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“New Developments in the Regulation and
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Layout & Distribution: Valéria Kozakova & Bernadette Curty

International financial reporting standards: Activities of the GA and Ideas on going forward

Gerald Dickinson

20th PROGES Meeting
'New Developments in the Regulation and Supervision
of Financial Services

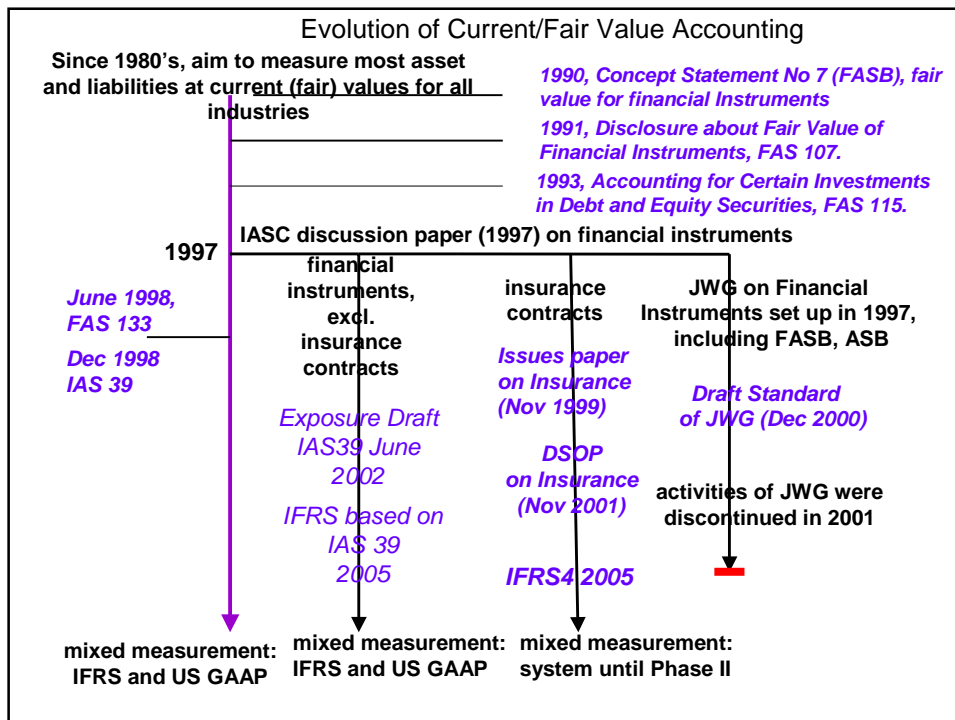
'International Financial Reporting Standards: Activities of the
Geneva Association and Ideas on Going Forward'

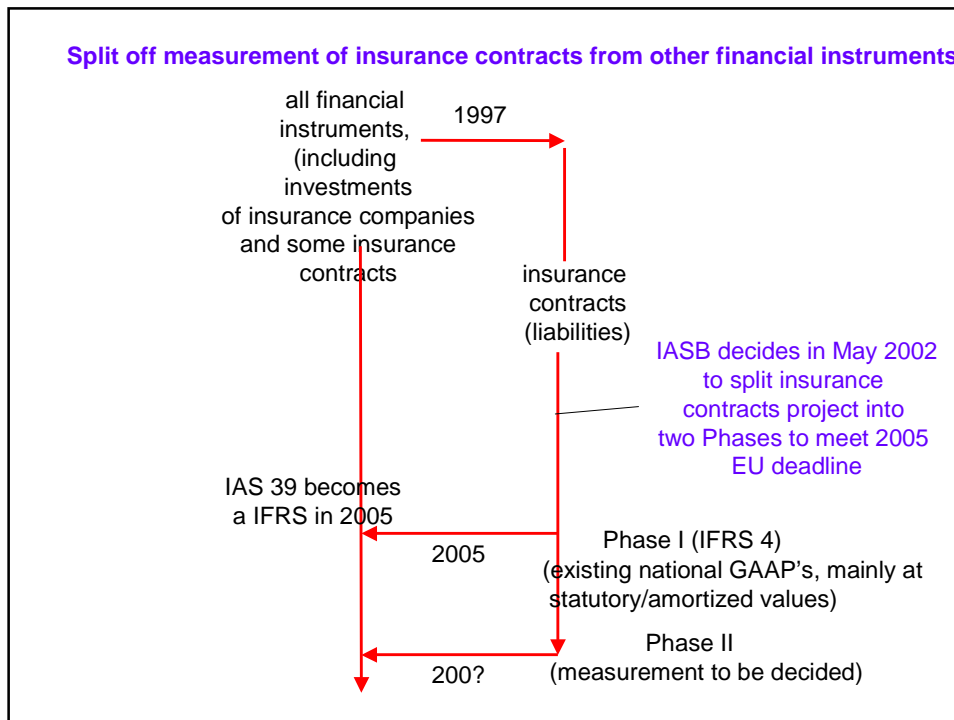
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Theoretical Foundations of Current Value (Fair Value)

