

Special Report

Mind the GAAP: Fitch's View
on Insurance IFRS

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■ Summary

The introduction of International Financial Reporting Standards (IFRS) in 2005 will have a significant impact on the way that many insurance companies report their financial statements. On introduction, the consolidated accounts of almost all listed insurance (and non-insurance) groups will have to be prepared in compliance with IFRS, including the recently published IFRS 4 – Insurance Contracts. The IASB intends to progress as quickly as practicable towards phase 2 although this is not expected to be before 2007 at the earliest. The IASB has indicated a conceptual preference for fair value accounting at phase 2 although the target accounting model has yet to be finalised.

Fitch welcomes the progress made by the IASB towards standards that will be more transparent and comparable across regions. The agency recognises the significant limitations of phase 1 but believes that the enhanced disclosure and greater consistency at phase 1 of the insurance accounting project (set out in IFRS 4) will aid in the analysis of insurers and is a useful stepping stone to the more valuable phase 2.

The agency notes that there is still much to do in defining the accounting for phase 2, and finding a balance between sophistication, consistency and practicality will be highly challenging. Nevertheless, Fitch supports the conceptual shift to fair values although cautions that this must be in partnership with detailed disclosure allowing an assessment of important items such as methodology, assumptions and risk.

Although concern has been raised by some about the effect of the expected additional volatility stemming from IFRS, Fitch is only critical of reported volatility that does not reflect the underlying economic reality and therefore lacks informational content (i.e. 'accounting volatility'). Some accounting volatility may be induced at phase 1 (e.g. due to bond price movements stemming from changing interest rates where assets and liabilities are matched), but the agency regards this volatility as being a small price to pay for showing an up to date picture of the balance sheet position. At phase 2, Fitch expects reported volatility to be more closely related to the underlying economic reality. The agency welcomes the transparency provided by this reported economic volatility and in particular, the information provided on the mismatch between assets and liabilities and therefore, overall risk.

The agency notes that it does not expect any rating actions as a direct result of the move to IFRS. However, Fitch cannot rule out the possibility that the additional disclosure and information contained in the accounts could lead to rating changes due to an improved perception of risk based on the enhanced information available. In addition, the new accounting regime could have a medium term rating impact for some companies depending on the response of management and investment markets to the new standards or if the basis of taxation were to be affected.

■ Introduction

International Accounting Standards began to be developed in 1973 when the professional accountancy bodies of Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK, Ireland and the USA founded the International Accounting Standards Committee ('IASC'). In 2000, the committee underwent a major restructuring process and in 2001, the newly restructured and renamed International Accounting Standards Board (IASB) held its first meeting.

The newly formed IASB adopted all of the standards that had been prepared by the IASC and new accounting standards produced by the board will be known as International Financial Reporting Standards (IFRS). The term IFRS is understood in this report to refer to both these new standards that will emerge over time and those set by the IASB's predecessor organization.

IFRS will become particularly important as from 2005, essentially all EU companies that are listed on European exchanges will be required to produce their *consolidated* accounts in accordance with IFRS¹. This is expected to affect around 7,000 entities, including many of the largest insurance companies in Europe. In addition, IFRS is likely to also be adopted by companies in many other jurisdictions, including Hong Kong and Australia, and many EU countries will permit non-listed companies to file accounts under IFRS. Over time, the use of these standards is expected to become increasingly prevalent, particularly for those companies wishing to access the capital markets.

Currently, there is no IFRS that deals with the accounting treatment of insurance contracts. Companies that already use IFRS to prepare their accounts typically use US GAAP to "fill in the gaps" in the published guidance. The current project to develop standards for insurance contracts aims to remedy this situation and improve the transparency of reporting.

This paper sets out the key issues surrounding IFRS for insurance contracts (both phases 1 and 2) and the likely impact of these issues on insurance companies. The paper focuses on general insurance issues and does not deal with issues specific to life insurers.

¹ Individual member states have the option of requiring all companies to comply with IFRS from 2005 onwards. It should also be noted that some kinds of listed company, at the option of individual member states, may not have to comply with IFRS until 2007. This delayed implementation may affect companies with debt securities only (not shares) listed on a regulated market of a member state. In addition, companies with a listing outside the EU and already using internationally accepted standards (e.g. US GAAP) may also avoid IFRS implementation until 2007.

However, many of the points made for general insurance are also applicable to life insurance. Although many uncertainties surround phase 2, Fitch believes that phase 1² can only be understood and assessed in the context of the fair value accounting that the IASB aims to achieve.

This paper does include some comments in respect of IAS 39 ('Financial Instruments') which will have an important impact on insurers but it should be noted that the paper is deliberately limited in scope. The paper does not set out to outline all of the consequences of IAS 39³ implementation or the likely impact from the implementation of other IFRSs (e.g. 'Employee benefit costs' (IAS 19) or 'Related party disclosures' (IAS 24)). Where material, such issues are likely to be addressed by subsequent Fitch reports.

This paper is divided into the following sections:

- Overview of Insurance IFRS.
- Main features of Insurance IFRS – phases 1 and 2.
- Key issues arising from the planned Insurance IFRS.
- Business implications of fair value reporting.
- Impact of Insurance IFRS on analysis methodology.
- Impact of Insurance IFRS on ratings.
- Conclusion.

The report also includes a number of appendices:

- **Appendix A** – Principal benefits and costs of the new Insurance IFRS reporting.
- **Appendix B** – Additional Insurance IFRS issues
- **Appendix C** – Example of possible insurance accounting treatment.

■ Overview of Insurance IFRS

The IASB has tentatively concluded that the overall goal of new insurance standards should be to move towards fair value accounting (i.e. recording both assets and liabilities at the "amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."⁴) More specifically, this can be

² 'Phase 1' and 'IFRS 4' are considered to be equivalent and so these terms are largely used interchangeably in this report. Phases 1 and 2 are considered to be two stages in the same process and so are collectively referred to as 'Insurance IFRS'.

³ IAS 39 and IAS 32, which relate to accounting for, and disclosures of, financial instruments are yet to be endorsed by the European Union in order to require their use from 2005. A failure to endorse these standards would leave EU companies as being non-IFRS compliant and could negate many of the proposed benefits for a common reported standard (including acceptance by the SEC). Fitch expects resolution of this situation in the near term.

⁴ Appendix A of IFRS 4 Insurance Contracts

seen as a combination of two distinct processes. Firstly, a move away from the current (P&L focused) deferral and matching approach and towards a (more balance sheet focused) asset-and-liability approach. Secondly, as a move away from the current situation of differing levels of reserving prudence and towards a more standardised approach focused on the best estimate. These concepts are defined further below.

After the start of the insurance project in 1997, it was hoped that a fair value standard could be agreed by 2003 for implementation in 2005. However, in May 2002, due to the complexity of the task and the relatively slow progress made, it became necessary to split the project into two parts. Phase 1 will be introduced in 2005 and has recently been published in the form of IFRS 4 Insurance Contracts. This standard will require significantly increased disclosure and certain other changes to the way that insurance contracts are accounted for (set out in the next section). Also very important in 2005, will be the implementation of IAS 39 Financial Instruments by many insurers requiring most investments to be accounted for at fair value.

The implementation of fair values for liabilities, a more complex task due to the lack of a liquid market, has been postponed to phase 2. The IASB is committed to completing phase 2 as soon as possible but this will take some time to complete. The IASB included a sunset clause⁵ in exposure draft 5 (ED 5) indicating that implementation could be scheduled for 2007 but this was deleted from the final accounting standard (IFRS 4). The deletion of this clause means that there is currently no 'deadline' to work to and in Fitch's view, implementation for this date seems optimistic.

Timetable of Introduction for IFRS on Insurance Contracts

Date	Comment
October 2003	End of consultation period on Exposure Draft 5 – ED 5
March 2004	FRS 4 published following comments received on ED 5. (Phase 1)
2005	Exposure draft on Phase 2 to be published
2005 ⁶	IFRS Financial statements to be published for EU listed insurers (limited IFRS comparatives for 2004 required.) Mandatory Implementation of phase 1.
2007/8?	Phase 2 implementation scheduled?

Source: IASB, Fitch Ratings

⁵ See Appendix B of this report for further details.

