



International Association for the  
Study of Insurance Economics

# Études et Dossiers

---

Extract from

## Études et Dossiers No. 296

**Insurance and International Finance  
Reporting Standards**

1 December 2004  
Milan, Italy

April 2005

**Working Paper Series of  
The Geneva Association**

© Association Internationale pour l'Etude de l'Economie de l'Assurance

The Geneva Association Working Paper Series “Études et Dossiers” appear at irregular intervals about 10 - 12 times per year. Distribution is limited.

The “Études et Dossiers” are the working paper series of The Geneva Association. These documents present intermediary or final results of conference proceedings, special reports and research done by The Geneva Association. As they contain work in progress or summaries of conference presentations, the material must not be cited without the express consent of the author in question.

Layout & Distribution: Valéria Kozakova & Bernadette Curty

# The Impact of International Accounting Standards: Strategic Challenges for European Insurance Industry

Gérard de La Martinière

## INTRODUCTION

**Insurers will implement IAS as of January 1, 2005. To avoid any uncertainty, CEA on behalf of the industry has urged the Commission to endorse IFRS 4 and IAS 39.**

**However, some problems need to be solved with respect to phase 1 and phase 2 if we want this revolution to result in the degree of transparency and comparability that all stakeholders wish.**

**A. Phase 1 poor and uncertain solutions for insurers**

**B. The open-ended nature of discussion on phase 2 is a plus**

**C. The new standards may bring significant changes to the industry profile**

December 2004

MILAN

**A. Phase 1 poor and uncertain solutions for insurers**

**1. Which standards for phase 1?**

**2. Remaining uncertainties in their future implementation**

**3. Where the standards fall short**

December 2004

MILAN

## 1. Which standards for phase 1?

### ➤ IFRS 4 Insurance Contracts

- **One-off changes in accounting for liabilities**
  - ✓ Disappearance of equalization reserves
  - ✓ Keeping option of measuring non-life liabilities on a discounted basis
- **Keeping local standards for insurance liabilities**
  - ✓ Contracts covering an insurance risk
  - ✓ Investment contracts with participation features

### ➤ IAS 39 Financial Instruments

- **Fair value accounting of assets**
  - ✓ Three FV accounting methods (Held To Maturity, Sale, Trading)
  - ✓ Consolidation of ad hoc entities, incl. mutual funds in trading portfolio
- **Limited scope with respect to accounting for liabilities**
  - ✓ Participating contracts excluded
  - ✓ FV for UL contracts by virtue of older directives

December 2004

MILAN

## 2. Remaining uncertainties in their future implementation

### ➤ Major problems of interpretation

- **Limits of insurance risk versus financial risk?**
- **Limits to the application of HTM rules (Held To Maturity)?**
  - ✓ According to the Board, applies largely to insurance assets
  - ✓ Not at all clear in terms of IAS 39
- **Procedures for using options permitted under IFRS 4?**
  - ✓ Numerous options introduced to attenuate the asset/liability mismatch
  - ✓ Complex options (shadow accounting, interest rate adjustments)
  - ✓ Possible reluctance of supervisors

### ➤ Who will provide guidance?

- **IFRIC: has the power but lacks the capacity**
- **EFRAG: has the competence but not the power**
- **ARC: more political than technical**
- **National standard setters : no uniform interpretation**
- **=> Auditors? Analysts? Market authorities?...**