Accounting theory drew on the theory of finance (financial economics) which developed new concepts from late 1950's onwards:

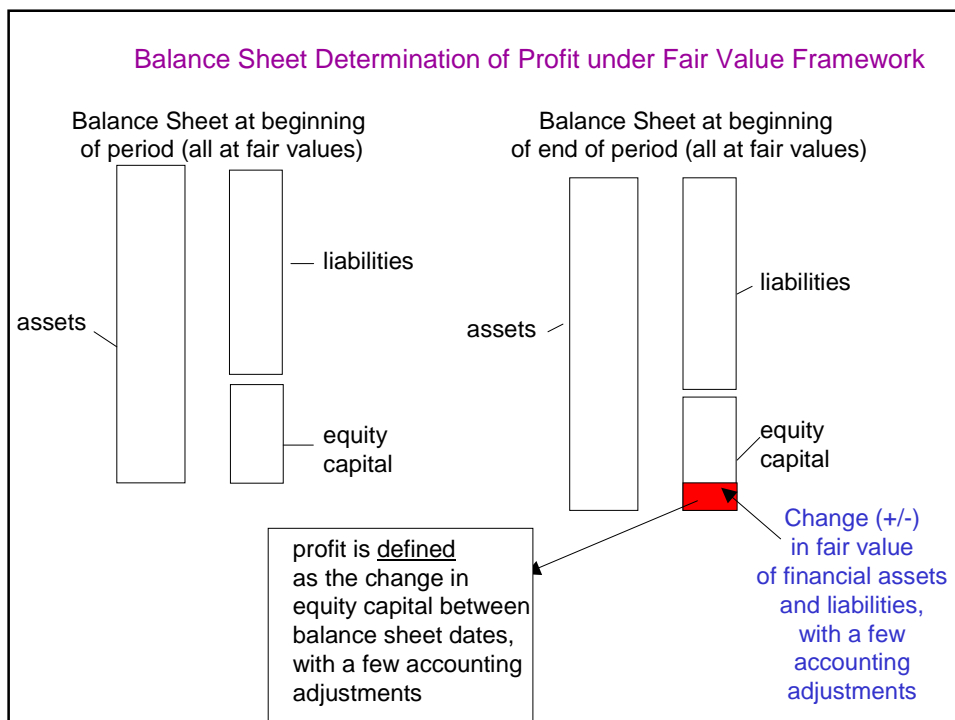
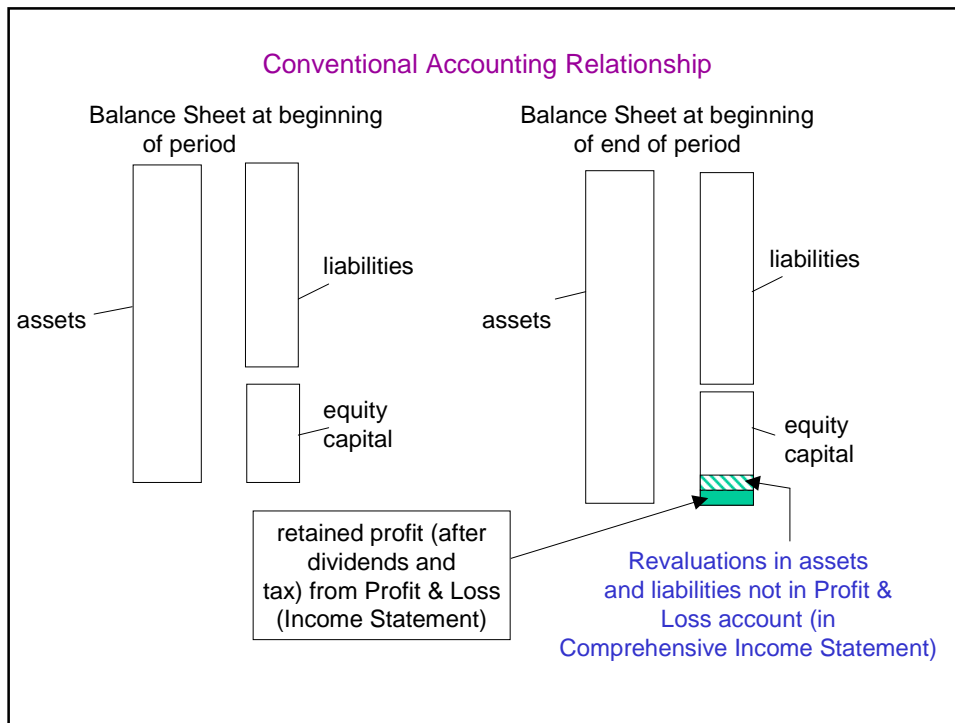
- Assets or liabilities should be valued in terms of their economic value, which is defined as the present value of their expected future cash flows, discounted at a risk-adjusted cost of capital (opportunity cost to providers of capital, allowing for their collective risk aversion)
- The theory (hypothesis) of information efficient capital markets suggests that the best estimate of the intrinsic value of an asset or a liability is when priced in a well-informed, well-traded capital market.
(assumes that there are no asset price bubbles)
- The theory of capital structure (M&M) assumes that financing decisions of the firm can be considered to be independent of investment decisions from the stock market perspective
(effectively rules out the relevance of asset-liability management)