⁶ IFRS 4 is mandatory for financial periods beginning on or after 1 January 2005 although earlier adoption is encouraged. The target phase 2 implementation date was financial periods beginning on or after 1 January 2007. However, this now looks likely to be postponed by at least a year.

The proposed asset-and-liability approach (where assets and liabilities are recognised to the extent that they meet required definitions with income and expenses defined in terms of changes to assets and liabilities) represents a significant departure from the current situation, where revenues and costs are matched and earned gradually over the period of the contract. This matching of revenues and costs is achieved through the deferral of some costs (deferred acquisition costs – DAC) and revenue (unearned premium reserve – UPR) to be earned over the contract period.

Neither DAC nor UPR meet the IFRS framework definition⁷ of an asset (a resource expected to give future benefits) or a liability (an obligation arising from past events expected to result in an outflow of value from the company). The move across to fair values for both assets and liabilities will ensure that the balance sheet does not contain assets and liabilities that fail to meet the respective definitions and is also designed to increase the transparency of reporting.

■ Main Features of Insurance IFRS – Phases 1 and 2

Phase 1

Fitch believes that phase 1 of the insurance accounting project should not be appraised on a stand-alone basis but as an intermediary step to achieve the fair value accounting envisioned at phase 2. Phase 1 of the insurance accounting project will require relatively limited accounting changes compared to the ambitious overhaul planned under phase 2. However, the standard introduces some important principles, requires some (limited) changes to accounting methodology and will require significantly increased disclosure.

The broad plans for phase 1 (through ED 5) have been public for some time and summaries have been produced by all of the major accounting firms. As such, only a brief summary of the requirements of IFRS 4 is included below. The principal features of IFRS 4 are:

Definition of Insurance Contracts

The IASB wants to ensure that similar transactions are treated in a similar way and, therefore, the accounting treatment specified will affect all insurance contracts whether written by a registered insurer or not. The definition of insurance contracts given by IFRS 4⁸ is overleaf.

⁷ IFRS definition included in the IASB Framework – para 49.

⁸ Appendix A – IFRS 4 Insurance Contracts

“A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain event (the insured event) adversely affects the policyholder.”

This is an important change which should lead to a focus on the substance of economic transactions rather than the legal form and help to standardize the treatment of insurance contracts across industries. The definition will also mean that certain contracts that are written by insurers will no longer be classified as insurance contracts. Certain financial reinsurance contracts and policies with a low degree of risk transfer (e.g. certain finite risk contracts) will not meet the above definition and therefore be required to be treated as deposits.

Unbundling of Contracts and Accounting for Embedded Derivatives

IFRS 4 will require some contracts which have investment and insurance features to be unbundled and accounted for separately. However, as a result of numerous exclusions, this will not be as onerous as originally feared and it is largely only financial reinsurance contracts that will require unbundling in phase 1. Examples of contracts that could be affected in phase 1 include certain multi-year reinsurance contracts linked to an experience account. This could be extended further in phase 2.

Similar to the requirement to separate the investment and insurance components of a contract is the requirement to account for embedded derivatives at fair value, with movements in this value being recorded in the income statement. Embedded derivatives that will have to be recorded at fair value during phase 1 include life products offering a guarantee of minimum equity returns on surrender or maturity. However, phase 1 gives an exemption to embedded derivatives that are themselves insurance contracts, significantly reducing the contracts affected. Examples of embedded derivatives that may need to be accounted for at fair value at phase 2 if these rules are tightened include guaranteed annuity options (GAOs) and guaranteed minimum death benefits (GMDBs).

End to Equalisation Reserves

The IASB takes the view that claims reserves are only permissible to the extent that they relate to actual liabilities (i.e. a “present obligation ... arising from past events ... which is expected to result in an outflow ... [of] resources embodying economic benefits”⁹). Equalisation and catastrophe reserves do

not fulfil this required definition and so will no longer be permitted once phase 1 is implemented¹⁰.

Treatment of Investments

Changes to the treatment of investments will not be a direct result of IFRS 4 (or therefore, of phase 1) but will result from the implementation of IAS 39. Nevertheless, the requirements are closely connected to the phase 1 requirements and will be one of the most important changes of accounting for many companies in 2005 when they adopt IFRSs for the first time. Under IAS 39, the investment assets of insurance companies will have to be categorized as either held to maturity (with the investments held at amortised historic cost), available for sale (investments marked to market with changes recorded in reserves), or held for trading (marked to market with changes recorded in the income statement)¹¹.

Given the nature of insurance company liabilities, most investments are liable to be categorized as “available for sale” with the associated volatility in shareholders’ equity. Many insurers would prefer to classify investments as “held to maturity” in order to avoid the volatility associated with marking to market investment. However, for investments to be classified as ‘held to maturity’, the insurer would need to be able to demonstrate both positive intent and an ability to hold the instrument to maturity. This would imply that the insurer was willing to forego future profit opportunities generated by these financial instruments as well as implying a greater degree of certainty as to the timing of cash flows than is usually possible.

In practice, one of the main obstacles to investments being classified as ‘held to maturity’ are the harsh penalties set out in IAS 39 if these assets are sold prior to maturity. These ‘tainting rules’ (subject to a few exceptions) include a ban on using the held to maturity classification for any financial instrument for the year of sale and for two following financial years.¹²

Insurance Accounting

Deferred acquisition costs will still be permitted for insurance contracts during phase 1, and whichever GAAP that companies currently use will continue to prevail on the accounting for insurance contracts.

⁹ IAS 37.10

¹⁰ Equalisation and catastrophe reserves will not be allowed as liabilities following implementation of IFRS 4. However, IFRS 4 does not prohibit the reporting of equalisation reserves as a component of equity.

¹¹ ‘Loans and receivables originated by the enterprise’ is a further category that is carried at amortised cost but this categorisation will principally be used by banks, much less so by insurers.

¹² IAS 39.83 (r.2000)

This will limit the potential benefit of increased comparability between accounting regimes but does serve to prevent companies having to change their accounting systems twice in the space of a few years.

Other Changes

Other changes expected following the introduction of IFRS in 2005 (not specific to insurance) include the fact that stock options will need to be expensed and goodwill will no longer be amortised (although it will require an annual impairment test).¹³ These changes are examples of the requirements that have already been published in 2004 and further developments are expected by the time that phase 1 for insurance contracts has to be implemented.

Disclosure Requirements for Phase 1

Fitch believes that increased disclosure is one of the most important aspects of phase 1 and supports the move to improve transparency as well as improved consistency between insurers.

IFRS 4 requires significantly more detailed quantitative and qualitative information on risk exposures, and importantly the disclosure requirements are formulated based on principles rather than set required disclosures. The required disclosures include the following:

1. Explanation of Reported Amounts

This disclosure category will include information on accounting policies, the derivation of significant assumptions and material changes to insurance liabilities, reinsurance assets and DAC. The disclosure will include whether margins are built into the assumptions, whether they are derived from actual company data and how they relate to recent experience. The IASB also requires insurers to disclose any gains or losses that have been made in buying reinsurance to aid comparison between companies.

2. Amount, timing and uncertainty of future cash flows

This will require the disclosure of risk management policies and terms and conditions that have a material impact on the amount, timing and uncertainty of the insurers' cash flows. In addition, companies will be required to report information on insurance risk that helps users to assess the insurer 'through the eyes of management', as well as additional information on insurance, interest rate and credit risks.

Disclosures on insurance risk will include information on concentrations of insurance risk, the sensitivity of profit or loss and equity to variables and claims development data (principally for general insurance). These disclosures will assist the users of accounts in assessing the insurance risk associated with an insurer and the accuracy of historic reserving practices.

The above disclosures will undoubtedly aid sophisticated users of financial statements in their understanding of companies and the underlying economic reality. However, Fitch would favour a greater degree of prescription for phase 2 as an overlay to a principles-based approach. The agency notes that although principles-based disclosure requirements can make compliance easier for companies and are unlikely to become obsolete, such a formulation does reduce the comparability between companies.

Some insurers have claimed that increased complexity for the financial statements could obscure the true economic picture for some, less sophisticated users. However, Fitch believes that such concerns are frequently overstated and can be largely addressed through suitable structuring of the accounts. In the agency's view, additional complexity does not represent a valid reason for maintaining the relatively low levels of disclosure that are currently offered.

