

# **GIRO INSURANCE CONVENTION 2003**

## **International Accounting Standards:**

### **Fair Value Working Party**

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### **Summary**

The International Accounting Standards Board has issued an exposure draft, ED5, on Phase 1 of its insurance accounting project. This covers almost everything except how insurance assets and liabilities will be valued in Phase 2. A “fair value” approach is currently selected for Phase 2, but many important details remain as yet unresolved. The current plan is for companies to disclose fair values from December 2006 and to account using fair values for accounting periods starting on or after 1 January 2007.

This paper reports briefly on the decisions on Phase 1, which are contained within ED5. It then attempts to find a relatively simple solution to the determining of market value margins, which are to be added to discounted mean estimated liabilities to arrive at a “fair value” of insurance assets and liabilities.

The working party does not expect these proposals to produce a consensus, but does hope that making them will generate constructive discussion towards the eventual implementation of Phase 2.

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# 1.0 Introduction

A paper on fair value accounting was produced for GIRO in October 2002, and a paper based on this was subsequently presented at the Institute of Actuaries on 24 March 2003.

The objectives of the current working party were as follows:

- Provide a limited update on developments relating to International Accounting Standards (IAS) for insurance as they affect general insurance.
- Produce suggestions relating to the implementation for general insurance of Phase 2 of the International Accounting Standards Board's (IASB) Insurance Project.

The main question we are considering under the second heading is the practical implementation of market value, or risk, margins. The difficulty of achieving this is one of the reasons the IASB has split the implementation of IAS (International Accounting Standards) for insurance into two phases.

There have been a number of papers discussing the theoretical background to and the practical implications of the IASB's fair value proposals, and inevitably we repeat some of the ground they cover. In order to move things forward and to make the debate as constructive as possible, we have attempted to develop some specific proposals. We are not under the illusion that we can quickly solve the problems relating to market value margins. This paper's main purpose is to contribute to the debate and to encourage further contribution from the actuarial profession. We fully expect that many faults will be found in our suggestions.

This paper is also background material for a workshop discussion. This workshop will give an opportunity to discuss possible solutions, and will include a more detailed presentation on techniques than in this paper, particularly techniques based on the cost of capital principle.

We look forward to a general debate on any of the theoretical or practical issues relating to phase 2. We have attempted to find a way through the various compromises needed to make phase 2 happen. We believe that some of the more elegant theory may have to be dropped, certainly in the early years of the new regime.

In order to keep this paper as short as possible, we do not try to cover the ground in a comprehensive fashion. We give some background, but we do assume some prior knowledge of developments in IAS.

This paper should not be regarded as representing the views of any individual member of the working party nor of any of the organisations at which they work.

## **1.1 Brief note on background**

In December 1999, the predecessor to the IASB published an *Insurance Contracts Issues Paper*. This included a definition of **fair value**. The latest definition reads as follows.

*“The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”*

The IASB produced outline proposals for the principles to be used in valuing insurance assets and liabilities in its Draft Statement of Principles (DSOP). This can be found on the IASB’s web site [www.iasb.org.uk](http://www.iasb.org.uk). As it was designed to do, the DSOP has generated much discussion. Last year’s GIRO paper was prompted by the DSOP.

The IASB’s insurance project covers all insurance, but we are concerned here only with general insurance aspects.

The latest development is the publication by the IASB on 31 July 2003 of an exposure draft, ED5 which covers Phase 1 of the project. There is some information about the Board’s current thinking in relation to Phase 2, in which full “fair value” accounting will be implemented.

There is a short consultation period on ED5, ending on 31 October 2003. We expect the IASB to issue an accounting standard based on ED5 some time in 2004. Under the proposals in ED5, disclosure of fair values of

insurance assets and liabilities, as opposed to their incorporation in the balance sheet, is to be required from 31 December 2006. As it is only in Phase 2 that the precise principles for determining fair values will be determined, there is a danger that companies will have very little time to prepare themselves for producing fair value estimates. As regards Phase 2, we could see an exposure draft at the end of 2004, followed by a further standard in 2005, to be implemented in 2007/8.