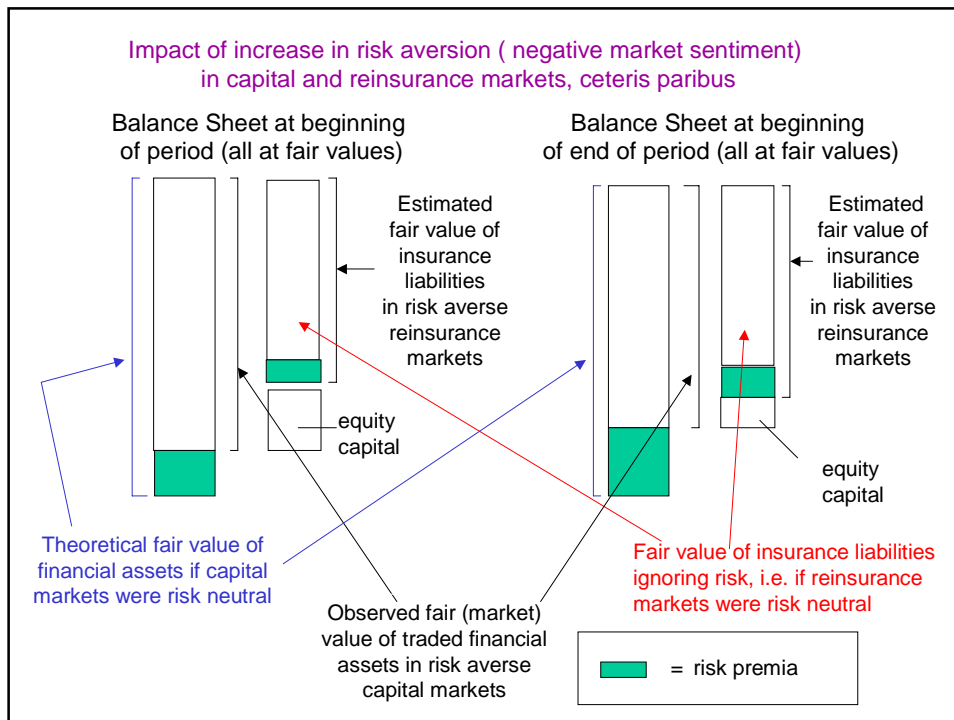




Main features of a full fair value reporting system

- All financial assets and liabilities would be stated in primary balance sheets at 'fair' values (i.e. market value or estimated market value)
- All of the changes in the fair values of financial assets and liabilities between accounting periods would be recorded directly into Income Statements (Profit and Loss Accounts)
- All equalization and catastrophe provisions would not be considered as accounting provisions, and deferred acquisition costs not treated as assets





