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The predicament of market value accounting

by Richard S. Robertson

Financial Accounting Standard 115 presents insurance company management with a painful dilemma. Do we adopt investment and management strategies to reduce the fluctuations in GAAP book value that result under the standard? Or, do we continue with business as usual and hope that our financial publics ignore the effect of the standard on reported book value?

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Reducing the effects of FAS 115

Several strategies can be used to reduce the effects of FAS 115. The average duration of invested assets could be shortened. Mortgages and other investments outside the scope of the standard can be used more. Management can commit to hold investments to maturity, thereby qualifying those investments for valuation at cost. Some companies are considering holding most investments to maturity and using options and other derivatives to manage the relationship between assets and liabilities.

A particularly imaginative approach I heard about was using interest rate swaps to hedge market fluctuations in both assets and liabilities. Because hedge accounting follows that of the item hedged, it is claimed that a company could effectively undo the market value accounting through buying and selling identical swaps.

Strategy drawbacks

Any of these strategies has its costs. In today's environment, shortening durations significantly reduces investment yield. In any environment, it could leave a company vulnerable to future decreases in market interest rates. Strategies that limit a company's freedom to sell securities reduce the flexibility and effectiveness of investment management. Derivative securities have transaction costs and can have unintended consequences.

Dangers in FAS 115

I am a strong advocate of not letting bad accounting cause bad business decisions. I believe it likely that investors, rating agencies, and other sophisticated users of our financial statements will see through the accounting folly and will adjust the financial information back to a cost basis in forming their financial opinions.

Not all those using our financial reports, however, are sophisticated analysts. Statistical reports in publications and elsewhere frequently are based on unadjusted information, with inappropriate conclusions citing the reported financial information as support. The resulting confusion will adversely affect the confidence of policyholders and investors in insurance companies.

The effect of this accounting can be extreme. Even for a duration as short as seven years, a 300 basis point increase in interest rates would reduce the value of a security by about 15%. That could be a significant part of a company's equity. Would even sophisticated analysts have confidence in a company reporting little or no GAAP equity?

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Market value accounting (continued)

FAS 115 and mutual companies

Because the standard is limited to GAAP reports, mutual companies may believe this is not a critical issue for them. Perhaps they believe that GAAP statements will not be widely used, or they may be willing to accept the qualified auditors' opinion that will be given for statutory statements. However, in an environment where investment markets cause reported equities of publicly-held companies to be weak, analysts probably would make comparable adjustments to statements of mutual companies. Regulators would be under pressure to "reform" statutory accounting.

Accounting based on historical cost is no longer an option. We fought that battle and lost, perhaps because serious weaknesses exist in historical cost accounting. The assertion that variations in asset values are offset by variations in real liability values breaks down when assets and liabilities are not perfectly matched. Changes in asset values due to credit deterioration are not matched by changes in liability values. This last shortcoming may have been the factor that caused us to lose the battle, given the significance of investment credit issues in recent years.

Restoring integrity of statements

Many of us have concluded that the only alternative that will restore validity and integrity to our financial statements is to change the way we value liabilities to make that valuation consistent with asset valuation.

Although insurance liabilities are not traded enough to establish a "market value," a gross premium valuation with suitably chosen assumptions would be a reasonable proxy for market value. An accounting system that uses market values for assets and a gross premium valuation for liabilities would tend to include in a company's reported equity the value of the insurance in force. Such a system would report valid and useful information.

One characteristic of an accounting system based on a gross premium valuation is that most or all of the expected profit would be released when a policy or contract is issued. This is significantly different from present accounting. Users of insurance company financial statements would have to fundamentally change their perception of the significance of financial data. Comparability with financial statements of non-insurance corporations also would be a problem.

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Theoretical model

If one wished to avoid releasing profit at issue, suitable loadings could be built into the valuation process. Such loadings could be designed to release profit in proportion to revenue, risk, or any other appropriate measure.

An interesting approach is to establish loadings that replicate the loadings in the existing accounting model. If investment markets are stable and asset values do not change, the financial statements would be identical to those produced under the existing model. If investment values change due to changes in market interest rates and if changed interest rates are reflected in the assumptions used to value the liabilities, the resulting change in equity can be shown to be entirely from the value of net differences in asset and liability cash flows. In a perfectly immunized situation, equity would not change.

This approach would be an excellent theoretical model for designing a liability valuation system for use with investment market values.

Time to move quickly

Several approaches to liability valuation would be consistent with use of market values for assets. We must agree on one such approach quickly if we are to re-establish the validity and credibility of insurance company financial statements.

FAS 115 will be in effect for 1994. I know of several companies, including mine, that will be disclosing the amount by which liabilities would change to be comparable to the change in investment values. Users of financial statements will be seeking comparability of these adjustments and an understanding of how they are derived. The actuarial profession needs to provide the leadership to accomplish this.

Richard S. Robertson is executive vice president at Lincoln National Corp., Fort Wayne, Indiana, and a past president of the Society of Actuaries.

U. of Singapore receives grant

The Society of Actuaries recently awarded a $2,500 grant to the National University of Singapore in recognition of full-time faculty member Ka-Cheng Albert Tsui attaining Associateship status.

The university will use the grant to help with actuarial exam fees, purchase actuarial science books, and fund fees for staff members attending actuarial science conferences.