International Section News

September 2000 – Issue No. 23

International Accounting Standards for Insurance

by Bruce D. Moore

The International Accounting Standards Committee released an Issues Paper on Insurance late last year. The Insurance Steering Committee has been working for almost two years on a project that will ultimately result in an Accounting Standard for insurance. The actuarial professional has been heavily involved in that effort, primarily through a special committee of the International Actuarial Association focused on this issue. The result of this project will have broad implications for the insurance industry, including ultimately U.S. insurers as well. The IASC released its Issues Paper in December 1999, with a comment deadline of May 31, 2000. A copy can be obtained from the following Web site: *www.iasc.org.uk/frame/cen3_113.htm.*

This article reviews the background of that project, the processes by which the actuarial profession and others are providing input to that, and some of the more important issues.

Background

A number of important trends during the 1990s have influenced the development of International Accounting Standards. The internationalization of capital markets has led to a need for accounting standards that could be used for multinationals to access capital outside their home country. The increasing use of complex financial instruments such as derivatives has led to a need to reexamine accounting standards at both an international level and individual countries. (FASB is actively reexamining the accounting for financial instruments now). The convergence of banking, insurance, and other financial services industries has also led to a need for more consistent accounting between financial services industries. The deregulation of insurance markets and the ever-increasing market share of multi-national insurers has led to a need for common standards in insurance for both general purpose financial reporting and for regulatory purposes.

This globalization of capital markets and the trend of large multinational companies to list their shares on several international stock exchanges (and report different earnings according to the accounting regime dictated in each) prompted the International Organization of Securities Commissions (IOSCO), in 1994, to challenge the International Accounting Standards Committee (IASC) to develop a set of consistent accounting standards that could be used in those circumstances and to have the task completed by the end of 1998.

The IASC accepted this challenge by undertaking a major drive to strengthen all of the international accounting standards. The first step was to review and update all standards generally applicable to all industries by the end of 1998. Industry specific standards such as insurance were to be handled after that date. In some areas, compromises had to be made to meet the December 1998 target. For financial instruments, the standard adopted, IAS 39, has many similarities to FASB 115. But there is also an on-going project by another multinational accounting working group to revisit accounting for financial instruments with a goal of moving towards full fair value accounting.

The actuarial profession also noted the increasing importance of international activities, and as a result formed the International Forum of Actuarial Associations (IFAA) as a section of the International Actuarial Association (IAA) in 1995. In 1998 the IAA restructured itself and took over the role of the IFAA. North American actuarial leaders such as Paul McCrossan and Walt Rugland played important roles in these developments. The IAA now serves as the primary voice of the actuarial profession on international matters.

The IAA had its first interaction with the IASC in working together on an accounting standard for employee benefits, which was part of the broad overhaul of IAS. The IAA got involved a bit late in that process, and it was a challenge to reach a workable compromise with the accountants on some issues. Having learned from that experience, the IAA geared up its efforts on the insurance accounting standard much earlier in the process.

The initial meeting of the IAA insurance accounting committee took place in April 1997. It is chaired by Sam Gutterman, and other members from North America include: Mo Chambers, Dick Robertson, and Bruce Moore. The IAS Steering Committee on Insurance had not yet been formed. However, an IASC Discussion Paper on financial instruments had just been released in March of 1997, with a clear intent to move towards fair value accounting for all financial instruments and a conclusion that insurance policies should generally be considered to be financial instruments.

The IAS Steering Committee on Insurance was formed in late 1997. Its members are from public accounting firms and insurance companies, representing countries around the world. The actuarial profession has been an active contributor to its work. Paul McCrossan represents the IAA as a non-voting member at the meetings. The IASC manager for this project, Peter Clark, occasionally attends the IAA Insurance Accounting Committee meetings. In addition, there is very active exchange of ideas via e-mail. The IAA Committee had provided input on earlier unpublished drafts of the IAS Issues Paper. In addition, a number of actuarial position papers have been shared with the Steering Committee.