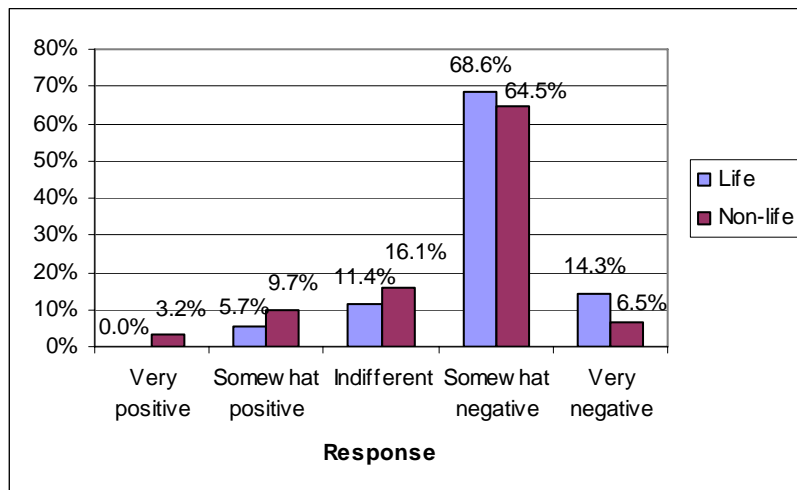
Aims of Geneva Association Impact Survey on Insurers 2003/4

