentation of the income statement, using a margin analysis style presentation, will be a significant change in how companies think of, measure, manage and communicate their earnings performance. This will require more of a focus on the underlying drivers of the emergence of profit.

This income statement analysis, along with the required reconciliation of movements in the insurance and reinsurance balances, can be a difficult and time consuming exercise to perform, particularly on a market-consistent basis. The effort to develop robust, repeatable processes, which deliver these analyses within the reporting timelines, should not be underestimated.

The risk management disclosures are similar in nature and content to current IFRS requirements. However, as discussed above, a greater alignment of risk management information, risk-based capital assessments, and any risk margin under insurance accounting standards, will undoubtedly require careful consideration and communication.

Finally, considering the extent to which information is confidential or may provide advantage to competitors will be important. Presenting information in a way that allows the intended messages to be conveyed, but limits sensitive information, will clearly be worthwhile.

DEALING WITH THESE CHALLENGES

In order to construct an effective communication strategy to deal with the above areas, it is useful to consider three fundamental metrics that are important to the users of insurance company financial statements:

- *Cash*—The generation of GAAP and statutory earnings in any period. This is a combination of the release of profits from in-force business and the potential strain as a result of writing new business in the period.

- *Capital*—This is a combination of regulatory capital requirements along with companies' own internal view of how much capital they need to manage the business and meet corporate objectives. Regulatory capital requirements will dictate the minimum amount that needs to be maintained within the company. Capital required to meet internal objectives is likely to be a more economic, and risk-sensitive view of capital. In particular, it may include rating agency objectives, such as maintaining a particular ratings classification.

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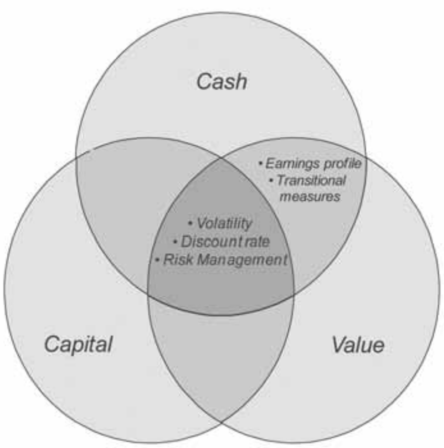
- *Value*—This is the long-term value that is ultimately expected to become available to shareholders. It represents retained earnings, “locked in” capital and the potential for future profits to emerge from the business. This value could be based on the current in-force business (similar to embedded value reporting currently common in Europe) or an appraisal value metric allowing for the new business generating capacity of the company.

Using these fundamental metrics to explain the impact of the change in accounting basis can ensure that this not only conveys the impact at conversion, but also in the longer term through value and the interaction with risk management and capital.



This diagram shows that each of the areas identified above impacts multiple metrics, and considering only one of them will miss an important part of the message.

Reconciling the metrics—One of the key difficulties that users of insurance company financial statements often find is being able to understand the linkage and interactions between these fundamental metrics. Explaining the relationship between the metrics will increase transparency and aid understanding of how the change in accounting basis fits within the overall position of the company. Starting with regulatory surplus capital, adjustments can be shown (for example for any policyholder surplus, intangibles and other valuation differences) to reach an IFRS equity position. This can then be continued to remove any long-term capital costs and then add in the expected future profits to result in the long-term value metric. European companies already on an IFRS basis who show this type of reconciliation commonly do so in tabular form or as a waterfall diagram.

Earnings profile and transitional measures—On adoption of the new insurance standard there will be substantial disclosures required consistent with any restatement or change of basis. However, it is also worth considering the ongoing impact, and how to communicate the likely change in earnings profile in future years. In particular, in subsequent reporting periods, the potential lower returns as a result of transitional measures may need to be explained.

The linkage between cash and value is clearly important here. One message is that the long-term value is unchanged, and retained earnings have increased today, in exchange for lower future years’ earnings. Although not recognized in earnings on conversion, value has been released earlier than it would have under existing GAAP and is therefore more tangible; although return on equity may be lower as a result in future years. A graphical presentation of profit signatures before and after may be a useful approach to communicating this message.