The requirement in ED5 to disclose fair value estimates from 31 December 2006 has attracted some criticism, as the interpretation of “fair value” is not yet decided.

## **2.0 Phase 1 decisions in ED5**

Apart from the disclosure point mentioned above, the major changes, those implementing a fair value basis for insurance assets and liabilities, have been left for phase 2. The IASB recognises that both theoretical and practical issues with fair values need further work.

### **Interim changes:**

- definition of insurance

This requires that for a contract to be treated as insurance, the uncertain event on which compensation depends must adversely affect the policyholder.

- no equalisation reserves
- no catastrophe reserves
- day 1 credit for reinsurance purchased limited to the amount of the premium ( watch this space!)

This is designed to avoid implicit discounting of the gross liabilities if the company's accounting policy is not to discount. An anti-financial reinsurance measure, but a blunt instrument in its current form.

- loss recognition test

This requires that reserves should not be less than the future value of the liabilities, and that any deficiency is recognised in profit or loss. Companies' existing accounting policies are likely to meet this test already.

- Apart from the above, companies can keep existing accounting.
- Companies may not change existing accounting unless they move closer to fair value, or at least closer to "relevant and reliable". For example, companies can't stop discounting if they are already doing so.
- Unbundling of deposit components – implications for certain financial reinsurance contracts.

## **3.0 Phase 2 - what are the big decisions to come?**

ED5, together with the DSOP issued previously, indicates the IASB's current thinking. This is not set in stone at this stage. As well as an invitation to comment, ED5 includes a section explaining the basis for the conclusions in the draft standard. This contains (in paragraphs BC6 to BC8) the Board's "Tentative conclusions for Phase 2".

From a general insurance perspective, the first change compared to the DSOP is as follows. The "entity specific" option has been dropped as the valuation basis in favour of a fair value measurement objective. Perhaps the most significant difference is that, according to BC8, "fair value, unlike entity-specific value, reflects the credit characteristics of the contract, including the effect of policyholder protections and insurance". Apart from this, there was little difference between entity specific and fair value objectives.

The second change we would mention compared to the DSOP prevents the immediate booking of profits on sale of a contract. The following is quoted from BC6 (b) (ii) :

*In the absence of market evidence to the contrary, the estimated fair value of an insurance liability shall not be less, but may be more, than the entity would charge to accept new contracts with identical terms and remaining maturity from new policyholders. It follows that an insurer would not recognise a net gain at the inception of an insurance contract, unless such market evidence is available.*

Almost everything in the proposals is controversial to someone. We do have some doubts whether the IASB's current proposals make theoretical sense, and also whether they will be workable in practice. It seems that a theory designed for banking is being applied to insurance. We do recognise, however, that most of the members of our working party do not come from an accounting background and therefore are not fully familiar with accounting theory.

**The fair value principle** looks almost certain to be adopted in some form. Some hold the view that discounted best estimate without a margin is the only solution. It looks as if a margin is extremely likely to be required. The one thing we are almost 100% sure about is that there will be discounting for the time value of money.

The big question is how best to implement something as close as possible to the fair value principle in insurance, and this has been our main focus.

We suggest that the fair value principle can not be taken literally in insurance for both practical and theoretical reasons.

Will there be a reduction in accounted liability to reflect own credit risk? IASB appear to regard this as following automatically from the adoption of the fair value objective.

## **4.0 Coming off the fence**

As well as the DSOP itself and the IASB's subsequent publications, there are plenty of good papers considering the principles and practice involved in a fair value approach to insurance liabilities. Most papers provide a discussion of the issues, but do not contain specific recommendations, though they may indicate principles which their authors thought important.

One interesting reference, which only mentions IAS as part of a discussion of wider issues, and which definitely does come off the fence, is the report of the HIH Royal Commission. Written by Justice Owen, this is the result of a major investigation into the failure of HIH, an Australian insurer. The report was published on 4 April 2003 and contains a chapter on accounting standards. The report is available for download on [www.hihroyalcom.gov.au](http://www.hihroyalcom.gov.au).

