FINANCIAL SERVICES

SETTING THE STANDARD V

The IASB's discussion paper on Phase 2 of its insurance accounting project, with its focus on better alignment of asset/liability valuation, has important implications for future financial reporting and certain types of products. This article is the fifth in a series.

By Peter Wright and Alexander Dollhopf

In 2007, after waiting for more than a year, the insurance industry and other stakeholders will finally see the International Accounting Standards Board's (IASB's) discussion paper on Phase 2 of its insurance accounting project and have an opportunity to comment on it.

EXHIBIT 1
New estimated timeline for Phase 2

Discussion paper	Published in February/March 2007
Exposure draft	To be published at least 18 months after the discussion paper (latter part of 2008)
Final standard	To be issued at least 12 months after the exposure draft (2010)

Although the paper was not available when this article was prepared, in all likelihood, the centerpiece of the IASB discussion paper will be a market-consistent approach to liability measurement that will better align the valuation of assets and liabilities. However, this approach may also have negative implications for the continuing viability of certain products that have optionality, guarantee features or rely on the achievement of investment spreads. This is the case where current reporting approaches do not impose a full market-consistent assessment of the relevant obligation.

Many companies will have much work to do in order to be in a position to carry out market-consistent valuations. Even though the approach has not been finalized, it is important for companies to understand, anticipate and test the major alternatives in preparation for future compliance requirements.

In the main, judging largely from the tentative conclusions reached at IASB board meetings, the IASB's position is well supported. However, there are some areas where further evaluation may be needed in order to produce a high-quality, credible standard. These include the treatment of participating business, allowance for market-based rather than company-specific expenses and the restricted allowance for future premiums.

TIMETABLE DELAYS

Publication of the discussion paper comes over one year later than envisaged (*Emphasis* 2005/3, "Setting the Standard IV"), and this means that the completion date for the final standard is probably pushed back to around 2010, which would be 13 years after the insurance project was formally launched (see *Exhibit 1*). While the delays have created frustration within the industry, they also allow additional time to assess the IASB approach, make suitable comments and, ideally, help make sure that the final standard is suitable for the continued sale of attractive products.

It is understood that the U.S. Financial Accounting Standards Board (FASB) will also invite comments on the IASB discussion paper. In the light of the responses received, the FASB will decide whether to add to its own agenda a joint project with the IASB to develop a comprehensive standard on accounting for insurance contract liabilities. The additional credibility and comparability to be gained by the FASB also issuing a standard based on the IASB's insurance project would be welcome, although there is some concern that the involvement of the FASB would inevitably slow down development of the international standard.

The International Association of Insurance Supervisors (IAIS), in its comments on the IASB proposals, is generally supportive, but there are some areas of disagreement (*Emphasis* 2006/4, "Toward a Global Solvency Standard II").

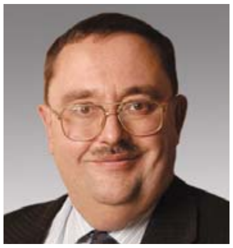

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EXHIBIT 2

Complications with an entry value approach

- It requires parallel calculations of exit value for purposes of the liability adequacy test.
- It requires a definition of acquisition costs to calibrate the risk margin.
- Treatment of embedded derivatives needs to be defined.
- Artificial rules need to be set to run off additional risk margin.
- Anti-avoidance rules are required for financial reinsurance.

BASIC MEASUREMENT

In 2005 and 2006, the IASB considered a number of options for the basic approach to measuring insurance liabilities. The two final alternatives were a current exit value and entry value approach.

Both approaches are based on a discounted mean estimate of future cash flows using market-consistent assumptions for hedgeable risk together with a risk margin over "best estimate" (defined as the mean) assumptions for non-hedgeable risk. For expenses, assumptions used should exclude any clearly identifiable effect arising from the economies or diseconomies of scale applicable to the insurance company.