Following conversion, it may also be worth considering whether to separate out the return on equity for the converted business and the new business written since conversion, to show that the return on the new business block is similar to pre-conversion measures.

The GAAP retained earnings, plus the risk and residual margin (or composite margin) may become a proxy for the long-term value of the business. However there may be reasons why this is not a good value metric (such as amounts that may be allocated to policyholders), and embedded value techniques may become a more important metric.

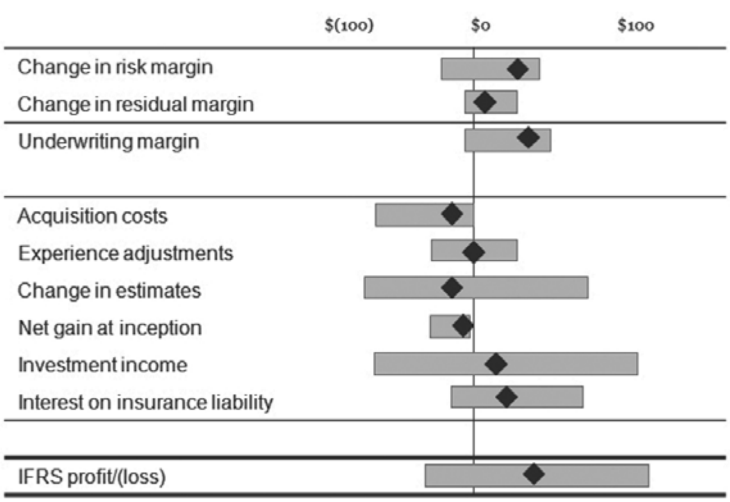
The margin analysis style of income statement presentation will also be helpful in explaining what the drivers of the earnings in any period are. However, to fully explain the sources of earnings, a subdivision between the business in-force at the start of the period and the new business written in the period will be useful. With the addition of a new business contribution, the income statement will provide a valuable tool in explaining how earnings may progress over time and dealing with volatility (see below).

Some companies already perform this type of analysis and present it as a waterfall diagram showing the movement in GAAP equity in the reporting period.

Volatility—Again, the revised income statement presentation, on a margin analysis basis, is a helpful starting point for explaining volatility. Some elements of the income statement will be more stable than others. These lines can be used as a reasonable basis for forming expectations of earnings, from similar sources, in future periods. For example, the residual margin should be reasonably predictable and will follow the chosen amortization and interest schedule. However, investment margins may be more volatile and less predictable.

Linking the GAAP margin analysis to the business planning cycle, and performing stress testing, can create an understanding of the range of likely outcomes for each line in the income statement. For example, the impact on earnings of stress testing to optimistic and pessimistic assumptions can be shown as a bar for each income statement line. This type of analysis will be useful in communicating performance.

It is unlikely that companies would go as far as external disclosure of the above analysis. However, it is useful internal information, and helps facilitate a better understanding of how variable the earnings drivers are and, therefore, what the external messages need to be.



Producing the full margin analysis is likely to be an onerous and time consuming process, which will realistically only be performed a few times a year. Therefore, being able to separate out the reasons for volatility, and developing more readily available key predictive metrics (for example, a claim loss ratio may indicate the need for a change in estimate), will also help in the understanding of performance as it emerges over the year. This will enable early, internal and possibly external communication of under- or over-performance.

This type of analysis also facilitates communication of actions taken by management to reduce volatility. These actions may often incur cost, but show no direct earnings benefit in current conditions. Being able to show the possible volatility of earnings, before and after, will help demonstrate the value added by the management action.

It is already common to perform sensitivity testing of GAAP and capital results. Doing this across cash, capital and value metrics on a consistent set of stresses will also further help explain the interaction among the metrics and how they move relative to each other in particular situations.

Discount rate—One of the areas where a market-consistent valuation may not show the realistic economic value for a block of business is where earnings are driven by investment spreads. This is clearly a significant consideration in the United States. The difficulty arises as the crediting rate is set, based on expected asset performance, and this can be in excess of the risk-free rate. Additionally, minimum guaranteed crediting rates may also be in excess of the risk-free rate. The benefits can therefore be assumed to grow faster than the discount rate, resulting in projected investment losses and, therefore, a valuation strain.