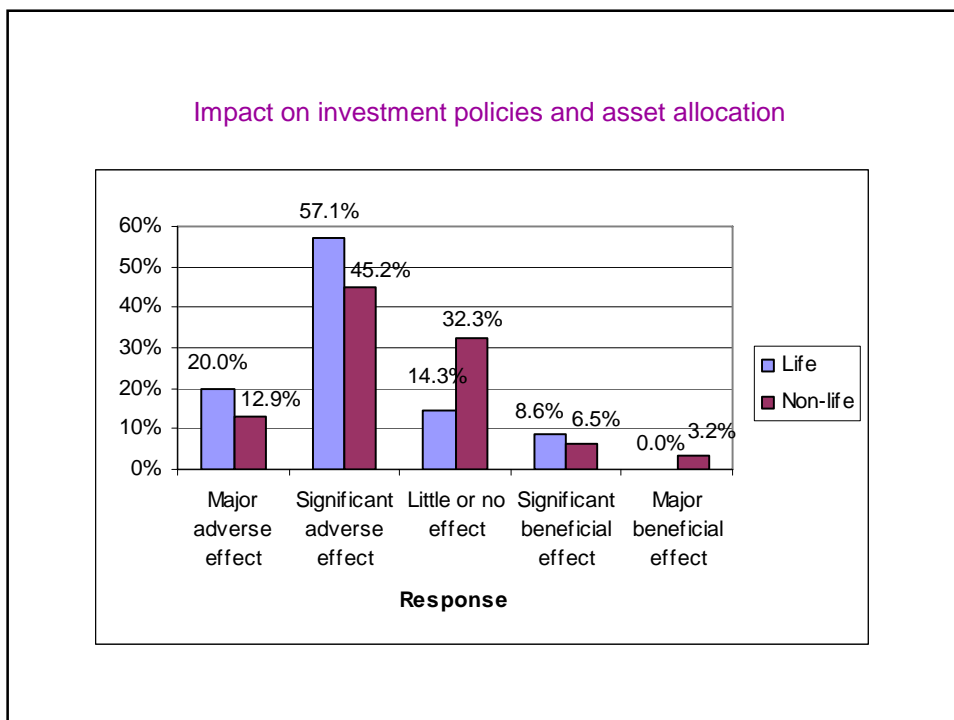
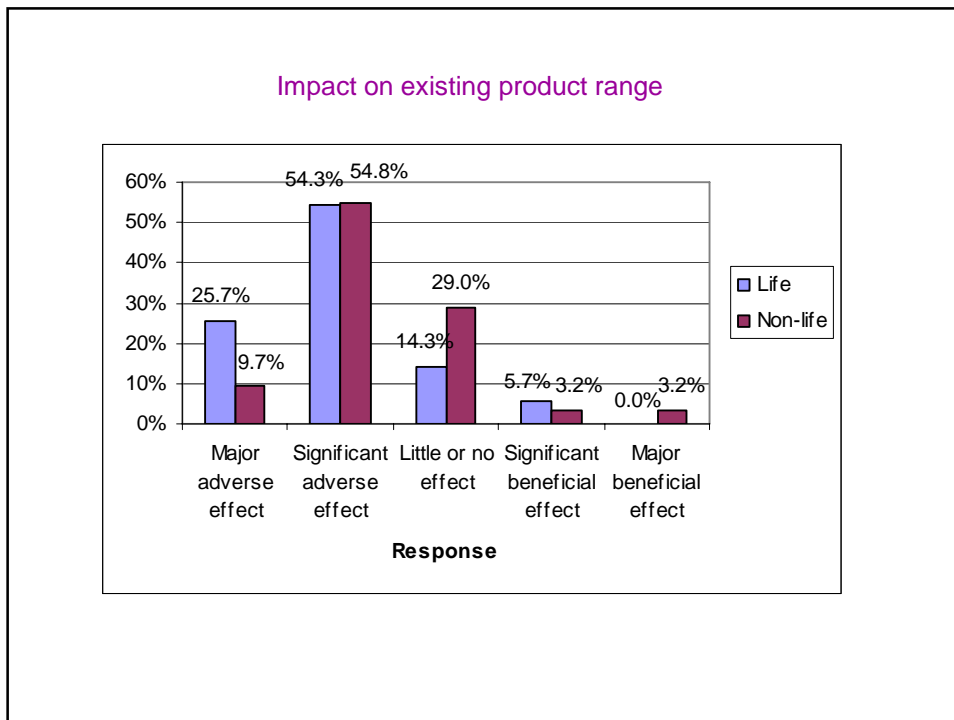
- To ascertain views of senior management in a large sample of leading international insurers on the likely impact of a full fair value reporting system on their business models and corporate policies.
- To obtain opinions on set of wider issues, i.e. increased transparency of fair value reporting, the cost of capital, and risk absorption role of insurance in the wider economy.
- Paul Volker, chairman of the Trustees of the IASC Foundation, stated late 2003 that international reporting standards should not undermine the economic role of commercial banks and insurers.