December 2004

MILAN

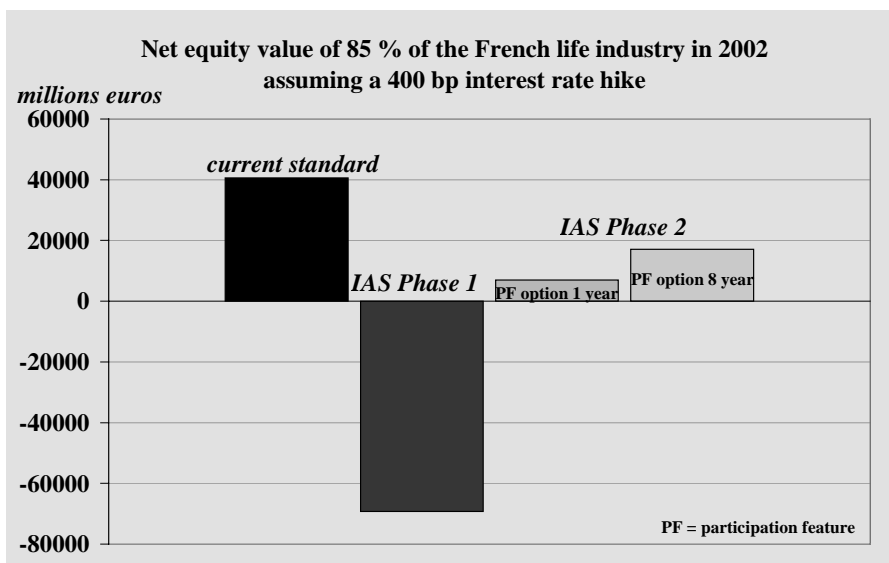
### 3. Where the standards fall short

- **IAS 39 is incomplete**
  - **Carve-out of rules pertaining to bank hedging**
    - ✓ Broad technical consensus for amending these rules
  - **Carve-out of the fair value option**
    - ✓ Even though this option is needed to attenuate asset/liability mismatch
- **IFRS 4 needs to be corrected**
  - **To mitigate asset/liability mismatch**
    - ✓ High risk embedded in this mismatch
    - ✓ Various solutions still possible
  - **To clearly determine the scope of the deposit floor**
    - ✓ Necessary to ensure that the fair value option is not merely theoretical
- **Critical standards not yet published**
  - **Performance reporting**
    - ✓ Key to financial statement readability
  - **Revenue recognition**
    - ✓ Especially important to life insurance

December 2004

MILAN

### High risk embedded in this the mismatch



December 2004

MILAN

### 3. Where the standards fall short

- **IAS 39 is incomplete**
  - **Carve-out of rules pertaining to bank hedging**
    - ✓ Broad technical consensus for amending these rules
  - **Carve-out of the fair value option**
    - ✓ Even though this option is needed to attenuate asset/liability mismatch
- **IFRS 4 needs to be corrected**
  - **To mitigate asset/liability mismatch**
    - ✓ High risk embedded in this mismatch
    - ✓ Various solutions still possible
  - **To clearly determine the scope of the deposit floor**
    - ✓ Necessary to ensure that the fair value option is not merely theoretical
- **Critical standards not yet published**
  - **Performance reporting**
    - ✓ Key to financial statement readability
  - **Revenue recognition**
    - ✓ Especially important for life insurance

December 2004

MILAN

## B. The open-ended nature of discussion on phase 2 is a plus

1. We are starting from scratch
2. The industry is highly motivated
3. Key phase 2 issues

December 2004

MILAN

## 1. We are starting from scratch

- **The board, due to its lack of familiarity with insurance**
  - As the imperfections of the DSOP and phase 1 testify
  - The need for a transition is result of this lack of familiarity associated with a great ambition
- **Insurance industry because process got behind schedule**
  - Problems with phase 1 led to delay
  - More experience with Embedded Value than with Fair Value
- **Public authorities, because they had other priorities**
  - Priority for prudence and supervisory needs
  - Users more than standard setters
- **Analysts & investors, due to late & limited involvement**
  - Always interested in additional financial information and better comparability
  - But rather neutral about the structure of this information
- **Consequence: all options must be kept open**

