The Geneva Papers on Risk and Insurance Vol. 29 No. 1 (January 2004) 75–77

Proposed Changes in Insurance Accounting Rules

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For many years, the International Accounting Standards Committee (IASC) and its successor, the International Accounting Standards Board (IASB), have embarked on a far-reaching reform process. This process has included a "fair value" agenda, which has been met by rather forceful opposition from both insurance and banking industry representatives and most regulators and supervisors in the industrialized countries. This note summarizes some of the more problematic issues associated with the implementation of fair value in insurance accounting. It pleads for a considerate approach that pays proper attention to the expected cost and benefit of fair value accounting.

At the outset we should recognize that the IASB has made great efforts to bring the reform process to its current status. It cannot be denied that the proposed fair value concept is based on sound principles, and the logic of its application is hard to refute. Clearly, an accounting approach based on fair values, if it could be applied consistently and in an even-handed way for all firms, is bound to be superior to a system based on historic cost, which are, after all, fair values set at some arbitrary dates in the past.

Furthermore, on the backdrop of recent accounting scandals in the U.S. and Europe it can be readily agreed that there is a need for greater transparency in financial statements not only of insurance companies but of all industries. Appropriate disclosures will assist in meeting that need. Given that companies compete globally for the attention of international investors, we also support the continued efforts at the IASB to promote convergence with accounting principles generally accepted in the United States (U.S. GAAP). Indeed, the worldwide application of one comprehensive body of accounting standards would benefit all stakeholders of insurance companies, including policyholders, investors and regulators. It would facilitate the comparison of financial statements of different entities and allow for informed judgments about those entities.

Finally, more transparency based on appropriate disclosure is likely to contribute to increased financial market stability. Thus, accounting standards go a long way in meeting a number of public policy goals, from ensuring investor's confidence to enhancing financial market efficiency and stability.

The IASB decided to take a two-phase approach to implementing the new standard. Phase I, expected to be effective by 1 January 2005, is an interim step that will require preparers to classify their products in line with a definition of insurance contracts, but to continue their current accounting measurement standard for those which qualify as insurance. This phase would also eliminate certain existing practices that have been deemed incompatible with the IASB Framework, such as the recording of catastrophe reserve provisions. Proposed disclosures would focus on three principles: the identification and

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Article number = K268

explanation of insurance-related amounts in the balance sheet, the estimated amount, timing and certainty of cash flows from insurance contracts, and, from 31 December 2006, the disclosure of fair values of insurance assets and liabilities.

Phase II would require the recording of insurance assets and liabilities at fair value. As there is no active market for the trading of insurance liabilities, fair value would be determined through expected present value of the cash flows resulting from the insurance contracts. While convincing in theory, this present value calculation would be fraught with difficulties under any set of practical circumstances.

The inherent difficulties with present value calculations are not the only reason why the implementation of fair value accounting would come at a considerable cost. That is why the insurance industry has concerns about the practicality of the proposed standard as it currently exists. This is true in particular in light of the current state of the industry as companies are challenged to reconsider their business models and strengthen their balance sheets. Let me quickly review some of the salient objections.

- First, the proposed standard will be expensive to implement. Companies will be required to make significant investments in IT hardware and software to gather the appropriate data and to perform the highly complex calculations necessary to determine fair value. It will also be expensive and difficult to recruit trained actuaries and accountants who would be capable of developing and analysing new models, as there is already a shortage of these talents in the marketplace.
- Second, insurance companies will require time to analyse not only the accounting impacts of the proposed standard, but also the potential impacts on product-pricing and asset liability management. By changing the accounting model, the industry would have to change the way it currently conducts its business.
- Third, we believe that it would be inappropriate to have a financial reporting model that is very different from the models currently used by regulators, rating agencies and analysts to evaluate insurance companies. These important stakeholders must be given an appropriate period of time to fully consider the implications and to consider changing their models.
- Fourth, the timing of fair value implementation poses a serious problem. For such an extensive reporting and measurement standard, preparers are being given less than an optimal amount of time to implement. Although proposals currently considered have been discussed for a number of years, our industry would have only 18 months to implement phase I from the Exposure Draft (and much less from the date of the final standard).
- Finally, we are concerned about maintaining a level playing field. The insurance industry is being asked to report using fair value to an extent that is currently not required for other industries. For example, while banks also must report their assets at fair value, their primary liabilities, customer deposits, are not. This disparity in the accounting model may lead to changed perceptions of the risk associated with the insurance industry. This, in turn, may lead to the market charging a higher premium for capital at a time when most European insurers are looking to strengthen their capital base. There is a distinct danger that market participants will not understand all implications of fair value accounting for the insurance industry, putting insurers at a disadvantage relative to firms in other industries.

Although we accept fair value in principle, we also believe that there are some serious issues, and they should be properly aired. It is quite conceivable that we may see a broad implementation and acceptance of fair value at some point in the future. But given the current

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state of industry, the fragility of financial markets, and the practicality of determining and reporting fair value in an appropriate and consistent manner in such a short time frame, we question the wisdom of moving along the current schedule. Instead, we propose not to proceed at this time and not in the current format. As phase I is expected to become effective on 1 January 2005, and the IASB as yet has not issued an Exposure Draft, it is not possible for any company to know whether it can meet this deadline. An extensive reporting and measurement standard takes longer than 18 months to analyse and plan before implementation, which also takes some time. At this juncture, the industry should oppose the schedule with considerate determination, but it should choose its battles carefully.

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