Fair Value Accounting for Insurance

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Introduction

- It's not just fair value, it's "Performance Reporting"!
- FASB and fair value.
- IASB and insurance contracts.
- Actuaries and fair value: what we've done to date.
- Exhortation!

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Why change now?

- "Corporate financial accounting has now become so changeable, inconsistent, undisciplined and uncomparable that its primary function - enabling both managers and investors to measure a company's performance - is threatened."

Financial Digest, June 2001

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Why change now?

- "Too many companies are finding ways to manipulate their reported results. The solution, the [IASB] believe[s], is to press bravely ahead and impose fair-value rules for all financial instruments."

  The Economist, August 16, 2001

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Performance Reporting

- Fair value discussions have focused on the balance sheet.
- The income statement was an afterthought, derived simply from the change in balance sheet entries.
- But investors and managers care about earnings, so standards setters have realized they must deal with performance measurement.

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Performance Reporting

- The new IASB has made Performance Reporting one of its major priorities.
- Fair value of financial instruments has taken a back seat for now.
- Under discussion: a single statement of recognized income and expense, including the effects of all changes in net assets (except capital transactions).

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Performance Reporting

- FASB has proposed a new agenda project on reporting financial performance.
- FASB would work with IASB.
- Concerned with increased use of pro forma reporting, declining use of net income.
- Lack of consensus on key financial measures that reporting should provide.

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FASB and Fair Value

- February, 2000: Issues Concept Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*.
- Adopts fair value as measurement objective when employing present value.
- Includes entity's own credit standing in measuring its liabilities.
- Framework for future accounting standards.

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FASB and Fair Value

- Concept statement controversial.
- FASB has issued four "Understanding the Issues" papers to explain its position.
- Available on www.fasb.org
- Co-authored by various FASB members and Wayne Upton, then on FASB's staff and now IASB Director of Research.

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FASB and Fair Value

- Why the old "most likely" standard was not the best target for estimated cash flows.
- Example: estimated liability using 3 scenarios discounted at risk-free rate and judgement probability weighted to arrive at fair value.
- Use third-party service prices to value liabilities.

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FASB and Fair Value

- Assume "highest and best use", no information asymmetries, buyer that wants the specific item.
- Defends use of entity's own credit standing as "economic reality".
- Asserts stockholder's equity should never go below zero.

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FASB and Fair Value

- "Nobel laureate Robert Merton['s] … analysis is unfamiliar to many accountants and actuaries, but it is a cornerstone of modern financial economics."
- Note: Nobel Laureate Robert Merton was also a founding partner of Long-Term Capital Management where he was able to extensively "test" his theories.

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IASB and Insurance Contracts

- New IASB formed in April, 2001.
- Met standards requested by FASB and SEC.
- Paul Volcker, former chair of the U.S. Federal Reserve, chairs IASB Trustees.
- EU planning to adopt IASB standards for 2005 reporting.
- Maybe we need to take IASB standards seriously.

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IASB and Insurance Contracts

- IASB not doing fair value of financial instruments now, just fixing IAS 39.
- Therefore, insurance contracts project likely to go with entity-specific value for now.
- Eliminates own credit risk in valuing liabilities, and allows use of assumptions specific to entity.

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IASB and Insurance Contracts

- ESV, like fair value, recognizes income on an asset and liability measurement approach, not on deferral and matching.
- ESV could be the same as fair value in a given situation, but it would never be the same as current U.S. accounting.
- Not entirely clear how the IASB will proceed with insurance contracts project.

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Actuaries and Fair Value

- CAS Task Force on Fair Value Liabilities was chaired by Ralph Blanchard.
- Completed *White Paper on Fair Valuing Property/Casualty Insurance Liabilities* in August, 2000.
- Available for download from www.casact.org/research/tffvl/index.htm
- 132 pages including appendices.

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Actuaries and Fair Value

- Not for or against fair value, but a discussion of the actuarial issues involved in estimating the fair value of insurance liabilities.
- ESV is briefly discussed, but many of the concepts discussed apply as well or better to ESV than to fair value.

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Actuaries and Fair Value

- Executive summary: overview and findings.
- Background and FV in insurance context.
- Alternatives to fair value.
- Estimating risk adjustments (w/appendices)
- Accounting presentation issues.
- Implementation issues.
- Accounting concepts and credit standing.
- Professional readiness and Summary

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Actuaries and Fair Value

- Stated pros and cons of various methods without drawing conclusions.
- Identified issues that were likely to require further work or research.
- Identified and described 9 potential methods for calculating risk adjustments.
- Market prices may conflict with result of "fair value" estimation process.

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Actuaries and Fair Value

- CAS Risk Premium Project (discussed in Workshop B12 yesterday) is producing more research and refined techniques that can apply to the topic of discounting insurance liabilities.
- CAS developing an RFP for case studies of fair value accounting applied to general insurance.

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Actuaries and Fair Value

- Bowles Symposium, May 2001
- Two days of papers from life actuaries (including UK actuaries) on fair value.
- FV and ESV showed substantial increase in volatility of results compared to current US GAAP for life insurers.
- Volatility regarded as good - keeps CFO's on toes. Little advice for the poor CFO.

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Actuaries and Fair Value

- FV and ESV were shown to magnify (relative to current US GAAP) the current year impact of any assumption changes.
- Many presenters felt FV provided a superior picture of a life insurer, although implementing FV would be a significant burden.

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Actuaries and Fair Value

- AAA Fair Value Task Force, chaired by Burt Jay of Mutual of Omaha.
- In 2000, developed comments on FASB Preliminary Views on Financial Instruments at Fair Value.
- Also in 2000, developed comments on IASB Insurance Issues Paper.
- Expressed concern on "own credit risk" issue.

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Actuaries and Fair Value

- Recently completed letter on JWG Draft Standard on Financial Instruments.
- JWG Draft "scopes out" insurance contracts, but would give a big push to fair value accounting for insurance if it were adopted.
- Currently summarizing principles and methods applicable to fair valuing insurance liabilities.

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Conclusions

- Changes are coming to performance reporting for companies in general and insurers in particular.
- Accounting standards setters are pressing for accounting consistent with the efficient markets hypothesis, whether or not actuaries think the hypothesis is valid or practicable of estimation.

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Conclusions

- The IASB is quicly building critical mass as an influential accounting standards setter.
- Even the FASB seems to be working closely with the IASB.
- The IASB will seriously consider adopting the ESV approach. This "fair value light" method will significantly change insurer financial reporting almost everywhere.

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Conclusions

- A "fair value" world will significantly change the jobs of most actuaries who deal with reserving or financial reporting.
- Now is the time to think about whether you think that is a "good thing" or a "bad thing".
- Actuaries are influencing the course of events, but few general insurance actuaries are much involved with this issue.

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Exhortation!

- As a larva, the sea squirt has a brain-like ganglion that allows it to sense its environment and swim around.
- As an adult, the sea squirt permanently attaches itself to a stationary object and then digests most of its own, now useless, brain.
- Whether you favor or oppose fair value, do NOT emulate the sea squirt.

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