Phase 2

Further draft guidance on phase 2 is expected to be released in 2005. The summary included below is therefore based on the 'Draft Statement of Principles' (DSOP) produced by the IASC, indications that have emerged from the IASB and preliminary discussion between industry participants. Although the IASB has currently only expressed 'tentative conclusions' regarding phase 2, this paper works on the assumption that phase 2 will aim to measure assets and liabilities arising from insurance contracts at their fair value.

As previously mentioned, the move to fair values (also known as prospective provisioning) will see an end to the deferral of acquisition costs and the spreading of premiums over the duration of the contract. Both premiums and expenses will be recognized immediately as a contract is signed, with the accounting focused on the present value of expected future cash flows.

For example, on writing a new policy, all present and future expected cash flows will be recorded. The net present value (NPV) of relevant contractual premiums will be recorded as assets (and as

¹³ These requirements are set out in the recently published IFRS 2 'Share Based Payment' and IFRS 3 'Business Combinations'. See the Fitch report 'Accounting for Stock Options: Should Bondholders Care?' (available at www.fitchratings.com) for further details of the impact of stock options on ratings.

premium income) whilst the future expected cash flows for claims and expenses will be discounted to their NPV and recorded as liabilities (and claims/expenses).

This is conceptually straightforward in the case of non-life contracts where a single premium is paid at the start of the contract. The concept is more complex for policies where premiums may be received over a long period (e.g. life assurance policies). The IASB has indicated that future premiums will be able to be recognized if policyholders have “non-cancellable continuation or renewal rights that significantly constrain the insurer’s ability to reprice the contract to rates that would apply for new policyholders whose characteristics are similar to those of the existing policyholder” and that “those rights will lapse if the policyholders stop paying premiums.”¹⁴ For example, insurers would typically charge lower premium rates on an existing life assurance policy compared with a new policy for an individual of the same age. Assuming that the definitions included above are met, the insurer would recognize the expected cash flows (including premium and payments) allowing for projected lapse experience.

In addition to reserving for the best estimate of the present value of future cash flows, it is expected that insurers will also have to include a market value margin (MVM) on top. This margin aims to take total reserves to the level that would be sufficient to encourage a third party to accept the relevant liabilities and therefore represent a proxy for fair value in the absence of a liquid market.

■ Key Issues Arising From the Insurance Accounting Standards

Some of the key issues arising from the implementation of Insurance IFRS (phases 1 and 2) are commented on below:

Phase 1 and Phase 2

ai. Increase in Volatility

Volatility associated with results is expected to increase as a result of IFRS, particularly for those entities that currently employ a national GAAP that records investments at amortised historic cost (e.g. Germany and France). The increased volatility will largely stem from:

- Financial instruments (including equities, bonds and derivatives) being valued at market value rather than at amortised historic cost. The

classification of financial instruments as available for sale or held for trading will lead to volatility being recorded in equity or the income statement respectively. (IAS 39)

- The removal of claims equalization or catastrophe reserves which act to smooth reported profits. (IFRS 4)
- The calculation of fair values (e.g. for embedded derivatives and claims reserves) will be dependant on a number of assumptions and external variables that can move significantly. Fair values may be sensitive to small changes in these assumptions. (This volatility will be caused by phase 1 in the case of some embedded derivatives and phase 2 in the case of claims reserves.)
- The fact that premiums and costs will no longer be smoothed over time (through deferred acquisition costs and an unearned premium reserve) would be expected to increase volatility in results. The degree of profit-smoothing over time will depend on the calculation of MVMs and other factors noted under *Recognition of Income* below. (phase 2)
- Removal of prudential margins which have historically been used by many insurers to reduce profit in the good years and enhance profit in the bad years. (phase 2)

Volatility in results will be a particular factor following phase 1, and whilst assets and liabilities are subject to different treatment (assets at fair value, liabilities at historic cost.) On implementation of phase 2, the overall reported volatility could be moderated due to the impact of also recording liabilities at fair value.

For example, following the introduction of fair values and the subsequent discounting on reserves, changes in the value of assets due to interest rate movements will be counterbalanced by changes to the valuation of reserves (e.g. an increase in interest rates will lead to a fall in the value of bond assets but also a fall in the discounted value of reserve liabilities.)

It is important to note that the above example assumes that volatility caused by interest rates for both assets and liabilities is recorded similarly in the financial statements (i.e. both in shareholders’ equity or both in the income statement). If there is an asymmetry of treatment then income statement volatility is liable to increase.

¹⁴ IASB IFRS 4 Insurance Contracts – ‘Basis for Conclusions’ – BC 6 (d).

iii. Impact of Increased Volatility

It has been suggested by some (including the ABI, the insurance association in the UK) that the increased volatility from the proposed new insurance standard would lead to a higher cost of capital due to investors demanding a higher risk premium associated with an investment. The 'headline profit', it is argued, will be significantly affected by various external factors and the impact of this will be significantly greater on the results of insurers than would be the case for a typical corporate entity.

Fitch believes that an impact on the cost of capital does remain a possibility but there is little evidence that the cost of capital would change to levels inconsistent with the actual risk associated with insurers. As the IASB has noted, many of the insurers with access to the capital markets already report assets at market value with the volatility to profit or shareholders' equity that this entails. In addition, to the extent that transparency is improved and risk reduced by the proposed new reporting and this is rewarded by the markets, there could be some offsetting benefit to the cost of capital.

The agency believes that in considering volatility, it is important to make the distinction between that resulting from economic mismatch ('economic volatility') and that stemming from accounting mismatch ('accounting volatility'). Economic volatility reflects the underlying economic reality of the business and does have informational content. This is very different to accounting volatility which stems solely from asymmetrical accounting treatment (e.g. the use of a different accounting basis for assets and liabilities.)

Fitch welcomes the transparency provided by reported volatility to the extent that it reflects the true economic mismatch between assets and liabilities (i.e. is economic volatility). Assessing this mismatch is important information for the users of financial statements, allowing analysts to better determine a company's risk and profitability.

Fitch's concerns therefore relate not to volatility *per se*, but to accounting volatility that does not reflect the underlying economic reality and lacks informational content. The agency believes that accounting requirements should be structured to minimise the level of accounting mismatch. Although phase 1 does result in some accounting volatility (e.g. due to assets being largely at fair value whilst liabilities are not) this sub-optimal result is still considered to be vastly preferable to a stability in reported results that is misleading.

Phase 2 Only

b. Use of Discounting

The discount rate used in phase 2 is likely to be the return on a risk-free asset, although there is still some discussion about whether the credit quality of the enterprise in question should impact the liability recorded. This aspect is further commented on below.

In the past, Fitch has argued against the use of discounting for most insurance reserves due to the uncertainty that is associated with both the level and the timing of the payments. Fitch believes that in many cases, after adjusting the discount rate for a risk premium to allow for uncertainty (the risk premium is deducted from the discount rate in the case of a liability), the appropriate discount rate is low and close to zero.

However, the agency recognizes that the market value margin is designed specifically to address the issue of uncertainty. Under these circumstances, Fitch may consider an allowance for the time value of money through discounting to be appropriate, depending on the definition, formulation and sophistication of the calculated MVM. The agency notes that the effect of the discount on reserves may be partially or completely cancelled out by the imposition of the MVM¹⁵.

c. Market Value Margin (MVM)

A market value margin is likely to be calculated at phase 2 reflecting uncertainty and aiming to take total reserves towards a level that would be sufficient to encourage a third party to take the liability on. The rationale is that due to risk (which is not necessarily readily diversifiable), and perhaps due to transaction costs or asymmetric information between the trading parties, investors would require a premium above the best estimate to take on the liability¹⁶.

An allowance for risk could be achieved either by risk-adjusting the discount rate applied to expected cash flows or by adjusting the cash flows directly to take risk into account and then using a risk-free discount rate. MVM's take the latter approach and can therefore be viewed as a method of adjusting

¹⁵ This is particularly likely for short tail business (as the effect of the discount is relatively low) and, potentially, for longer term exposures with a high degree of uncertainty (e.g. asbestos).

¹⁶ Conceptually, the allowance for risk in respect of insurance liabilities is similar in nature to the allowance for risk that is achieved on the assets side of the balance sheet. Fixed income investments, for example, are represented by the net present value of future cash flows discounted by a risk adjusted discount rate. For cash flows with a higher degree of risk (e.g. a 'BB' rated bond) a higher discount rate and therefore lower value is appropriate as compared with an investment having more certain cash flows (e.g. a 'AAA' rated bond).

expected cash flows to allow for the uncertainty surrounding the best estimates of insurance liabilities that have been derived.

