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Insurance Accounting in the 21st Century

by Anthony J. Willemin

On March 5 and 6 in New York City, Ernst & Young LLP hosted a comprehensive seminar on the subjects of Fair Value, Embedded Value and International Accounting Standards. Titled "Insurance Accounting in the 21st Century," the seminar took one and a half days to cover improvements and changes that are likely to affect the insurance industry worldwide. Eleven presentations —punctuated by frequent questions and lively discussions—provided technical basics, case studies, discussion of significant issues, the trials and triumphs of implementation and the value of the information provided. The speakers included Peter Clark, Senior Project Manager of the International Accounting Standards Board, Ad Kok of AEGON, Hans Wagner of AXA and Tom MacKinnon of Scotia Capital, in addition to a team of Ernst & Young's experts in the field. Over 60 people attended, including senior executives from over 20 companies, analysts, rating agencies and other interested parties. In addition to the U.S. and Canada, other countries represented included the United Kingdom, France and the Netherlands.

The focus of the seminar was on life insurance performance measures and financial reporting. Several key themes resounded:

- Current U.S. and other local GAAP reporting is likely to change
- Implementation of new reporting standards could take years (2-4 based on IASB "field visits")
- Balance sheet and income statement results may be volatile
- New business value is a primary focus of attention by companies—embedded value may be the best measure
- The payoff is deeper insight into the business

The following provides a synopsis of the eleven modules:

Module 1—In "The Basics" Mike McLaughlin set up the seminar. He reviewed the main topics, indicated the magnitude of the shift in philosophy ("the matching principle is gone") and provided some historical perspective on the evolution of thinking at the IASB and FASB. Mr. McLaughlin also outlined the IASB structure and identified the multitude of decision makers shaping International Accounting Standards. Finally, Mr. McLaughlin described the role of embedded value, and its increasing use by companies, analysts, rating agencies, and regulators.

Module 2—Rick Lynch discussed the international accounting standards emerging for financial instruments, including the efforts of the Joint Working Group of Standard Setters (including the FASB), International Accounting Standard 39 (IAS-39 on recognition and measurement) and its proposed amendments, and IAS-32 (on disclosure and presentation). Mr. Freedman started his presentation by describing the scope of the DSOP—contracts with insurance risk. He then covered the requirements of the DSOP, highlighting the controversies, issues of interpretation, some product-specific implications and business implications.

Module 3—Ad Kok described AEGON, its experiences with IAS so far, and its schedule for developing a complete reporting package timed to meet the 2005 European Union deadline. AEGON piloted various life insurance products in the Netherlands, the United States, and the United Kingdom during 2001. Mr. Kok's view breaks the insurance portfolio down to product level, and each product down to the various risks covered. This should lead to measures that can be aggregated easily, but understood, and discussed by reference to the significant drivers of results. Mr. Kok sees information technology as the biggest challenge. Key hurdles include capturing the necessary data within and ultimately uploading the accounting result of the projection models (some stochastic) into the financial results in time to meet monthly reporting schedules. The Dutch Insurers Association, concerned about these difficulties and unresolved conceptual issues, has proposed that IAS be phased-in starting in 2005, beginning as disclosures in the notes to more traditional financial statements.

Modules 4, 5, and 6—Mike McLaughlin returned to explain embedded value reporting, including the components of embedded value, reporting of achieved profits, and variance analysis. Jim Milholland then walked through a case study, which further developed embedded value concepts with a concrete example. This was an opportunity to illustrate some key implementation issues (such as setting the discount rate and the approach to target surplus), and to show embedded value as a planning tool. Finally, Tim Roff discussed embedded value in the United Kingdom and across Europe. Mr. Roff presented the Association of British Insurers (ABI) embedded value standards (finalized in early-2002), discussed implementation issues, and charted published embedded value figures for three large insurers to show volatility of total achieved profits, the relative stability of achieved profits from operations, and significance of new business margins.

Module 7—Day 2 of the seminar commenced with Peter Clark's guided tour of the IASB Project on Insurance Accounting. Mr. Clark gave the IASB perspective on critical issues such as: whether to require entity-specific value or fair value, the treatment of renewal and cancellation options with insurance contracts and the appropriate provisions for risk. Mr. Clark also related the findings, so far, from the IASB field visits, the next steps in the insurance project, and some information about other current and potential IASB projects.

Modules 8 and 10—Peter Duran built on the work of Luke Girard to explain the theoretical link between fair value and embedded value. When consistent sets of assumptions are used, it can be shown that the fair value of liabilities equals the fair value of assets less the embedded value. Mark Freedman and Peter Duran provided practical information about modeling fair value financial results. They then demonstrated using modeled results for term life insurance and for single premium deferred annuity products under different crediting strategies. Graphs depicted anticipated statutory, GAAP, and fair value earnings over the projection horizon. Analysis included the impact of XXX deficiency reserves on term, experience variances, unlocking, and stochastic analysis on fair value results.

Module 9—Hans Wagner presented AXA's perspective on the implementation and uses of embedded value in the context of a global insurance enterprise with diverse companies, businesses, and geography. Mr. Wagner laid out AXA's template for consolidating results from a variety of local entities and described the several challenges faced. He stressed the importance of internal and external communications about embedded value as one of several measures used to interpret financial experience.

Module 11—To close the seminar, Tom MacKinnon shared an analyst's perspective on the value of embedded value information. Mr. MacKinnon provided some cautionary tales about situations in which statutory and GAAP financial reporting distort the view of a company's performance. He balanced the ability of embedded value to eliminate some of these distortions against several arguments against using embedded values. To facilitate comparability, Mr. MacKinnon "normalizes" the discount rates and mortality improvements. He provided a table of market indicators for six Canadian insurers that included several measures based on embedded values. Canadian embedded value reporting is just beginning and 2001 will provide the first opportunity for "movement analysis" (i.e., the components of the change in embedded value from the beginning to the end of the year).

Interest in the seminar was high, not only because of keen interest in performance measurement. The European Union has set 2005 as the date that European companies will need to adopt International Accounting Standards. IAS likely will require fair value reporting, or a similar "entity specific" value for all insurance liabilities. The Canadian Institute of Chartered Accountants may adopt IAS and the Financial Accounting Standards Board has publicly expressed its preference for fair value reporting. Given the substantial time needed for implementing these complex new standards, some U.S. and global companies have already begun the conversion process. □

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