There have been a number of other IAS issues affecting the actuarial profession, and the IAA Committee on International Accounting for Insurance has been busy with those as well. (The IAS standards for employee benefits are handled by a different IAA committee). These issues include such areas as provisions and contingencies. A separate IAS project on discounting, an area of obvious importance for insurance, has recently started. Sam Gutterman is the actuarial representative on that committee. Wayne Upton of the FASB staff, a person well known to most U.S. actuaries involved in financial reporting, is also actively involved in both the insurance accounting project and the discounting project.

The IAS Insurance Steering Committee started its work in 1997 and met several times in 1998 and again in 1999. This work culminated in a publication in December 1999 of the Issues Paper covering the broad high level issues of insurance accounting. The comment deadline was May 31. The next step of this committee will be to review the comments received and release a Draft Statement of Principles for comment, followed by a similar process for a final Statement of Principles and finally an Exposure Draft of the Standard.

The target effective date for a new Insurance Accounting Standard is 2004. Throughout this project, an assumption stated by the IASC is that by the time the new insurance standard is in place, a new standard requiring fair value accounting for substantially all financial instruments will also be in place. So the asset side of the balance sheet for insurers will be on a fair value basis.

Developing Responses to the IASC Issues Paper

As noted above, the International Actuarial Association is taking the lead on this for the actuarial profession. The interaction over the last two years has been intense, and there are many parts of the Issues Paper where the impact of earlier actuarial input is clearly evident.

In January of this year, there was a joint meeting of representatives of the IASC Steering Committee and representatives from the IAA Committee to discuss key issues. The IAA Committee on Insurance Accounting conducted an intensive effort to develop an official actuarial response to the IASC. This process was (and continues to be) very open, with most of the work shared via e-mail with over 150 committee members and interested parties. There was a three-day drafting session in London in early April, with an additional final review last May in Jerusalem. The IAA responses will provide specific comments on the preliminary views expressed or questions raised in the Issues Paper, with more in-depth papers on a number of key issues of concern to actuaries (e.g., impact of the cash value floor for liabilities, the role of the actuary, reflecting the issuer's risk credit risk in fair values, catastrophe and equalization reserves).

There has been a lot of activity outside the actuarial profession as well. In the U.S., the NAIC has a committee dedicated to responding to IASC proposal. The AIMR also has a committee to respond to the IASC (with a broader-than-just U.S. perspective). FASB helped stimulate insurance industry interest in this by publishing *Preliminary Views on Reporting Financial Instruments at Fair Value* with the same May 31 comment deadline. While many U.S. insurers have shown little interest in International Accounting Standards (which are not now intended to replace U.S. GAAP for U.S.-based securities issuers), similar issues raised in the FASB document do get their attention. On the actuarial side, the American Academy of Actuaries has a Working Group on International Accounting Issues and recently formed a separate task force chaired by Burton Jay to address fair value issues raised in both the IASC and the FASB documents.

The Casualty Actuarial Society and the Society of Actuaries also have committees working on this and on the broader research and education efforts that will be necessary in moving toward reliable system of fair value accounting over the next few years.

In Canada, the actuarial and accounting professions have been actively reviewing the IASC issues paper and a joint response to the IASC. The Canadian insurance industry associations are also actively reviewing this. Outside of North America, there also has been active review, including strong interaction among accounting and actuarial professions in a number of countries — the U.K., Australia, the Netherlands, Japan, and Germany being notable examples. There has also been a lot of insurance industry activity in response to this. Parallel to the case with banking, there is strong resistance by some major insurers to having fair value flow directly into income statements and balance sheets, and that will likely be reflected in their responses.

The Issues

The IASC's Issues Paper is a very impressive document and reflects a lot of progress over the last two years. It is essentially a review from first principles of how insurance contracts ought to be accounted for. The issues document itself is over 200 pages, with an additional 200 pages of appendices. We cannot cover all the issues here, but we'll highlight some that are of interest, and particularly those where the actuarial and accounting professions appear to have differing opinions at present.

1. The project is defined to cover insurance contracts, not insurance companies. Insurance contracts are defined broadly and include contracts where payment is in services (e.g., managed care organizations), and a number of other types of contracts not normally issued by insurance companies.