However, market value margins do have some theoretical and practical weaknesses and have been criticized for:

- Inconsistency with economic theory which says that no charge is appropriate for diversifiable risks.
- Not being consistent with other similar accounting standards (e.g. post retirement benefits).
- Making accounts more opaque (e.g. some capital may be “hidden” in the form of MVMs);
- Significant practical problems in their introduction.
- An ability to be misused as a profit smoothing device.

Despite the criticisms shown above, Fitch supports the use of market value margins as being a method of moving towards an estimated (although largely hypothetical) market price and as a necessary buffer to reflect the risks and uncertainties that are inherent in insurance contracts. The agency’s support for MVMs is derived from two main sources:

1. Theoretical

Whilst some aspects of risk are largely diversifiable within a single portfolio (e.g. process risk – risk that emerges from random statistical fluctuations), there are some elements of risk that are not so easy to diversify. For instance, model risk and parameter risk refer to the difficulty of accurately classifying the probability and severity of events and modelling expected payouts (e.g. there may be uncertainty as to whether losses will be normally distributed or otherwise and whether the probability of an accident is 5% or 10%). These uncertainties are much more difficult to diversify than process risks and in Fitch’s view represent an important justification for MVMs.

The theoretical justification for MVMs is increased by the fact that fair values are to be defined in respect of their current portfolio rather than the potential value to a hypothetical third party insurer. Given this fact, even risks that could theoretically be diversified away (e.g. process risk) may still warrant an adjustment for risk through the use of an MVM.

2. Practical

Based on past experience, Fitch believes that stated ‘best estimates’ of reserves deteriorate more frequently than they develop positively. This is especially true in liability lines and may be due to some elements of unintentional bias that can occur as part of the reserving process. Reasons for this bias

could include items such as actuaries basing reserves on existing rules, regulations and known risks.

In an environment where new risks and regulations emerge but few disappear, this may create some degree of a negative bias to estimates. The observed tendency for a general deterioration in reserves from ‘best estimates’ may also relate to a natural human optimism on behalf of management, or the ‘benefit of the doubt’ being awarded in formulating assumptions where uncertainty exists. Fitch also notes the possibility of insurers ‘cheating’¹⁷ as being a potentially important factor in some cases.

The market value margins, depending on their calculation and size, would go some way to counteracting this observed effect on reserves. In addition, the use of a market value margin which effectively risk-adjusts the NPV of claim and expense cash flows replaces the ‘buffer’ that was previously provided by the non-discounting of reserves.

This analysis applies to the concept of using MVMs and does not address the significant difficulties surrounding the formulation of the MVMs which are the subject of much debate within the actuarial profession. Particular difficulties will stem from specifying the required level of sophistication whilst at the same time promoting consistency between companies and minimising opportunities for manipulation.

d.) Recognition of Income

The recognition of income is a key controversy of the proposals. Concerns have been expressed that the move to fair values could lead to profits being declared with no evidence of the profit having been earned. This will be particularly important for life insurance companies with their longer term contracts and reliance in some cases on future investment returns in order to generate profit.

In general, the move away from deferral and matching to fair values will increase the level of profitability that is declared at the start of the contract for non-life insurers and reduce that recognized in subsequent years. This is due to the discounting of reserves (meaning that investment income is effectively recognized at the start of the contract) and the fact that premiums are not spread over the period of the insurance contract. However, as will be commented on further below, the pattern

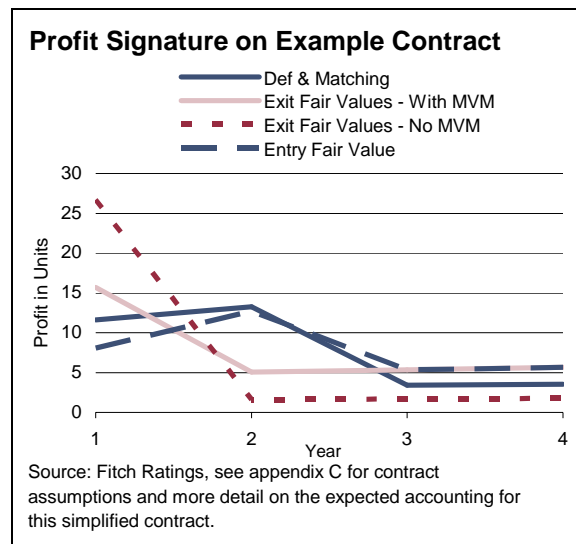
¹⁷ Inaccuracies in reserving have been categorized by some in the insurance industry as either due to ‘cheating’ or ‘being wrong’. See the Fitch report ‘Property/Casualty Insurance Reserves at Year-end 2002: Filling the Hole – Slowly’ for more details. Available at www.fitchratings.com.

of income recognition will be heavily impacted by the formulation of the market value margins and the type of business that is being written.

Broadly speaking, the profit declared on acceptance of an insurance contract would be equal to:

- + NPV of premiums
- NPV of claims and expenses
- Market value margin on reserves
- Acquisition expenses
- = **Profit declared on writing contract.**

If all expectations in respect of a particular contract are proved correct then the profit emerging in future years will solely relate to any return made through the investment return and to the release of market value margins as the risk associated with future cash flows reduces. Profits or losses may also emerge on contracts after year 1 as a result of any differences to expectation of claims or expenses.



The graph above shows the emergence of profit on a simplified non-life contract according to four different methods of recognizing income. The important feature to note is that although the total profit recorded is unchanged, the timing of profit recognition may be significantly affected by the move to fair value accounting and the way that fair value is defined. The possible definitions of fair value under discussion are as follows:

1. Entry Fair Value

Entry fair values are designed to reflect the premium that a third party would require to accept new contracts with identical conditions and remaining term. The implication of this is that unless an insurer's prices for a risk are demonstrably higher than the market as a whole then no profit would be recognized at the inception of the contract. Profitability emerges over time as the risk associated

with a policy expires. As a result of the additional conservatism at the start of the contract, profitability will emerge more slowly for accounting under entry values as compared with exit values. There are a number of ways in which entry values could potentially be formulated to allow profitability to emerge over time. In the example shown, Fitch has assumed that as risk expires, the entry value method converges to that of exit values with an MVM.

The rationale for using entry values would be a belief that: i.) entry value is more in tune with existing revenue recognition rules and makes allowance for the fact that the policyholder may have a right to cancel the policy mid-term; and ii.) the price charged in the market for a particular risk is an observable market price that can be used to determine fair value for unexpired risk.

This form of profit recognition appears to be favoured currently by the IASB, although there are some significant difficulties with this approach, particularly when applied to life insurers. An absence of profitability being recorded on new business written may make the relative performance of companies more difficult to measure. In addition, the approach could also lead to discontinuities in accounting (e.g. for expired and unexpired risk) which may add to complexity and reduce comparability over time and between companies.

In practice, if no profitability were permitted on new business, then it is likely that the insurance industry would employ some form of 'embedded value' reporting to allow companies to indicate the profitability that they expect to emerge. Fitch believes that supplementary reporting would add complexity, and in the absence of defined standards, reduce consistency between companies. Ultimately, the agency believes that the absence of some degree of profit on new business would be likely to reduce transparency and the usefulness of financial statements.

2. Exit Fair Value

This aims to set liabilities to the level required to induce a third party to take over the contract liabilities that exist. Importantly, this would allow profits to be recognized at the start of the contract with the level of profits recognized at inception depending on the size of the market value margins. There are two principal possibilities:

- **No Use of Market Value Margins**

It has already been noted that market value margins can be criticized on theoretical as well as practical grounds. If no market value margins were used then 100% of the expected profit would be recognized on accepting the new insurance contract. The profit

recognized would equal the net present value of all expected cash flows and if all parameters emerged as expected (e.g. loss experience, expenses, investment return) then no further profitability would emerge from the contract. However, to the extent that actual experience and updated expectations differ from that originally planned for, gains and losses would emerge from the contract from one year to the next.

This approach is favoured by some, including the Financial Services Authority (FSA) in the UK, which believes building in prudential margins can result in problems being opaque. Although the IASB regards the Market Value Margin as an adjustment to simulate the market price rather than a prudential buffer, the FSA currently favours basing all assumptions on best estimate without these margins. Under this reporting model, management and regulators would ensure that sufficient capital is available to deal with any negative shocks that may emerge.