December 2004

MILAN

## 2. The industry is highly motivated

- **Mobilization is crucial**
  - **Input hoped for but uncertain from EFRAG and ARC**
  - **The Board is torn**
    - ✓ More open than before (see formation of the Advisory Group)
    - ✓ But tempted to lean toward convergence with FASB
- **Mobilization in France**
  - **The FFSA has appointed a special task force**
  - **It participates in all CEA project work**
- **Mobilization in Europe**
  - **The top priority of the CEA accounting committee**
  - **The top priority of the CFO Forum**
  - **Tight coordination between professional bodies**
    - ✓ Between CEA, CFO Forum and other professional bodies
      - => Ongoing exchanges
      - => Common representation in the IASB Advisory Group

December 2004

MILAN

### 3. Key phase 2 issues

- **A dual general aim**
  - **Integrate insurance business particularities**
  - **Preserve business model and value added**
- **Five requirements**
  - **Due consideration of the duration of insurance liabilities**
  - **Consistent treatment of A/L starting from liability side**
  - **Portfolio approach for assets and liabilities**
  - **Integration of prudential concerns**
  - **Straight information, compatible with that of management**
- **A basic decision to be reached rapidly**
  - **Fundamental choice**
    - Asset-based model => priority to entry value
    - Liability-based model => priority to exit value
  - **Critical factors in making the choice**
    - ✓ Recognition or not of certain future profits
    - ✓ Place left to entity- or industry-specific value
    - ✓ Calibration of the market margin risk

December 2004

MILAN

### C. The new standards may bring significant changes to the industry profile

- 1. Changes with respect to competition**
- 2. Changed relations with the markets**
- 3. Changes in the insurance business model**

December 2004

MILAN

## 1. Changes with respect to competition

- **Competition and subjective information?**
  - The required disclosures go beyond objective, easily verified data
  - This leads to serious concerns about subjectivity: comparability, validation, etc.
  - How can we ensure an even playing field under these circumstances, especially within E.U.?
- **Competition and business intelligence?**
  - Much of the new information goes to the very heart of business strategy
  - In fact, the real value added of insurers lies in their ability to measure and price risk
  - How will competition evolve in the absence of intellectual property right protections?

December 2004

MILAN

## 2. Changed relations with the markets

- **Higher transparency & standards welcome in principle**
  - **However, adapting will be difficult**
    - ✓ Due to mismatch & multiplicity of options
    - ✓ Due to 2 successive big bangs (phase 1 & 2) & multiplicity of F.S.
  - **Uncertain consequences of more volatile financial statements**
    - ✓ Will markets overreact and demand a higher risk premium?
    - ✓ Will the other users (esp. customers) support higher volatility
    - ✓ Will the supervision scheme be adapted (consistency with solvency II)
- **Solutions that could mitigate these issues**
  - **Informed financial statement interpretation**
    - ✓ Auditors able to reconcile accounting principles and business reality
    - ✓ Analysts and rating agencies able to interpret volatility
  - **An adapted Solvency II reform**
    - ✓ Residual corrections to F.S. to reflect insurance business realities
    - ✓ Smoothing of F.S. pro-cyclicality for margin calculations

December 2004

MILAN

### 3. Changes in the insurance business model

- **Behaviors difficult to predict**
  - **Financial statements (FS) comparability difficult in phase 1**
  - **FS' lack of predictability and risk of instability at ST**
- **Three main potential consequences**
  - **Divergence between internal & external control**
    - ✓ Asked by the Geneva Association, concerned managers said they are ruling out using phase 1 financial statements to meet their own needs.
  - **Shift toward “conservative” asset allocation**
    - ✓ Reduction in the share of most volatile assets
    - ✓ Potential “victims” : equity (see USA), particularly private equity
  - **Development of risk transfer**
    - ✓ Risk transfer from principal to broker
    - ✓ Either toward financial markets or back to policyholders (see life)

December 2004

MILAN

## CONCLUSION

**The phase 1 standard not only moves us away from phase 2, it may also be a step backward in financial statement comparability.**

**Consequently, if we want to prevent the phase 2 standard from being reductive, serious reflection for a better alignment between IAS and realities of insurance is needed.**

**Especially since the adoption of IFRS is likely to lead to fundamental changes in the conduct of various stakeholders.**

December 2004

MILAN