2. The actuarial positions throughout argue that given the assumption that fair value will be used for financial instruments, the predominant asset class held by insurers in most

(continued on page 16, column 1)

International Accounting Standards for Insurance
continued from page 15

jurisdictions, liabilities should be accounted for on a fair value basis as well.

3. The Issues Paper suggests "unbundling" of insurance contracts in some instances. This includes unbundling the investment deposit from the risk and service features, along the lines of the treatment of investment contracts under FAS 97, as well as the unbundling of implicit derivatives à la FAS 133. The actuarial response argues that both types of unbundling are extremely difficult to do well in practice, are unnecessary if all components are accounted for on a fair value basis, and consequently should not be done.

4. The Issues Paper makes a distinction between "general insurance" contracts, defined as those contracts that commit the insurer to a pricing structure for not more than 12 months, and "life insurance" contracts, defined as those with price structure commitments greater than 12 months.

   More descriptive terms for this would be short-term and long-term contracts. In any case, the actuarial response points out that there is no clear separation into two types of contracts. The IASC guidance for general insurance and life insurance are virtually identical. In addition, many insurance contracts currently viewed as general insurance have price commitments over 12 months, while some contracts currently characterized as life insurance have pricing commitments of less than 12 months.

5. The Issues Paper adopts a concept proposed by the actuaries of providing for risk margins in determining the fair value of insurance liabilities. This is a recognition that the fair value of a contract, often termed the "exit value" at which the holder could sell the contract, is not necessarily the expected value of the future payments under the contract. In illiquid markets, of which insurance is certainly an example, as in active ones, the buyer of the contract will often require a risk margin be added to the expected payments to provide an incentive for purchasing the cash flow stream.

6. The concept of a deferred acquisition cost asset is rejected as not qualifying as an asset under the IASC basic framework.

7. The unearned premium reserve for short-term contracts is replaced by a provision for unexpired risk — the present value of future claims and expenses to be covered by premiums already received but not yet earned.

8. Catastrophe and equalization reserves are rejected in the issues paper, although it is noted that this was a split decision. The actuarial response pointed out that there is no uniform actuarial view on this issue as well.

9. Property/casualty loss reserves and by implication, the unexpired risk reserve, will be discounted.

10. The Issues Paper suggests that there is a case for the policy cash value as a floor unless fair values are adopted. This is an area of strong actuarial disagreement, but also an area where the accountants' views seem to be fairly firm. The strength of the accountants' position is apparently the result of extended discussions of the recognition of the "embedded value" in demand deposits in bank accounting. The actuarial response will point out that the circumstances are very different for life policies. This is a crucial issue, as the combination of a cash value floor and the elimination of DAC would take us back close to the pre-GAAP accounting systems used in the U.S. in the 1960s on the liabilities side; with fair value accounting on the asset side. Similarly, for short duration contracts, use of the premium refundable in the event of cancellation would put us back close to the old unearned premium reserve.

11. Future dividends will be allowed for in determining fair values, based on policyholders' reasonable expectations of what they would receive given the assumptions underlying the projections. Unallocated surplus will be reported as equity, including portions that will ultimately be allocated to policyholders.

12. On an issue familiar to many, the actuaries argue that deferred tax provisions for insurance should be discounted.

13. An interesting issue generating a lot of controversy is whether the issuer's credit standing should be reflected in valuing its liabilities. The actuaries involved in this, almost without exception, find the notion that an insurer's liabilities would be reduced, and its earnings increased, as a result of a ratings downgrade to be preposterous. But many accountants seem to find it hard to believe that anyone would disagree with that.

There is extensive discussion of what disclosure would be desired. This includes the impact of regulatory solvency requirements, the impact of changes in assumptions on results, and the impact of the market value margins on the total liabilities in earnings. In general, the actuarial position is in agreement with extensive disclosures.

The actuarial response also describes our standard processes in many countries today and indicates the actuarial profession's readiness to develop standards to make sure that the actuarial work products under the new IAS Standard for insurance are reliable, consistent, and auditable.

Bruce D. Moore, FSA, MAAA, FCAS, is a partner with Ernst & Young LLP in New York. He can be reached at bruce.moore @ey.com.