- **Use of Market Value Margins**

The use of market value margins would have the effect of smoothing the profitability associated with a contract. Some profitability would be likely to be reported at the start of a contract (calculated based on discounted expected future cash flows reduced to the extent of the market value margin). Over time, as further information emerges (e.g. through reported loss experience), the market value margin would be reduced (reflecting the reduced uncertainty) and some further profitability would emerge.

Fitch considers that the smoothing effect provided by MVMs does provide a practical alternative to the difficulties associated with other methods of profit recognition. This approach does provide information on the degree of uncertainty, and expected profitability associated with a portfolio which could be lost to many users if no profit were declared on writing a contract. In addition, Fitch does not favour the option of recording 100% of expected profit in year 1 for the same reasons that it supports the use of MVMs (see previous section).

e.) Need to Distinguish Between Distributable and Non-Distributable Reserves.

The volatility that is associated with the proposed fair value accounting gives rise to the issue of which accumulated profit reserves should be distributable and which should not. It is unlikely to be desirable for all profits that emerge as a result of assumptions made by management (e.g. assumptions as to the profitability of a new long tail business line being written) or as a result of market volatility (e.g. unrealized gains on unhedged, long term derivative

positions) to be distributable to shareholders. This issue will need to be considered objectively and could be dealt with by suitably structuring the financial statements or through the capital requirements that will be demanded by regulators (e.g. through the solvency 2 project.)

Although the income statement looks likely to include profitability from a number of sources, users of the accounts will need to become increasingly sensitive to the 'quality of earnings'. Earnings which are derived from management assumptions (e.g. assumed profitability on contracts written) will be treated as being of lower quality than realized profits which have been validated by experience.

f.) Should Fair Values Reflect the Credit Standing of the Insurance Company?

From a strictly theoretical point of view, the fair value of a liability, which is determined as the present value of expected future outward cash flows, should recognize that there is some possibility of default on the obligation. Recognizing this possibility reduces the expected value of future cash flows and therefore the level of the liability. Looked at another way, it would cost more for a company with a high credit rating to induce an insurer of similar credit standing to take over its liabilities than it would for a weaker company to achieve the same thing.

Therefore, theory suggests that weaker insurers should use a higher discount rate on reserves, resulting in a lower liability. In more general terms, the discount rate used by companies (theoretically) should be linked to their own credit rating and to the risk premium that the market requires for this risk.

Although this may be a sound theoretical argument, Fitch is extremely uncomfortable with this concept given the implication that weaker insurers would reserve less than stronger players for the same liability. Also, there is significant circularity in such arguments given that a credit downgrade could lead to reduced liabilities and therefore stronger reported capitalization. Finally, the agency believes that such a suggestion has significant practical problems (for example, how to treat unrated insurers or insurers with multiple credit ratings) and that such a move would reduce the comparability of financial statements and thereby their usefulness to the users of accounts.

As a result of the points made above, Fitch would prefer to see liabilities calculated independently of the credit quality of the insurer. However, if fair values were to reflect the credit standing of a particular insurer, the agency would look for

disclosures sufficient to allow for the standardization of reserves at a particular rating level.

g.) Disclosure

No details have yet been set out on the disclosure that will be required with phase 2 although the requirements are likely to be in line with the broad principles set out in phase 1. However, Fitch believes that detailed disclosure will be critical in enabling users of the accounts to properly interpret fair value accounts. Disclosures are particularly important for both assets and liabilities where they are “marked to model” in the absence of a liquid market. A recorded ‘fair value’ on its own can provide relatively little information on the likely standard deviation of returns, the sensitivity of returns to specific events or the maximum losses. All of these are relevant and important information for the users of financial statements.

The disclosures required as part of phase 2 will be developed by the IASB alongside the development of the required accounting. However, examples of important disclosure would include methodology, sensitivity analysis, and an outline of significant assumptions. Specific examples would include:

1. Disclosure of Inflation Assumptions

In the application of discounting, Fitch would welcome disclosure of the inflation assumptions that have been used and, in particular, the link assumed between interest rates and inflation rates.

The risk is that higher interest rates lead to a reduction in discounted claims reserves but inflation expectations may not be adequately reflected in claims reserves. For example, if an interest rate increase is due to higher actual or anticipated inflation, then expected nominal cash outflows are likely to increase – a factor that should be incorporated into reserve calculations.

The agency’s concern is that actuaries are often better at projecting historic trends forward than at estimating those that will emerge in the future. Disclosure of inflation assumptions would assist users in assessing the degree of conservatism that has been applied and ensure that insurers do not take additional credit for reserve discounting when the impact is likely to be offset by greater cost inflation.

2. Disclosure of MVM

It will be important for the market value margin to be disclosed in order that users of the accounts are able to clearly identify the best estimate of liabilities and the margin that has been built into the estimate. A segmental disclosure of the MVMs would further assist users in comparing between companies and

over time. This disclosure would be important for analysts to establish likely future profitability and also to identify the degree of confidence that actuaries are able to apply to the reserves set. In addition, this would give analysts the option of considering MVMs either as additional capital above a ‘best-estimate’ of reserves or as a prudential reserve to counter any uncertainties or bias in reserve calculations.

In highlighting the importance of disclosure, the agency includes the issue of performance presentation in addition to ‘footnote’ disclosures. Fitch believes that the way the income statement (and balance sheet) is structured and presented can significantly enhance the usefulness of the financial statement data.

h.) Other Areas

Other important areas where guidance will be required clearly include the formulation and calculation of the MVM as well as the following:

1. Diversification Credit

The MVMs are likely to be additive between the pools or segments that they are calculated in (i.e. the grouping of contracts used to calculate the MVM). This means that no diversification credit will be permitted between segments, although diversification credit may well be available for business calculated within segments (particularly if stochastic modelling is utilized). The logical consequence of this is that the size and formulation of the pool or segment will impact the size of the MVM required.

This could give insurers an incentive to carefully manage the business that is classified together for the purposes of determining an MVM or in performing such calculations based on as few large units as possible. The IASB will need to be wary of this possibility and set out guidance preventing possible abuse.

2. Discount Rates

The DSOP indicates a preference that cash flows at each maturity should be discounted by different rates depending on the term structure of risk-free interest rates. This means that any shift in the term structure of risk-free interest rates (i.e. changes to the yield curve) will affect the valuation of liabilities and therefore reported profitability (unless assets and liabilities are fully matched). Guidance may be required in how the term structure of interest rates should be calculated, particularly where there is no observable risk-free maturity.

3. Reinsurance Recoverables

The IASB has already specified that reinsurance recoverables should be shown separately on the balance sheet and not be netted off of liabilities. However, it is not yet clear whether the discount rate applied to estimated future cash flows should be risk adjusted. Practical difficulties will exist in determining the credit risk associated with particular reinsurers and it is not clear how dispute risk will be allowed for.

■ Business Implications of Fair Value Reporting

It is important to note that there will inevitably be some business implications associated with the implementation of the new standards. Given the current preliminary proposals, the full business implications of fair value reporting are not yet clear. However, the implications could include the following:

- Changes to product design – Some product lines that are currently profitable may be less profitable when assessed on a fair value basis and will need to be modified or scrapped. In addition, the duration of some (particularly life) contracts could be shortened in order to reduce the volatility that is associated with them.
- Improved matching – One of the key benefits of fair value reporting is the fact that it highlights cases where risks are not fully matched. It is likely that assets and liabilities will be more closely matched (e.g. in duration, currency) as a result of the move to fair values.
- Changes to Investment Strategy – In order to reduce volatility, there may be a trend towards closer matching and some companies may move away from equity investments and towards fixed interest investments. Hedging strategies may also need to be amended in order to ensure that they are compliant with the requirements of the published standards.
- The change in the definition of insurance contracts may have a significant impact on recorded premiums. Policies will need to be unbundled into their insurance and investment aspects which could result in a significant reduction in reported insurance premiums for many companies.

These business implications will have an important impact on the cost and benefits associated with the change to IFRS reporting. The claimed costs and benefits of a change to IFRS are shown in Appendix A.