Under the exit value approach, the risk margin is calibrated to the theoretical requirements of a business-to-business exchange of the liability. It is not a "shock absorber" as under U.S. GAAP, but rather reflects the current market price of risk. Under this approach, it would be possible to recognize a profit at issue, but where this is significant, the assumptions should be checked to ensure that they are reasonable.

This is similar to the checks required in a business combination when goodwill is assessed as being negative after the inclusion of all other tangible and intangible assets and liabilities of the acquired company.

Under the entry value approach, the risk margin is calibrated to produce a liability at issue equal to the premium received less any acquisition costs incurred. The resultant liability would then be tested for adequacy against an exit value approach. *Exhibit 2* lists some complications with the entry value approach, which nevertheless seems to be favored by many industry organizations, including the European Chief Financial Officers' Forum.

The IASB voted in favor of the exit value approach but avoided giving detailed guidance on the difficult question of how to calculate the resultant risk margin in the absence of generally observable market prices. This could be done, for example, by specifying a percentile or cost of capital approach. Rather, we understand that the discussion paper will set out criteria that will apply when determining risk margins.

These criteria are likely to require risk margins that are consistent with observable market prices for transferring risk and are explicit rather than implicit. They are also likely to state that risk margins must reflect all risks that arise from the liability but not other risks (e.g., asset/liability mismatch risk), be auditable and include allowance for tail risks. For the latter, option-pricing techniques or stochastic modeling may be needed.

In addition to a risk margin, the IASB has concluded that a service margin should also be incorporated. This should represent the unbiased margin, if any, that market participants would require for rendering other services.

DISCOUNT RATES

The objective of the discount rate is to adjust estimated future cash flows for the time value of money in a way that captures the characteristics of the liability. It is built up from three components, as shown in *Exhibit 3* (on the next page).

The basic building block for the discount rate is the risk-free rate. This could be a government bond yield, although many also would view an interest-rate swap yield, which typically has a slightly higher rate of return, as an acceptable risk-free instrument to avoid the supply-and-demand distortions that can arise with government bonds.

The centerpiece of the IASB discussion paper will be a market-consistent approach to liability measurement.

In terms of setting values for illiquid liabilities (e.g., annuities in payment), the discussion paper is likely to permit the discount rate to take credit for a liquidity premium. The appropriate size of the liquidity premium is difficult to assess. Where the swap yield is being utilized as the risk-free rate, any additional liquidity premium is likely to be quite small — possibly on the order of 0.1%.

The final element of the discount rate — the allowance for "own credit risk" — is particularly controversial. The IASB position is that the liabilities should be assessed assuming a transfer to another insurance company with equal credit standing. This approach is consistent with that taken in IAS 39 *Financial Instruments: Recognition and Measurement,* and indeed this consistency is its principal rationale. Many, including the IAIS, do not support this position.

The discussion paper seems likely to state that any allowance for own credit risk should reflect guarantees provided by policyholder protection schemes. It is not clear why the existence of such schemes should affect an exit value liability assessment, other than because it reduces the credit, which can be taken for the ability to default. In any event, it seems likely that companies will be required to disclose the impact of any allowance for own credit risk in reducing liabilities, if material.

EXHIBIT 3
Build-up of discount rate

PARTICIPATING BUSINESS

The IASB concluded in 2006 that policyholder participation rights should not be recognized in the liability until an insurer has an unconditional obligation that compels the declaration of a bonus to either current or future policyholders. Furthermore, a prior claim by policyholders to distributions from a pool of assets does not, by itself, oblige an insurer to recognize a liability. These same rules apply to both proprietary and mutual companies, and to participating insurance and participating investment contracts.

In reaching its conclusion on these issues, the IASB was heavily influenced by its proposed changes to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (which is to be renamed). This seems a good example of where general accounting rules, in this case for constructive liabilities, do not easily transpose to insurance company liabilities. For many countries, where the test to value future policyholder bonuses/dividends is not met, the result might be a distortion in financial statements. A large profit could be reported at the commencement of a policy if prevailing economic conditions are highly favorable and imply substantial bonuses could be declared, followed by a series of losses as bonus payments are actually made.

