International Accounting Standards: Threat or Opportunity?

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The move to International Accounting Standards (IAS, or as recently renamed, International Financial Reporting Standards or IFRS) is likely to be one of the most controversial issues for insurers and reinsurers over the next few years, especially in Europe. Having been an accounting issue with little commercial relevance a few years ago, IFRS has created outrage in the insurance industry recently. Although a few companies see IFRS as an opportunity, most of the industry is united in its opposition. Criticism has rarely been constructive, however, arguing mostly for the preservation of the status quo, rather than proposing alternatives that meet IFRS objectives. As debate continues, IFRS enthusiasts, those that are merely resigned to it, and those that vigorously oppose it must all prepare for IFRS now.

The urgency arises from the recent publication of the draft IFRS for insurance contracts (Exposure Draft 5), and because the EU plans to require all listed EU companies (not just insurers) to report on an IFRS basis from 2005 onward (which means that comparative IFRS financial statements will also be required for 2004). At the time of publishing, there was one glimmer of hope for IFRS objectors, in that the EU had not formally adopted IFRS in the time frame originally envisaged. However, despite the strength of the insurance and other industry lobbies, its adoption is still expected. The pressure to adopt IFRS comes not just from the EU, but also from many other countries such as Canada and Australia. Furthermore, in the U.S., the SEC and the Financial Accounting Standards Board have announced that they are dissatisfied with current U.S. GAAP for insurance. Most new U.S. accounting standards take a 'fair value' approach, and the process of convergence of U.S. GAAP with IFRS is under way. Until recently (that is, the post-Enron era), the possibility of U.S. GAAP being replaced by--or even converged with--IFRS would have been thought laughable. Today, that is definitely not the case. Hence, the U.S. lobby against IFRS has echoed the objections coming most vocally out of Germany, France, and Japan.

Although many European insurers claim to report on an IFRS basis today, this is fairly meaningless since there is no IFRS for insurance yet, and in practice it means that companies are actually using a basis of accounting that is close to U.S. GAAP. The introduction of 'proper' IFRS is expected to hit the insurance industry harder than most other industries, part of the problem being that the insurance industry is different from most other industries in that it receives its principal revenues (that is, premiums) before it incurs its principal costs (that is, claims). Therefore, significant estimations need to be made in an insurer's financial statements, which sometimes prove to have been materially mis-stated with the passage of time.

Since the International Accounting Standards Board (IASB) has been slow to develop the insurance standard and insurers are substantially unprepared for the changes, the Board has decided to split the project into two phases, with phase one to be introduced to meet the 2005 deadline and phase two planned for 2007.

The industry had hoped that phase one might be quite cosmetic, but that does not seem to be the case. Phase one is significant, especially for reinsurers, and encompasses the following:

- Equalization reserves and catastrophe reserves will be prohibited. This will limit reinsurers' (and insurers') ability to smooth reported earnings from 2005 onward.
- Insurance contracts will be redefined, with a distinction made between insurance risk and financial risk. Applying the new definition will require splitting financial reinsurance into its finance and insurance components. The finance component will need to be treated as a deposit and not as a premium. Furthermore, the standard will not allow for a reinsurance transaction to immediately improve a company's results or equity. If the reduction in a ceding company's liabilities exceeds the reinsurance premium it pays, then any gain will have to be spread over the life of the period of the underlying policy. This will affect the nature of the financial reinsurance market significantly.

- The offsetting of insurance liabilities with related reinsurance assets will be prohibited. This means that balance sheets will need to be grossed up.
- For many life insurers, the impact will be even more dramatic, since life insurance contracts, such as single-premium unit-linked contracts with minimal death benefits, which are currently accounted for as premiums, will need to be accounted for as deposits. This is likely to reduce reported life insurance premium revenues in Europe by more than 50% in 2005! Furthermore, companies will need to identify 'embedded derivatives' (for example, guarantees contained in life policies) in their contracts and report them on a fair value basis in accordance with IAS39 and IAS32.
- Disclosure requirements will be onerous even at phase one. Some groups envisage the additional disclosures increasing the number of pages in their annual reports by up to 50%. Companies will be required to describe their business and the risks it faces in considerable detail. Disclosures will include accounting policies, significant assumptions made, the level of prudence included, the effects of changes in assumptions, sensitivity analysis of those assumptions, identification of risk concentrations (including insurance risks, interest rate risks, and credit risks), and, in the case of non-life insurers and reinsurers, a 10-year loss reserve development triangle.
- Insurance contract liabilities will be delinked from the financial assets held to match the liability. This will affect much life insurance business.

