



International Association for the  
Study of Insurance Economics

# Études et Dossiers

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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**

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Layout & Distribution: Valéria Kozakova & Bernadette Curty

# The Impact of International Accounting Standards on Insurance Market

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## **Plan of Presentation**


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- Where do we stand now?
- A brief overview of IFRS4/IAS39
- The operational impact
- The economic impact
  - Cost of capital
  - Asset allocation
- Conclusions




## **Where do we stand now?**

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- From 2005 onwards, all companies listed in the EU will report under IFRS
  - In the EU the legislation refers to adopted IFRS, i.e., those standards endorsed by the European Commission
  - EC has endorsed a carved-out version of IAS 39 on November, 19
  - At the present time, the EC has yet to endorse IFRS 4
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## **Product Classification (1/2)**

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- For contracts to be classified as insurance, significant insurance risk must be present
    - This is defined as an insured event that adversely affects the policyholder, paying significant additional benefits in any scenario except those that lack commercial substance. It must also be a pre-existing risk (not created by the contract)
  - The IASB provided detailed implementation guidance on the classification for many contract types:
    - Insurance: term assurance, whole life policies, most property/casualty insurance contracts, disability and medical cover
    - Investment: Unit-linked without significant death benefit; Guaranteed investment contract
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## **Product Classification (2/2)**

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- Discretionary participation contracts are temporally treated under IFRS4 (as insurance contracts), thus insurers may basically continue to use their existing accounting policies
  - contracts that have a guaranteed component, where the individual policyholder has an unconditional right to benefits, and a discretionary participation feature, where the insurance company has discretion over the timing or amounts payable to the policyholder.
- Once a contract has been classified as insurance, it will always be considered insurance. However, contracts originally deemed to be investment contracts may at some point meet the definition of insurance



## **Main Mandatory Changes (Phase I)**


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- Catastrophe and Claims equalization provisions are not allowed
- Liability adequacy testing and recognition of future losses is mandated
- Embedded derivatives are separated and accounted for at fair value, unless they are insurance contracts or discretionary participation features and are closely related to the host insurance contract
- Gains or losses on entering into a reinsurance treaty are disclosed




## **Policies allowed to continue (Phase I)**

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- Undiscounted measurement basis for claims reserves
  - Excessive prudence or deliberate overstatement of insurance liabilities that may be a result of applying local regulatory requirements
  - Reflecting future investment margins in the measurement of insurance liabilities
  - Measuring the rights to future investment management fees above the fair value
  - Recognition of deferred acquisition costs (DAC)
  - Non-uniform accounting policies for insurance subsidiaries
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## **Relevant issues**

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- The mismatch issue due to the valuation of assets under IAS 39 at fair value while the technical provisions for insurance contracts and so-called investment contracts with discretionary participation features will be valued at cost under IFRS 4
  - A Member State can permit or require companies to fair value liabilities under Article 31 of the Insurance Accounts Directive. Article 31 allows insurance companies, in the case of unit-linked contracts, to value liabilities - where the policyholders bear the investment risk or where benefits are determined by a certain index- according to the value of the underlying units, assets, share index or reference value (EC 19/11/2004 Memo, FAQ)
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### **The operational impact (1/4)**

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- Pricing and product design: significant changes in product design to reflect the product classification requirements of IFRS can be expected. In particular guarantees, options, embedded derivatives, profit sharing arrangements should be re-evaluated.
  - There could be pressure to move from with-profits or participating life insurance contracts towards linked-life products. In the non-life business there could be a reduced incentive to offer longer term insurance (liability insurance, accident and disability insurance)



### **The operational impact (2/4)**

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- The areas of financial planning and control systems would be the most affected
  - internal financial planning tools would tend to be consistent with external reporting
  - internal systems used to allocate capital across the company would have to change.
- Many operational areas will also be affected by the IFRS: among others, actuarial modeling, IT systems and software development, human resources



### **The operational impact (3/4)**

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- External communications to analysts, shareholders and policyholders will be a challenging task
  - Data processes will need improvements to collect additional (in some cases qualitative) information required for the enhanced disclosure requirement
- Interim reports
  - ANIA is currently discussing with CONSOB a gradual approach for 2005 interim reports. The idea is to allow the presentation of present GAAP with some form of reconciliation with IAS/IFRS.



### **The operational impact (4/4)**

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- According to the Geneva Association survey:  
*A typical estimate of the increase in total operating costs (excluding sales commissions) from a switch to full fair value reporting was about 5% for life insurance operations, with a slightly lower figure of 4% for non-life insurance operations. As might be expected, these estimates varied a lot among companies, falling mainly within the range from 3% to 10%*



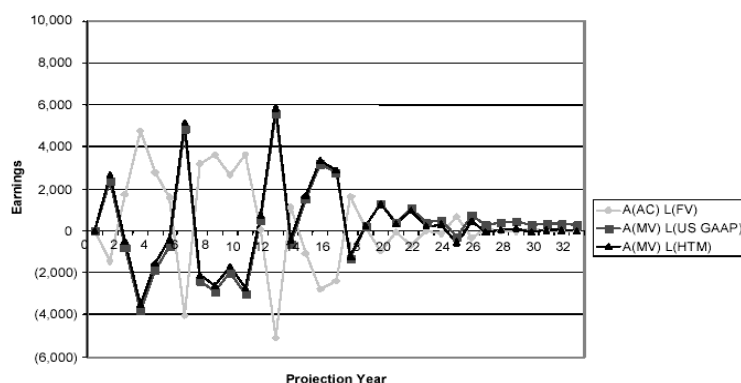
## The economic impact (1/7)