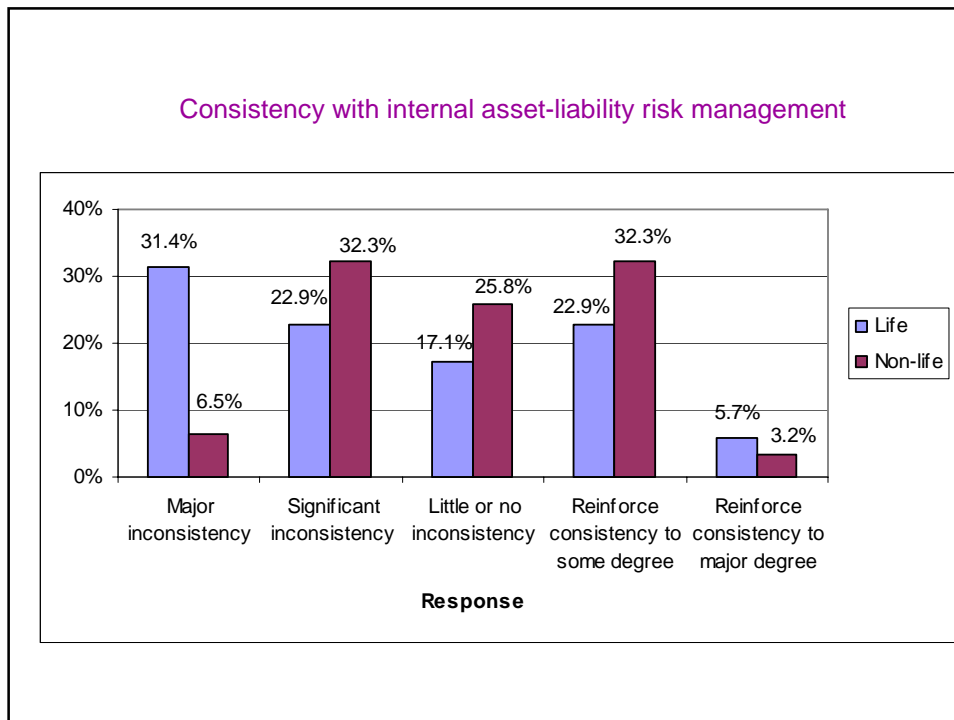
Key Findings of Survey

- None of the 40 leading insurers in the survey used full fair value as an internal accounting and financial system to run their businesses, nor would they voluntarily wish to do so.
- Management would be under some pressure over time to align their internal accounting and financial systems to any international financial reporting system.
- A full fair reporting system would significantly change business models, corporate policies and systems over time in a way that most insurers consider would reduce their competitiveness.

Impact on corporate strategy and business models

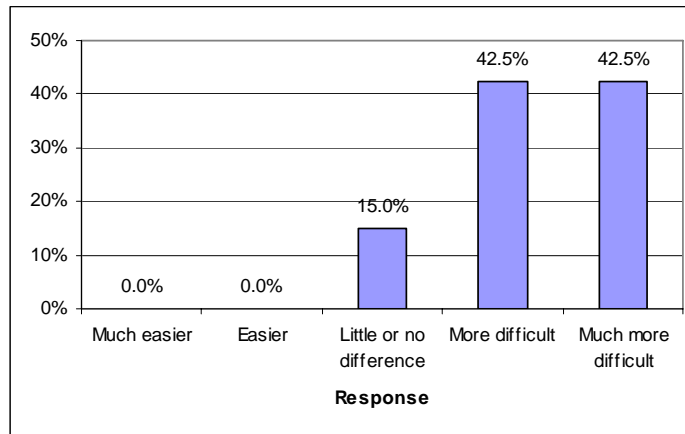




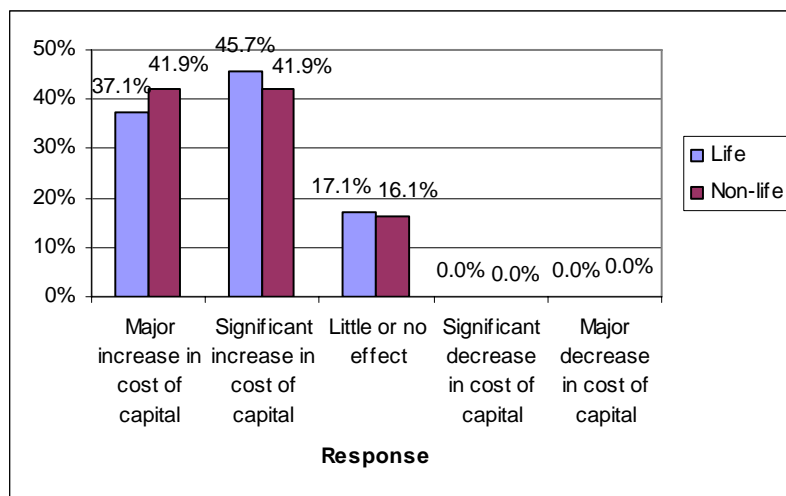


- Higher volatility of reported earnings would increase the cost of capital and make it more difficult to provide earnings forecasts or forward-looking information to the investment community. Other industries will not be reporting volatile earnings and earnings per share figures and there will be adverse stock market signalling.
- Measuring the fair value of insurance liabilities (insurance contracts) would be highly subjective and there might be compliance problems under the Sarbanes-Oxley Act.
- Majority of companies consider that the disclosure of the fair value of insurance liabilities would not increase transparency, but a minority considered it would to some degree, but any disclosure should be in notes.