Phase two is more radical:

- In general, insurance assets and liabilities will be measured individually at their fair value (market value if it exists, or otherwise based on discounted expected future cash flows). Balance sheets will not need to be reported at fair value until 2007, but disclosures will be required by 2006. As a consequence, familiar features of an insurer's balance sheet will disappear. Unearned premiums, deferred acquisition costs, and fund accounting all go. In establishing the single figure for claim provisions that will replace them, companies will be required to estimate the mean value, but will have to add to that explicit provisions for the riskiness around that mean (known as market value margins or MVMs). For example, long-tail liability provisions will need large MVMs, whereas short-tail property claims will need much lower MVMs. This will be partly offset by the need to explicitly discount claim provisions. In order to calculate MVMs, companies will need to conduct levels of sophisticated stochastic analysis used by relatively few insurers today.
- In life insurance, various common forms of accounting currently seen in financial statements around the world (such as statutory accounting, modified statutory accounting, embedded values, achieved profits, margin on services, Canadian GAAP) will disappear and be replaced by a fair value basis for policyholder liabilities (measures and methodologies yet to be fully developed and refined).

The objectives of the IASB are laudable at least. Currently, many insurers' financial statements are inconsistent, opaque, and provide inadequate disclosures. Although the equity, capital, and insurance (especially reinsurance) markets are global, the methods of financial reporting are not. Consistency is lacking, not just between countries, but also within countries, and even in some cases within groups! The application of IFRS will result in much greater consistency, enabling users to better compare profitability and balance sheet strength. In addition, transparency will be substantially enhanced, which is a commendable achievement in itself. The framework underpinning IFRS seems sound too: all companies will be required to value their assets and liabilities using a fair value approach (that is, a market value approach, at least where market prices are available). Under this framework, the profit for the year is the difference between the net assets in the opening and closing balance sheets (that is, the value added). So what is all the fuss about?

Insurers mainly cite earnings volatility, subjectivity, and cost. Insurers complain that IFRS will produce more volatile results, with a consequent decrease in their stock prices and increase in their cost of capital. Using the existing accounting frameworks, insurers often artificially shield their headline results by smoothing (using various tools available to them). However, the underlying volatility is real, so arguably this shield should not be tolerated. Conceivably, better communication of the risks to which a business is exposed would result in lower volatility in stock prices, whereas, in most recent times, insurers' stock prices reacted violently because of the uncertainty surrounding the impact of challenging market conditions. Insurers' balance sheets have been viewed with substantial mistrust in the recent past. The effects of reported IFRS headline earnings volatility would need to be offset by high-quality disclosure. Disclosure and transparency will be key.

Insurers also complain that this additional reported volatility will adversely affect the confidence of consumers (that is, policyholders) in the industry. But again, what is the justification for shielding consumers from the truth? Sophisticated consumers conduct their own assessment of the creditworthiness of their counterparties, and currently, financial statements do not give them the data for doing a thorough job. The less sophisticated tend to rely on regulators to look after their interests. Ultimately, the capital markets, consumers, and the more sophisticated financial statement users will reward insurers for their improved transparency rather than penalizing them for volatility.

Standard & Poor's fully accepts that volatility attributed to underlying movements in assets or liabilities that are not offset by similar movements on the other side of the balance sheet should be reflected in insurers' balance sheets. However, an independent accounting of assets and liabilities that does not reflect their symbiotic relationship would only produce obfuscation of underlying trends. Given that the longer term nature of insurance liabilities (compared with other financial services institutions) drives longer term investment strategies, Standard & Poor's looks for an accounting framework that would more accurately portray changes in economic balance sheet strength and realistically portray economic income. Accounting standards that promote volatility without reflecting the underlying economic fundamentals in the income statement and balance sheet would not be useful to Standard & Poor's, unless accompanied by scrupulous disclosure identifying this volatility and its mitigants.

Standard & Poor's concerns are focused on the more practical, rather than theoretical, aspects of applying IFRS. The resources required to implement IFRS will be considerable, especially at phase two. IFRS will require huge actuarial resources, which are already scarce. It will require investment in and migration to new systems. Accountants and auditors will need to be trained in a very short time frame. Costs will increase in an industry where margins are already under acute pressure (for example, in life insurance). Scale will become evermore important. In addition, insurers are nervous about the reaction of tax authorities to the absence of equalization and catastrophe provisions, and fear that if IFRS results in an acceleration of profitability, authorities will no doubt seek ways to tax it.

So what of the opportunities? Already mentioned has been the greater consistency and transparency of financial information. Many equity and fixed-income analysts have welcomed this. IFRS will also require a very sophisticated understanding of insurance businesses, the risks to which insurers are exposed, and their potential rewards. Companies' managements and boards will be better informed than they currently are when IFRS-imposed disciplines are introduced, and there should be a better alignment of product pricing and financial reporting. Regulatory benefits are also expected in the longer term, as IFRS-based financial statements will fulfill many regulatory objectives and may result in reducing regulatory filings and requirements. Perhaps insurance will be a better managed and thriving industry, and better understood by its investors.

Watch this space!

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