In recognition of this unsatisfactory state of affairs, the IASB is to consider whether the balance sheet equity and reported profit or loss should both be split between policyholder and shareholder interests. In this way, analysts could "back out" the impact of any distortion. At the time of this writing, it was also possible that the IASB might radically revise its views on participating business.

ALLOWANCE FOR FUTURE PREMIUMS

The allowance for future premiums under regular premium life contracts is a difficult area for the IASB where the value of such premiums exceeds the corresponding additional liability. Policyholders cannot, of course, be compelled to pay these premiums and so the normal accounting definition of an asset is not achieved. Nevertheless, the IASB has concluded that credit can be taken for future premiums where they confer rights to guaranteed insurability.

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This should resolve many of the industry's concerns in this area. However, problems remain for life policies where a death benefit in excess of the surrender value may not apply for the whole period to policy maturity. There is also a problem for investment contracts (measured under IAS 39) where, by definition, there is no material insurance risk.

IMPACT ON UNIVERSAL LIFE BUSINESS

At the time of finalizing this article, it was not yet known how the IASB recommendations on participating business and the allowance for future premiums will affect the measurement basis for universal life business, which is popular in North America. A difficult area is the extent to which the liability should reflect future crediting rates of interest in excess of those guaranteed in the contract.

REINSURANCE ASSETS

The IASB concluded that risk adjustments for reinsurance assets should be consistent with the corresponding risk adjustments made to the gross liability. This is notwithstanding that such adjustments will have the effect of increasing an asset. This is a sensible and pragmatic result.

Reinsurance assets should be adjusted to reflect credit risk. For this purpose, credit risk covers both risks of financial default and contractual problems with coverage. The deduction for credit risk should allow for both expected present value of losses from default and disputes, and for any additional compensation that market participants would require to cover this risk.

OTHER ISSUES

The discussion paper is likely to cover a number of other issues, in some cases giving a conclusion and in others merely setting out options and requesting views. Some of the more important of these are:

- How should anomalies between the proposed accounting for insurance contracts and the current rules for investment contracts be removed? Investment contracts are valued at either entry value or amortized cost and are subject to a deposit floor liability.

- Should premiums be recorded as operating revenue or should deposit accounting apply for some business? If so, what business?

- How should the yearly change in insurance liabilities be analyzed in the financial statements?

ROOM FOR IMPROVEMENT

The publication of the discussion paper gives the insurance industry and other affected stakeholders an important opportunity to comment on the direction of Phase 2 of the insurance project. U.S.-based commentators will presumably respond to the FASB request for comments. Important insurance trade bodies in Europe, North America and Japan have been active in prior consultations, expressing a preference for an entry value approach.

For general insurance, there are likely to be particular practical issues that will have to be addressed to assess appropriate risk margins. However, the overall accounting framework being proposed does appear to be appropriate for a high-quality global standard.

For life assurance business, however, there are a number of areas where the framework seems likely to lack credibility as a basis for realistic, fully prospective reporting. While some of these issues may be addressed following representations on the discussion paper, it seems likely that investment analysts used to receiving supplementary embedded value information will still wish to see this published.

Indeed, international financial reporting standards currently permit such information to feature in the disclosure of risk monitoring for segmental reporting purposes and in the accounting for business combinations. It is conceivable that the IASB may wish to control the methodology used to calculate this information by insisting on a market-consistent approach.

The move toward a market-consistent or fair-value approach in accounting generally seems unstoppable. In framing comments on the IASB proposals, respondents need to bear this in mind. Where products would not show up well if reported on the IASB basis that seems to be emerging, serious consideration needs to be given to making appropriate changes in product design. More broadly, insurers need to act now to evaluate the implications of these changes on their operations, financial reporting and future strategies.

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