■ Impact of Insurance IFRS on Analysis Methodology

Fitch's publicly available criteria for rating insurance companies were designed to be sufficiently flexible to allow the agency to rate insurers reporting under a variety of accounting standards. The agency ensures that it understands the material differences that arise as a result of various accounting methods so that insurers can be compared between countries.

That said, the introduction will have a number of specific effects on the way that Fitch considers insurers:

- The significant additional disclosure that is available will undoubtedly aid analysis. Fitch supports the general principle of requiring management to disclose more information on the risks that they perceive "so that users can assess the insurer's financial position, performance and cash flows 'through the eyes of management'". Particularly welcome are the disclosure requirements on assumptions, concentrations of risk and sensitivity analysis as well as the requirement to provide information on insurance risk, interest rate risk and market risk.

In addition, the agency welcomes information on claims development and the requirement to disclose risks with special characteristics. This latter regulation will require information on items such as asbestos and recognizes the important risks that these exposures can represent.

- Investments – Recording investments at market value rather than amortised historic cost will have little impact on the way that insurers are viewed. Fitch already considers balance sheets and profitability based on market values in virtually all cases. This information is either based on disclosure in the financial statements or on additional information requested from the rated insurers.
- Reserves – Phase 1 will have little impact on how reserves are viewed given the fact that they will continue to be calculated in the same way. Changes to disclosure, however, could have some impact on our view. Phase 2 is likely to have more of an impact due to new information that could be provided by the market value margin and the requirement to reserve to the best estimate.

- Capital – Equalisation and catastrophe reserves are currently treated as part of an insurer’s capital base. Therefore, the release of these reserves will not impact capital sufficiency unless they are either taxed (which appears unlikely in the near term) or paid out as dividends. Similarly, the ‘Fund for Future Appropriations’ in life companies are typically also treated as part of the capital base and this is not expected to change under IFRS. The financial flexibility of insurers (i.e. their ability to source additional funds relative to needs) is unlikely to be materially affected by IFRS but this will continue to be assessed on a case by case basis.

Although Fitch’s view may be affected by new information on the size, method of calculation and definition of the MVM, the agency currently expects to treat MVMs as part of the best estimate of reserves and not as part of capital. This treatment, which differs from the 100% equity credit awarded to existing equalization and catastrophe reserves, is a result of several factors:

1. The perceived bias in best estimate reserves to deteriorate rather than improve (as discussed earlier). In recent years, this deterioration has been despite reserves not having been discounted for the time value of money which should have provided an additional level of comfort.
 2. The discounting of reserves removes a reserving buffer that previously existed and exists in many other jurisdictions (including US GAAP). Consistency with other accounting regimes will be increased by application of a prudential margin to reserves above best estimate. The inclusion of MVMs as part of reserves will offset this effect.
- Earnings – These are likely to change significantly at phase 2 although the effect will depend on policies surrounding income recognition. Fitch will continue to consider the reported profitability although, particularly if profit recognition is very slow, the agency will consider the ‘embedded value’ that has been generated. The agency will also continue to be mindful of the quality of earnings which will become particularly important in the move to IFRS, whilst also ensuring that insurers are treated fairly with those reporting under other national GAAP.

Reinsurers that offer financial reinsurance could see the demand for their product change as a result of adjustments to the method of accounting for contracts with low levels of financial risk. Fitch believes that this is most likely to have a negative effect on demand for such solutions at phase 2. However, demand for financial reinsurance may increase following phase 1 due to the additional volatility in the results of some insurers which they could seek protection from.

■ Impact of Insurance IFRS on Ratings

A change in accounting standards does not impact the underlying economic reality within the business and, therefore, no rating changes would be expected as a direct result of the move to the new insurance IFRS. That said, the new standard could have business implications (as already noted) and could conceivably shed additional light on new issues. To the extent that the new disclosures and financial reporting provides a better view of the true economic picture, rating actions could result. Further factors that could lead to changes in insurance company ratings would include:

Taxation

A change in the method of accounting may have a real impact if it affects the basis of taxation. It currently seems unlikely that the move to fair values for listed consolidated companies will have a significant impact on the tax that has to be paid.

In many countries within Europe (e.g. Germany and France), tax is calculated based on individual company, unconsolidated accounts. These accounts will continue to be prepared under local GAAP based on current plans leaving the tax liability unchanged. In other cases (e.g. the UK), tax law generally prevails over statutory reporting and is therefore also unlikely to be affected by the change to insurance IFRS in the near term. However, over the medium to long term, it is possible that the use of IFRS will be expanded to include individual company accounts and, as a result, the basis of taxation could change.

IFRS could have a particular impact if the release of equalization reserves on the consolidated accounts were to lead to the taxation of these reserves. In this case, claims could no longer be met by equalization reserves (held pre-tax) and would need to be met through shareholder equity (post-tax). Although this only relates to a timing difference in when tax is due, it would still result in a significant loss of effective capital to the insurance industry and a corresponding benefit to state coffers.

Product Demand

It has already been noted that demand for some lines of business (e.g. some low risk transfer products such as financial reinsurance) could be impacted by the proposed insurance IFRS. Any shift in product demand could have an effect on Fitch's credit view relating to particular companies. However, rating changes solely based on this factor are expected to be rare.

Business Reaction

As noted above, the change to fair values may have real effects, because they may cause management to change the way in which they run the business. For example, changes to product design, improved matching and changed investment strategies could all have some impact on the ratings assigned. Fitch does not expect business reaction to have a significant credit impact in the majority of cases.

Investment Market Reaction

If changes to accounting standards were to affect the perception of risk associated with the insurance industry then this could affect financial flexibility and therefore ratings within the industry. For example, if the cost of capital were to increase for insurance companies due to the accounting change then this could negatively affect the credit quality of the industry by reducing access to new funds.

In practice, Fitch believes that the chances of a significant impact on credit quality from changes to the cost of capital are low. This is a result of a low expected change in cost of capital, the ability of the insurance industry to pass on a higher cost of capital to policyholders in the form of pricing, and a possible offsetting effect if market participants perceive the new accounting information as being of a higher quality.

■ Conclusion

Fitch is very supportive of the efforts being made by the IASB to bring greater comparability and

increased disclosure to the insurance industry. The agency also views the move towards fair values as being an important and valuable aim which, when fully implemented, should lead to increased transparency and will assist users of accounts in better determining the underlying economic reality within an insurance company.

However, Fitch notes that significant challenges remain before fair values can be introduced. There are a number of important issues that still need to be resolved and companies will need time in order to implement the necessary system changes and collect the required data to produce fair value accounts. The original deadline of 2007 for implementation seems very optimistic given the issues that still need to be resolved and the slow pace of progress in recent years.

The agency does not anticipate many rating changes to occur solely as a result of the change to insurance IFRS, and the current rating methodology is sufficiently flexible that changes to analytical methodology will be limited. Companies that are most likely to be impacted are those where the basis of taxation may be affected by IFRS (this is not anticipated in the short to medium term) or that see reductions in product demand as a result of the change.

Fitch welcomes the additional disclosure required at phase 1 and notes that disclosure at phase 2 will be extremely important in interpreting financial statements. Experience with US accounting standards (e.g. FAS 133) has shown that fair value disclosure by itself is not sufficient. It is also essential that disclosures allow users to assess the level of risk associated with the fair values shown, e.g. through disclosure of significant assumptions and areas of judgment, as well as through sensitivity analysis. The agency would prefer to see a greater degree of 'prescribed' disclosure at phase 2 to ensure that certain important disclosures are presented in a consistent and comparable form.

■ Appendix A – Principal Benefits of New Insurance IFRS reporting

The principal benefits claimed for the move towards the new standards are as follows:

- **Transparency** – Fair values and improved disclosure offer greater transparency and insight into the financial position of the company. Showing assets (and liabilities at phase 2) at fair value gives a better view of the financial position of the company at a point in time. In addition, showing both assets and liabilities at fair value has the added advantage of avoiding the mismatch that occurs if these categories are treated differently.

One of the important features of the move to fair values is that embedded derivatives and options will be shown at market value. This may be particularly important in the cases of certain embedded derivatives such as Guaranteed Annuity Options (which caused significant difficulties at Equitable Life) and other products with associated guarantees. At phase 2, the fair value of these options and guarantees are likely to be included in the financial statements; at present, these options often go unrecorded.