It is worth quoting a few paragraphs from chapter 7 on accounting standards, where Justice Owen discusses the IASB's DSOP:

*“The notion that the credit standing of an insurer should affect the value of its liabilities is a logical extension of the notion of fair value only if that is the amount for which the insurer's liabilities could be settled, rather than taken over.*

*There is and can be no market for the settlement of liabilities of an insurer. Necessarily, the only participants in the settlement of liabilities could be the insurer and its policyholders or their assignees.*

*The idea that a true and fair view of the value of HIH's liabilities to its policyholders could be obtained by asking what knowledgeable and willing parties (that is HIH and its policyholders) would pay to settle those liabilities is to my mind bizarre. If the policyholders would rationally accept \$0.20 in the dollar because HIH is insolvent, does that mean that HIH should report its liabilities as being a fifth of what they actually are? The proposition has only to be stated to be rejected.”*

#### **4.1 Prepared to see proposal shot down**

In order to take the debate forward, we have attempted to devise a possible solution including a set of specific suggestions for Phase 2. In the following sections we set out our arguments and attempt to show how we have arrived at our conclusions.

We then discuss some things we know our solution fails to do. Our view is that we will have to live with a less-than-perfect solution if anything like the spirit of fair value measurement is to be achieved.



## **4.2 Start with the spirit of IASB's proposals**

Just because there is in practice no market for the settlement of insurance liabilities does not mean we should reject the fair value concept out of hand. We therefore ask, “just what is the spirit of the IASB's proposals?” We then ask: “How can this spirit best be satisfied in a practical and understandable way?”

In the next section we set out some thoughts on valuation principles.

## **5.0 Possible objectives for valuation principles to satisfy**

In our discussions we found it difficult to come up with solutions because each solution had so many theoretical imperfections. It is possible to discuss the issues for a year without coming up with any proposals. We recognise that there is limited consensus even on the objectives the valuation principles might satisfy, so we will welcome comments on all aspects.

- Start with the spirit of the fair value proposals (willing buyer, willing seller concept; current market price concept)

We know that there can be no true market in second-hand insurance and reinsurance, but what might the pricing be like if there were? This argument leads inevitably to there being a margin. Only by ditching the fair value concept completely can we avoid there being a margin.

If there is a margin, it follows that the more unattractive the business the higher the margin

- Valuation principles should reflect economic substance, irrespective of the apparent form of the insurance assets or liabilities

Requiring a mean discounted best estimate as the core of the insurance liability (or the reinsurance asset) number will prevent one type of accounting arbitrage based on the difference between undiscounted and discounted values.

- Avoid the ridiculous

If it were not for the idea that an insolvent insurer could show a solvent balance sheet after adjustment for credit risk, we would not have invented this objective. Another possible contradiction, which may not belong under this extreme heading, is that between taking any reduction for credit risk, and the general presumption that financial statements are prepared on a going concern basis.

- Give consistent results for the same liabilities between different companies.

A willing buyer willing seller price implies there are a number of potential parties willing to take on the liabilities. If this were the case, then the price charged for a risk would reflect the balance of supply and demand for the type of business concerned. This price would be independent of the company that currently has the liability. In the theoretical open market world, it is in the balance between supply and demand that the economic impact of diversification would be felt.

- Simple to apply

In our view, this is a vital consideration, particularly if Phase 2 is to be capable of implementation in a short timescale. We would suggest it makes sense to implement something simple in the medium term, with a plan to review the success or otherwise of the new standard after a few years of operation.

- Easy to understand

This is also important for successful implementation. Actuaries may be attracted to complicated solutions, but we have tried here to restrain ourselves.

- Not seriously at odds with common sense

Common sense, in spite of its name, is subjective. This objective is difficult to achieve.

For example, can we say this about risk margins? Surely, by definition the proposed approach gives reserves which are, on average, more than is finally needed to meet the liabilities?

On the other hand, there are powerful arguments in favour of risk margins being incorporated into accounting estimates. These arguments do not all rely on the fair value concept. One such argument is that as the business of insurance involves the acceptance of other parties' unwanted risks of loss, the profits of insurers are only earned as the risks run off. For physical catastrophe business, this process is complete shortly after the end of the policy period. For long tail classes, huge uncertainty can extend into the development period, long after the policy period has passed.