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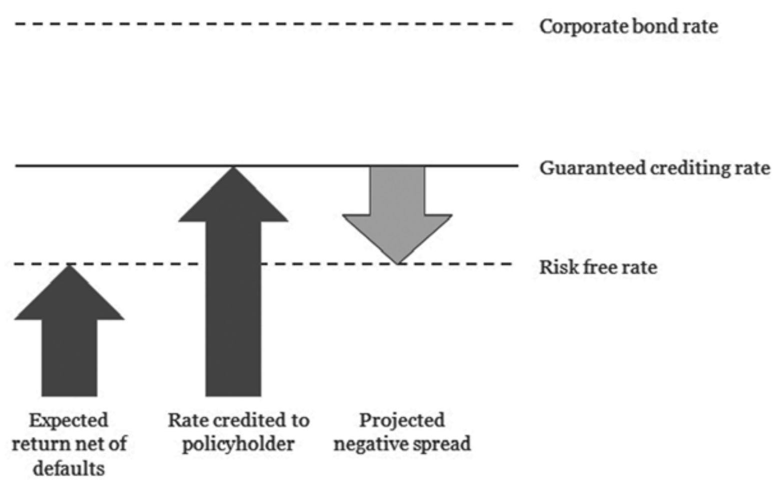

This is an issue that companies in Europe have recently faced when converting to market-consistent embedded value under the European CFO Forum MCEV Principles©.

Due to the financial significance of this issue, a number of companies made additional disclosures (both in their supplementary financial statements and analyst presentations) to explain the reason for the apparent loss, and to explain why these products are still economically viable.

A number of companies used diagrams similar to that shown above, to explain the projected negative spread. They commented that, as management expects the return earned each year to be closer to a corporate bond rate, there would be an expectation of a positive investment variance each year in the future.

In the model, invested assets are equal to baseline statutory reserves and required capital, with distributable earnings released as earned.

Some companies showed this by illustrating historic returns on their asset portfolio in relation to the risk-free rate. They demonstrated that they had achieved a positive spread each year, rather than the negative spread projected in the valuation. Some companies also included illustrative profit profiles showing that the loss suffered would be returned through investment variances.

For companies with substantial portfolios of spread-based business, getting this message across will be critical.

The approach to determining the liquidity premium applied to the discount rate, and the products to which it is applied, are likely to be useful disclosures. MCEV reporters already disclose these as well as sensitivity to the liquidity premium applied.

Explaining asset performance relative to the discount rate in the period will also be an important element in adding commentary to the margin analysis presentation of income.

Risk management—The linkage between cash and capital is clearly important in explaining the risk margin in the context of "locked in" capital needed for regulatory, risk management or rating agency purposes.

In the past, the amount of capital required to meet rating agency objectives has often been based on multiples of regulatory capital. However, with the rating agencies becoming more focused on enterprise risk management, economic capital will also become more important. If a risk margin is part of a new insurance contract standard, then this is also likely to require an economic capital style calculation, and many companies will use their existing internal capital models to calculate this.

This will ultimately create a process where GAAP profits will be more sensitive to risk management actions, and therefore GAAP commentary will need to link to risk disclosures.

WHAT CAN BE DONE TO PREPARE?

The impact of moving accounting to an IFRS for insurance contracts will vary from company to company. One of the key preparations that can be started now is to investigate which of the above areas are important for your business. Understanding which areas will be important, and which will require careful communication to investors, will allow time to develop the required analyses and processes and to ensure information is available to facilitate the message.

Early quantitative analysis of the likely impact of the required changes on the balance sheet and future income statements, along with product level analysis of changing profit signatures, will enable identification of important areas and board education and allow early preparation for communication strategies.

There is likely to be increased pressure and greater demands from investors and analysts to communicate the performance of insurance companies going forward. The difficulties of producing these disclosures in a robust manner should not be underestimated. It is likely that implementing them will pose significant challenges around data and systems for most companies.

However, showing the accounting change in the context of other metrics, and being able to show that the underlying business strategy, plans and inherent value are not compromised, is likely to lead to greater understanding by investors and analysts with potential beneficial results. ■

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