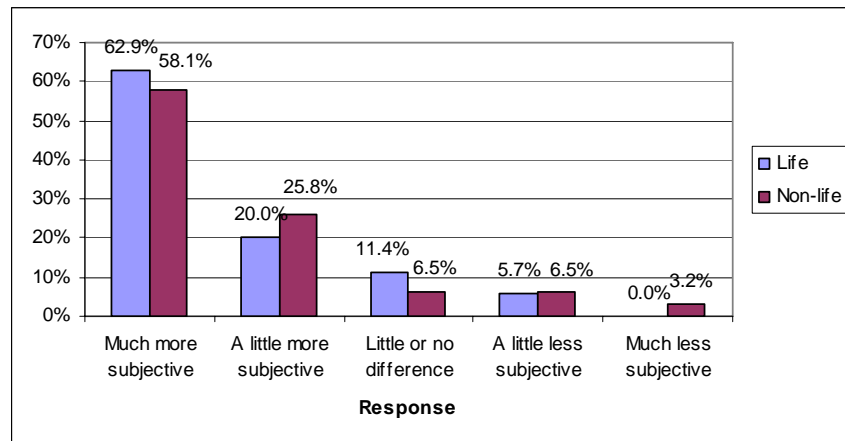
Impact on management's ability to provide earnings forecasts



Perceived impact of more volatile reported earnings on cost of capital



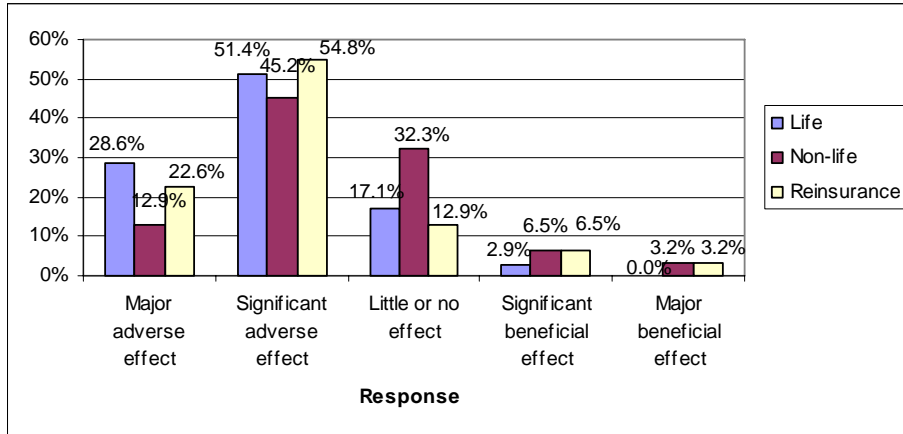
Subjectivity and the measurement of insurance liabilities (contracts)



Impact of full fair value reporting system on the risk intermediation role of insurers within the wider economy:

- Decrease in time horizons would reduced the ability to diversify risks over time.
- A higher cost of capital would reduce capacity.
- Less guarantees and options in life and pensions contracts would undermine long-term savings role to some degree.
- Greater shift away from stocks to bonds and shortened duration in bond portfolios would have implications for capital markets and for corporate and government financing.
- But there would be benefit if it were to lead to more economic pricing of risks.

Perceived impact on the insurance industry's risk transfer role in the economy



Key Findings of User Needs Study of Geneva Association

Non-life Insurance Operations

- Financial analysts and investors in Europe or United States consider that there is not a lot wrong with current deferral and matching financial reporting system. 'It is only slightly broke hence is there a need to have a new untested model ?'
- US analysts strip out realised (and unrealised) gains or losses to focus on the profitability of the core underwriting business as well as various rate of return on capital metrics.
- Would like to see greater consistency on valuing claims provisions (loss reserves). Do not want revaluation surprises from strengthening claims reserves. Some support the discounting of claim provisions, while others are against as it hides performance of the core business of underwriting and claims management
- Fair (market) value of investments are already increasingly available in primary financial statements or in the notes.
- Very limited support for a full fair value reporting system among European or US financial analysts. They would strip all noisy factors which obscure the underlying earnings growth