- Attractive to capital providers

It is extremely unattractive to have to pay tax on theoretical profits which cannot be distributed or otherwise used within the business. This argues strongly for there being a risk margin within accounting estimates. Jurisdictions which permit these margins to be included in the liabilities for tax purposes will tend, over time, to attract insurance business from those jurisdictions which do not.

- Auditable

The simpler the process for determining market value margins, the easier it will be to audit (and the less demanding on auditors' actuarial resources).

- Not unduly distort the market

This should be satisfied if accounting follows commercial reality. Our suggested approach is based on cost of capital. Cost of capital is very much part of the modern underwriting process. For a large commercial or reinsurance risk, many insurers will hypothetically allocate an amount of capital and will price in a return on that capital.

- Attractive to regulators

Different regulators will have different views. Regulation for financial strength and protection of policyholders does not have to follow accounting. Nevertheless, a consistent and effective accounting regime should be of great benefit to regulators if more consistency exists between different jurisdictions' accounting regimes. Clear disclosures of the elements of the reserves will be important, particularly the market value margin and the mean discounted estimates.

In the UK, the new regime is focused on the position of individual insurers and requires a careful understanding on the part of each insurer of its own risk profile. Not all regulators are as sophisticated as this. If the insurance liabilities are calculated using a non-stochastic model (see practical suggestions below), it could still be necessary to carry out stochastic modelling, or at least scenario testing, as part of the information about sensitivity of reported profit or loss and equity to changes in variables that have a material affect on them (ED 5, para 29(c)(i)). The UK regulators are proposing the introduction of stochastic modelling for capital adequacy purposes.

The issue of “going concern” is also important. Is up to the regulator to decide who has the ability to write business, and also the principles to be applied if an insurer is to be wound up or declares itself insolvent.

## **7.0 Some practical (?) suggestions + discussion**

In this section, we set out some suggestions and invite comment on them and on any other aspects. Our suggestions are as follows:

1. Insurers develop mean best estimate cash flow projections for their liabilities – and hence the “expected” part of the fair value liability is determined using risk-free interest rates.
2. A basis for allocating capital to lines of business (here incorporating specifically unexpired periods and run-off periods) is adopted by IASB, or perhaps by a national accounting body

An example of this could be the capital requirement factors developed in CP190, the FSA's proposed new minimum capital requirements. One could, for example, take 150% of CP190 factors.

3. A precise method is set down for determining the rate of return to be required over and above the risk free rate. This extra return could take into account financial market conditions.
4. Start with an initial amount of capital allocated to the business, determined in accordance with the formula in 2 above, together with a further fund of cash. We now need to solve for this required further amount of cash. Project forward the future cash flows and the future capital requirements as the risks run off, and solve for the amount of the initial fund required to give the required rate of return (i.e. the risk free rate plus the extra return) on the capital allocated over the period. The capital is assumed to be withdrawn as the risk runs off and the capital requirement falls.

The required further fund is the fair value of the liability

So:

*Capital required + fair value of liability GIVES return on capital*

And if it is necessary to separate out the mean discounted value of the liabilities, we have:

*Market value margin = fair value of liabilities – mean value of liabilities*

These suggestions will be developed further and discussed in the workshop. We intend to incorporate material from the workshop into this paper when it is published on the Institute of Actuaries web site.

### **Advantages and disadvantages of the above suggestions**

1. Modelling inherent in CP190 (or its equivalent for this purpose) will be designed to reflect some sort of “typical company”. This is where

the stochastic work is done. No stochastic modelling will be required by the insurer in order to implement IAS.

2. Simple approach will in theory give similar results for the same liability, independent of the insurer.
3. The basis for determining the capital to be allocated has to be imposed externally.
4. The approach fails to recognise the different levels of risk margin one would expect to find within each unit of business. For example, a high layer should in theory have a higher risk margin compared to its expected cost than a low layer.

### **Other questions for discussion**

These are left to the reader, but further questions will be posed at GIRO.

## 8.0 Appendix – some references

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