The improved transparency and disclosure may result in improved decisions by management and better targeting of capital by investors. In particular, phase 2 is likely to encourage management to more closely monitor and control their risks (e.g. matching of asset and liability duration to reduce interest rate risks).

- **Consistency** – The standardization of accounting standards will be an important achievement in itself. This will promote greater comparability between companies and may improve the ability of some insurers to access global capital markets. The existence of a common European standard will also make it easier to promote a convergence of global accounting standards. Both FASB and the IASB have indicated that they are keen to achieve this convergence.
- **Reduce accounting arbitrage** – Applying insurance accounting to insurance contracts rather than only to registered insurers will reduce the opportunity for arbitrage between different accounting methods. Currently, there may be benefits or costs to performing a particular transaction either inside or outside an insurance entity based on the different accounting treatment.
- **Improved management** – The greater sophistication of tools that will be required to

improve fair values will encourage companies to improve their capital management, risk management and asset/liability matching. This greater sophistication may also give management and analysts greater insight into those products that are most efficient at producing value.

Against this, there are a number of concerns that have been cited by industry observers and in particular, by insurance companies themselves:

- **Cost of Capital** – Insurers are concerned that there will be an increase in the cost of capital as a result of the increased volatility that is expected from the new reporting standards and investors interpreting this as an increase in risk.
- **Reliability** – The reliability of fair value reporting, particularly for insurance liabilities, is often questioned. The production of these values is said to require a level of sophistication (e.g. in stochastic modelling techniques) that may be beyond many insurers and the results of these models may not be reliable. In addition, the use of such techniques will inevitably require some assumptions to be made and these assumptions may be susceptible to manipulation by management
- **Practicality** – The practical aspects of implementation will inevitably be difficult due to the tight deadlines that have been set, the lack of trained personnel (particularly actuaries) and the need for firms to gather new types of information and to educate analysts and other users of the accounts.
- **Investment Strategy** – Some insurers have suggested that volatility may adversely affect the investment strategies that are used. Some insurers may choose to switch investments from equities to more stable investments such as bonds in order to reduce potential volatility. It is argued that the resulting investment strategy could be over-cautious and not justifiable for either policyholders or shareholders on a long term view. Other stakeholders would see this improvement in matching to be a positive development.
- **Achieving consensus** – There are difficulties still to be resolved in agreeing the standards. A number of contentious issues still exist over the details of implementation, including the method of calculating the market value margin, which forms of profit should be distributable to shareholders, and when to recognize profitability.

■ Appendix B – Additional Issues

This appendix includes a number of additional issues that are also noteworthy in considering IFRS.

Firstly, it is worth noting a number of issues that have proved controversial but now appear to have been resolved:

Phase 1 – Sunset Clause

A feature of exposure draft (ED) 5 that came under some criticism is the existence of a “sunset clause” which set a time limit on the progress towards the implementation of Phase 2. The draft exempted insurance companies from applying IAS 8 (‘Accounting policies, changing in accounting estimates and errors’) until 2007. In the absence of this exemption, insurers would have been required to account for liabilities in accordance with IAS 37 (provisions, contingent liabilities and contingent assets). This standard would require the use of a discounted best estimate (using a risk-adjusted discount rate) of non-life liabilities and potentially the use of US GAAP for life liabilities¹⁸, each of which would represent a significant change for many companies. Therefore, in the absence of amendments to the proposed standard or a subsequent override, any delay in phase 2 (fair values) would have resulted in a second ‘interim solution’.

IFRS 4 still refers to the IAS 8 exemption as temporary but no time limitation has been included in this standard.

Phase 2 – Entity Specific Values

Although the objective of the insurance accounting standard would ideally be to reach the fair value of insurance liabilities, this is hampered by the lack of a liquid market. This determination of value is also hindered by the fact that fair value cannot be determined as the sum of that associated with individual risks. The value of a portfolio varies according to the portfolio which individual risks are held in and the efficiency of the administration. Such factors will often vary by buyer.

In order to address this difficulty in finding a true fair value that a third party would be prepared to pay, the DSOP (Draft Statement of Principles) originally defined an ‘entity specific’ value. This allowed the use of assumptions based on the insurer’s own experience and expectations in the valuation calculation. For instance, a true fair value (based on a third party arms length transaction) could require an assessment of industry expense levels, or ideally, an assessment of the expense levels associated with possible buyers. Given the difficulties associated

with each of these options, the entity specific fair value of the portfolio allowed the company to use its own expense experience in order to calculate policy fair values and is considered to be a reasonable proxy.

The IASB still expects insurers to use entity specific parameters (e.g. for expenses) but has defined ‘fair values’ in such a way as to be consistent with the use of this entity specific information.

Secondly, there are a few other areas of IFRS that are not considered to be central to this report but are worth noting:

Comparison with US GAAP

As insurers increasingly switch to IFRS, accounting standards will move increasingly to a situation where there are two dominant sets of accounting standards, IFRS and US GAAP. Over time, it is expected that these two sets of standards will converge but in the meantime there will be some important differences that are of particular relevance to insurers. For example:

- IFRS currently requires that impairments that have been recorded on assets are subsequently reversed (no further than the amortised historic cost) where the valuation recovers. This is an important difference from US GAAP, which forbids such a reversal. This may benefit insurers currently reporting under IFRS compared with those reporting under US GAAP, particularly under current market conditions where the stock market is showing signs of recovery after heavy falls and high impairment charges. It should be noted that this will change in 2005 with the revised version of IAS 39 (as noted below).
- Phase 2 will require discounting of liabilities, which is generally not permitted under US GAAP. Some US insurers have expressed concerns that this may give European insurers an advantage, particularly in reporting profits on long-tailed lines of business. In reality, the true impact is currently very difficult to assess given the uncertainty surrounding the way that the market value margin will be calculated. Rating agencies and other users of the accounts would also be expected to standardize reporting as far as possible between different reporting standards to ensure that companies are compared on a common basis.

¹⁸ Source: Tillinghast-Towers-Perrin – 4/2003.

Recent Changes to IAS 39.

Although this paper does not intend to review IAS 39 (Financial Instruments) in detail, there are a few important points to note. In December 2003, the IASB released a revised version of IAS 39 and IAS 32 which is not required to be used until 2005 although companies do have the option of early adoption.

The IAS 39 revised standard has some important differences to that currently in use by companies reporting under International Accounting Standards. Some of the main differences include:

Selected Differences Between IAS 39 (Rev. 2000) and IAS 39 (Rev. 2003)

IAS 39 (Rev. 2000)	IAS 39 (Rev. 2003)
i.) Impairment of an Available-for-Sale Equity investment...	
due to a significant (20%) and prolonged (6 months) decline in the fair value below its cost.	due to a significant (20%) or prolonged (6 months) decline in its cost (IAS39.61)
ii.) Impairment Losses of an Available-for-Sale Equity Instrument...	
recognized in profit or loss shall be reversed through profit or loss.	recognized in profit or loss shall not be reversed through profit or loss. (IAS39.69)

Source: IAS 39, Munich Re

For instance, the revised (2003) IAS 39 has a stricter impairment test than that implied by the previous standard as well as increased consistency with US GAAP and between companies in the treatment of revaluations following impairments. For those insurers that have made use of the option to apply the revised standards early, this has led to impairments that would otherwise have been taken in 2003 being taken in 2002 in a restatement of the prior year.

The revised standards have a greater comparability with US GAAP which forbids the reversal of

impairment losses. It is also noteworthy that the new IAS 39 standard includes an option to allow insurers to designate any asset (on initial recognition) as 'at fair value through profit and loss'¹⁹. This should help companies to limit the degree of accounting volatility contained within their financial statements by enabling them to more closely match the treatment of assets and liabilities.

Interaction of Insurance Reporting with IAS 39

IAS 39 specifies the way that investments, derivatives and options should be accounted for. It is likely that contracts issued by insurance companies that fail to meet the definition of an insurance contract will be accounted for as financial instruments under this standard.

It is important to note that the difference between an insurance contract and a financial instrument can be small. For example, a premium paid to gain protection against a credit rating downgrade of a particular entity would be accounted for as a derivative under IAS39. This compares with the similar situation where a premium is paid to gain protection against the failure of a debtor to pay when due. This counts as a financial guarantee contract that is outside of the scope of IAS 39 and would be accounted for as insurance.