Life insurance Operations

- Financial analysts and institutional investors in Europe and in few other countries increasingly using embedded values, often adjusting reported embedded values or estimating their own values. Embedded values preferred to 'fair values'. 'Life accounting is broke, certainly in Europe, but much less broke in the US'
- More European life Insurers are using embedded values internally and providing them as supplementary accounts. Launch of European Embedded Value Principles in May 2004 by number of leading European insurers. But some Canadian and Australian life companies are moving this way.
- In the United States, embedded values are not used by life insurance companies internally for financial planning. But a few life insurers are now looking at it again.
- Financial analysts and investors in US do not use embedded values. Greater emphasis on cash generation than value creation. They put a higher P/E multiple on firmer earnings figures. They want numbers they can put in own models to forecast earnings growth trends

Key Challenges Ahead and Some Suggestions

- During 2003, leaders in the insurance industry, including members of Geneva Association, and CEA and ACLI, have changed attitudes at the IASB. Paul Volker and Frits Bolkestein have both put pressure on IASB to improve its consultative process.
- The insurance industry is now working with the IASB to find a workable solution for Phase II with members or observers in its new Insurance Working Group. IASB is now listening in part because it has not been able to come up with a workable and reliable measurement system
- Following Norwalk Agreement Sept 2002, IASB and FASB are working more closely together and are co-operating on projects. Phase II is one of these projects. But FASB is now pushing ahead with its long standing fair value agenda, e.g. redefining its measurement hierarchy and seeing if it can be extended to all assets and liabilities, at least in the notes
- Insurance contracts, life and non-life, under US GAAP are likely to be revised but will be influenced by Phase II developments.

- A determining factor going forward will be the IFRS that emerges from IAS 39, and any changes to FAS 115. Both are likely to remain a mixed measurement system for investments in primary accounts (Banks will continue to block attempt use fair value of fixed rate loans in their primary accounts). Insurance contracts under Phase II will have to dove-tail into this, if there is to be consistent treatment of financial assets and liabilities.
- An embedded value is unlikely to be a solution for life business in Phase II, but will increase as supplementary accounts or in MD&A in the financial reports.
- Some evidence that IASB is move away from defining net income (profit) as the change in equity. Gains/Losses on 'Available for Sale' investments cannot go directly into P&L. IASB Working Group on 'Comprehensive Income' to be set up.

- One solution is to have a mixed measurement system for Insurance contracts (liabilities) as for investments so that there can be matching of asset and liabilities (see Geneva Report, February 2003)
- For life business, fixed annuities and term life can be considered as HTM; participating life contracts as available-for-settlement; and some linked-life contracts equivalent to 'held for trading'. But the amortization of the front-end expenses on new business will need to be addressed as DAC's go.
- Embedded options will be measured more clearly but allowance for policyholders' behaviour, but not to treat them as put options that will be exercised automatically, especially for surrender values. More flexibility in applying the Deposit Floor and Liability Adequacy Testing criteria.
- For non-life liabilities should be one category: HTM (broadly current system) or possibly available-for-settlement. ALM not so important as in life insurance. Not much wrong with current mixed measurement system. Case for keeping unearned premium provision (and amortizing acquisition costs) but some discounting claims provisions at a conservative rate.

- Move away from MVM to allowing for risk in the discount rate. Risk-adjusted rate for a liability entails deducting the risk premium from the risk free rate. Risk premia must capture risk aversion to be consistent with market values; value-at-risk measures do not do this.
- Case for greater flexibility in application of the fair value option to allow for ALM matching, but there should be at the same time more flexibility in application of tainting rules for HTM investment category. Rebalancing of investments for dynamic hedging should not be confused by IASB as trading
- Equalisation and catastrophe provisions are going but there needs to be some earmarking in the Capital & Reserves to allow for selective tax relief to ensure level playing field between risk retention and risk transfers through reinsurance in some countries
- Removal of own credit risk for insurance liabilities. The parallel that has been drawn by the IASB between insurance liabilities and corporate debt is not only misleading but theoretically incorrect.

- Unrealised investment gains and losses, unrealised currency gains/losses and revaluations (unrealised gains/losses) on insurance liabilities should be treated the same: either in a comprehensive income statement or in the notes. They should not be in the primary income statement (P&L), except when related to held-for-trading investments and fair value hedges with derivatives. All realised gains/losses should be in the income statement (P&L)