- The IAS adoption might lead to increased volatility in reported earnings: some of this volatility will correctly reflect market conditions, while another part will be an “accounting volatility” which is not related to the real risks in the underlying business
- The crucial point is: can investors distinguish between real and artificial volatility? In a perfect market the answer is: yes. In the real world the answer is: not always
  - Comparability within the insurance industry and between other industries may be reduced in the short term as there continue to be mixed existing accounting practices and alternative valuation options under IAS 39



## The economic impact (2/7)

Chart 1- Dissimilarly Valued Asset & Liabilities  
Corporate Strips Strategy: Invest cash pro-rata to liability CF  
Mortality Experience = Pricing

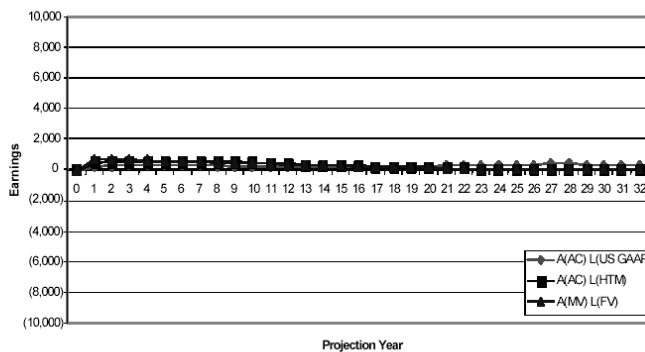


Source: Joint Research Project ACLI/IIA, p.11 available at [www.iasb.org/docs/ed05/ed5-cl72b.pdf](http://www.iasb.org/docs/ed05/ed5-cl72b.pdf)



## The economic impact (3/7)

CHART 2 - Similarly Valued Assets & Liabilities  
 Corporate Strips Strategy: Invest cash pro-rata to liability CF  
 Mortality Experience = Pricing

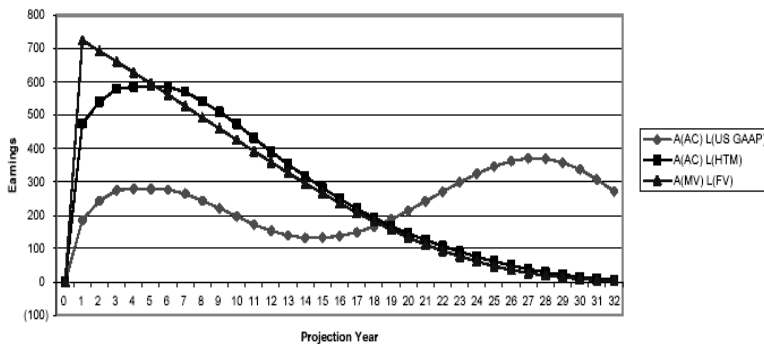


Source: Join Reserach Project ACLI/IIA , p.12 available at [www.iasb.org/docs/ed05/ed5-cl72b.pdf](http://www.iasb.org/docs/ed05/ed5-cl72b.pdf)



## The economic impact (4/7)

CHART 3 - Similarly Valued Assets & Liabilities  
 Corporate Strips Strategy: Invest cash pro-rata to liability CF  
 Mortality Experience = Pricing



Source: Join Reserach Project ACLI/IIA , p.13 available at [www.iasb.org/docs/ed05/ed5-cl72b.pdf](http://www.iasb.org/docs/ed05/ed5-cl72b.pdf)



## **The economic impact (5/7)**

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- Monetary policy is quite easy today in most of the G-7 countries.
- Currencies are experiencing sharp fluctuations
- Long term interest rates are close to 40 year lows
- Fiscal policy is very accommodative in many countries
- How might insurance companies react if background conditions change?



## **The economic impact (6/7)**

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- If investors are not able to separate artificial from real volatility an increase in the cost of capital may occur
- Insurance companies will need to consider whether they should change their asset allocation. In particular, companies might tend to reduce their risk appetite in order to reduce the volatility of their results:
  - by reweighting the investment portfolio away from equities towards bonds and a greater use of derivatives
  - by reducing the duration of their bond portfolio



## **The economic impact (7/7)**

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- Protecting against a significant variation of interest rates can reduce earnings, both shareholder earnings and policyholder earnings.
- Hedging is not cheap and can drive down reported profitability
- “The point is that holding a company to a standard of prudence that is not demanded of your counterparts may not often be a winning strategy for a CEO or CFO” (Mc Crossan, at Garp 2004)



## **Conclusions (1/2)**

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- The activities of the insurance industry are long term in nature. Insurance companies diversify risks not only cross-section but also over time
- A fair value reporting system might put pressure to reward business activities with a shorter pay-back period, thus influencing both product offerings and asset allocation policies
- The major risk is that insurance companies can be forced to mimic mutual funds



## **Conclusions (2/2)**

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- The measurement of insurance company liabilities under Phase II should be fully consistent with the nature of insurance, allowing companies to diversify risks over time
- Further, new solvency requirements should not induce any additional procyclicality