The adoption of Insurance IFRS, particularly at Phase 2, will require a detailed portfolio review of insurers' portfolios to identify areas that are covered by IAS39 (e.g. contracts that fail to meet the definition of an insurance contract and embedded derivatives such as index-linked bonds and guaranteed annuity options). This process will be complicated by the fact that the classification of a particular contract may differ during its life. The current proposals state that the contract is categorized at the start of its life and then will not be recategorised, although this could potentially be subject to abuse.

¹⁹ In response to concern from regulators that this proposal could be open to abuse (e.g. by recognising profitability on financial instruments whose valuation is subject to subjectivity), the IASB has recently released an exposure draft that would somewhat limit this option although still aims to meet the original objective.

■ Appendix C – Example of Possible Accounting Treatment.

The following very simplified example is designed to show the different way that income emerges under the current deferral and matching approach and under the fair value approach. The example also shows the importance of the definition of ‘fair values’ and the substantial impact that this may have on the pattern of income recognition.

It is important to note that these examples are illustrative only. The examples have been constructed to demonstrate the general principles inherent in the discussion of phase 2 and should not be taken as necessarily representing the way that accounting will work under phase 2, as the formulation of some concepts (e.g. entry values) is still under discussion. In particular, these examples have been presented in a simplified manner and do not represent the exact presentation that is envisaged at phase 2.

The simplifying assumptions made for the examples below include the following:

- A single policy is written for 100 of premium,

60 of claims are expected to be paid (and are paid) in year 4.

- Acquisition costs are 20, incurred at the time of writing the policy.
- The policy incepts half way through year 1 and lasts for one year.
- Premiums received and acquisition costs are paid at start of the policy. All other cash flows occur at year ends.
- Discount rate is 3% (risk free) with the yield curve assumed to be flat.
- Actual Investment Return = 4%.
- The Provision for Risk and Uncertainty (Market Value Margin) is assumed to be calculated as 12 (pre-discount) where exit fair values are used and the risk is assumed to decline by one-third in year 2 and by a further 50% in year 3 prior to settlement in year 4.
- Under Entry Fair Values, the MVM is set up such that no profit is made in year 1 (i.e. insurer is unable to show that it is charging more than the market average for the risk). As the insurance contract expires, accounting has been assumed to converge with that of exit values using an MVM.

Deferral and Matching

	Year 1	Year 2	Year 3	Year 4	Total
INCOME STATEMENT					
Net Premiums Written	100	-	-	-	100
Net Premiums Earned	50	50	-	-	100
Net Claims Expense	(30)	(30)	-	-	(60)
Acquisition Costs	(10)	(10)	-	-	(20)
Underwriting Profit	10	10	-	-	20
Investment Return	1.6	3.3	3.4	3.5	11.8
Profit	11.6	13.3	3.4	3.5	31.8
BALANCE SHEET					
Cash and Investments	81.6	84.9	88.3	31.8	
Deferred Acquisition Costs	10	-	-	-	
ASSETS	91.6	84.9	88.3	31.8	
Unearned Premiums	50	-	-	-	
Claims Reserves	30	60	60	-	
Retained Earnings	11.6	24.9	28.3	31.8	
LIABILITIES	91.6	84.9	88.3	31.8	
CASHFLOW					
Premiums	100	-	-	-	100
Expenses	(20)	-	-	-	(20)
Claims	-	-	-	(60)	(60)
Investment Income	1.6	3.3	3.4	3.5	11.8
Total	81.6	3.3	3.4	(56.5)	31.8

Source: Fitch estimates

Possible Accounting Treatment Using Exit Fair Value (With MVM)

	Year 1	Year 2	Year 3	Year 4	Total
INCOME STATEMENT					
Net Premiums (NPV)	100	-	-	-	100
Net Claims Expense	(54.1)				(54.1)
Provision for Risk and Uncertainty*	(10.8)	3.8	3.9	4.0	0.8
Acquisition Costs	(20)	-	-	-	(20)
Profit – Insurance Business	15.1	3.8	3.9	4.0	26.7
Investment Return	1.6	3.3	3.4	3.5	11.8
Unwind of Discount – Claim Reserve	(0.8)	(1.6)	(1.7)	(1.7)	(5.9)
Unwind of Discount – MVM	(0.2)	(0.3)	(0.2)	(0.1)	(0.8)
Profit	15.7	5.1	5.4	5.7	31.8
BALANCE SHEET					
Cash and Investments	81.6	84.9	88.3	31.8	
ASSETS	81.6	84.9	88.3	31.8	
Claims Reserves	54.9	56.6	58.3	-	
Provision for Risk and Uncertainty	11.0	7.5	3.9	-	
Retained Earnings	15.7	20.8	26.1	31.8	
LIABILITIES	81.6	84.9	88.3	31.8	
CASHFLOW					
Premiums	100	-	-	-	100
Expenses	(20)	-	-	-	(20)
Claims	-	-	-	(60)	(60)
Investment Income	1.6	3.3	3.4	3.5	11.8
Total	81.6	3.3	3.4	(56.5)	31.8

* Also known as the Market Value Margin or MVM.
Source: Fitch estimates

Possible Accounting Treatment using Exit Fair Value (NO MVM)

	Year 1	Year 2	Year 3	Year 4	Total
INCOME STATEMENT					
Net Premiums (NPV)	100	-	-	-	100
Net Claims Expense Provision for Risk and Uncertainty	(54.1)	-	-	-	(54.1)
Acquisition Costs	(20)	-	-	-	(20)
Profit – Insurance Business	25.9	0	0	0	25.9
Investment Return	1.6	3.3	3.4	3.5	11.8
Unwinding of Discount	(0.8)	(1.6)	(1.7)	(1.7)	(5.9)
Profit	26.7	1.6	1.7	1.8	31.8
BALANCE SHEET					
Cash and Investments	81.6	84.9	88.3	31.8	
ASSETS	81.6	84.9	88.3	31.8	
Claims Reserves Provision for Risk and Uncertainty	54.9	56.6	58.3	-	
Retained Earnings	26.7	28.3	30	31.8	
LIABILITIES	81.6	84.9	88.3	31.8	
CASHFLOW					
Premiums	100	-	-	-	100
Expenses	(20)	-	-	-	(20)
Claims	-	-	-	(60)	(60)
Investment Income	1.6	3.3	3.4	3.5	11.8
Total	81.6	3.3	3.4	(56.5)	31.8

Source: Fitch estimates

Possible Accounting Treatment using Entry Fair Value

	Year 1	Year 2	Year 3	Year 4	Total
INCOME STATEMENT					
Net Premiums (NPV)	100	-	-	-	100
Net Claims Expense	(54.1)	-	-	-	(54.1)
Provision for Risk and Uncertainty	(18.4)	11.7	3.9	4	1.2
Acquisition Costs	(20)	-	-	-	(20)
Profit – Insurance Business	7.5	11.7	3.9	4	27.1
Investment Return	1.6	3.3	3.4	3.5	11.8
Unwind of Discount–Claim Reserves	(0.8)	(1.6)	(1.7)	(1.7)	(5.9)
Unwind of Discount-MVM	(0.3)	(0.6)	(0.2)	(0.1)	(1.2)
Profit	8.1	12.7	5.4	5.7	31.8
BALANCE SHEET					
Cash and Investments	81.6	84.9	88.3	31.8	
ASSETS	81.6	84.9	88.3	31.8	
Claims Reserves	54.9	56.6	58.3	-	
Provision for Risk and Uncertainty*	18.6	7.5	3.9	0	
Retained Earnings	8.1	20.8	26.1	31.8	
LIABILITIES	81.6	84.9	88.3	31.8	
CASHFLOW					
Premiums	100	-	-	-	100
Expenses	(20)	-	-	-	(20)
Claims	-	-	-	(60)	(60)
Investment Income	1.6	3.3	3.4	3.5	11.8
Total	81.6	3.3	3.4	(56.5)	31.8

* It has been assumed that as risk expires, the entry value method converges to an exit value method. Under this formulation, the 50% of risk that is expired at the end of year 1 is accounted for on an 'exit value' basis (i.e. profit is taken on this business in a similar way to the 'exit value with MVM' scenario) whilst no profit is taken on the 50% of risk that is unexpired. This is one of a number of possible formulations for entry value accounting although details of the proposed required accounting treatment will become clearer as the phase 2 project progresses. Source: Fitch estimates

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