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# Current issues in general insurance

International Accounting Standards and Fair Values

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## IAS for general insurance

**Background reading:**

▪Before the conference if time:
**GIRO 2003 paper** by Fair Value Working Party - should be on CIGI 2004 part of www.actuaries.org.uk
- paper is v short: 15 pages and large print

▪After the conference if interested:
1) **IAAA's draft response** to IASB's ED5 dated 31 October 2003 - see www.iasb.org.uk ; and
2) **SIAS paper** dd March 2004 by Julian Leigh on Implications of Fair Value accounting for general insurers - see www.sias.org.uk/papers/Fair_Value_GI.pdf ; and
3) **IFRS4 itself** - available electronically from IASB for £7.50

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## IAS for general insurance - scope for today

- Importance of IAS
- Phases 1 & 2: hardest questions left for Phase 2
- Phase 1 decisions made: IFRS4 published 31 March 2004. Impact. Some surprises? "Tentative conclusions for Phase 2" published at same time.
- Phase 2: back to the drawing board on basis for valuing assets and liabilities
- Actuarial profession contributing to debate: hot topics.

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## IAS is contentious: some recent quotations

- On credit standing of insurer:

  "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." Justice Owen, April 2003.

- On volatile results:

  "The focus on providing a steady stream of earnings only distorts the picture and encourages practices that run counter to the aims of providing investors with accurate information" Sir David Tweedie, Chairman IASB, from Guest Editorial in BAJ Vol9 Part 4

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## Phase 1 - some of the decisions

- Fair value disclosures now to await Phase 2
- Not committed to a date for Phase 2.
- Anti-financial reinsurance provisions remain, but there's no longer an automatic ban on recognising a gain on the purchase of reinsurance.
- A (weak) liability adequacy test is to remain, but if reserves don't meet this test IAS37 applies. The *Basis For Conclusions* (published with IFRS4) points out that IAS37 is a fair-value type test, and requires a risk margin.

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## Tentative conclusions for Phase 2

- Contained within Basis for Conclusions
- Assets and liabilities to be recognised at fair value
- There's still a reduction for credit risk
- Minimum liability value set at current price for new business.

  …..And therefore………?

  - Not sure phase 2 as it currently looks meets actuarial sense checks.
  - But IASB now plans a thorough review of both conceptual and practical issues before the Exposure Draft for Phase 2

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## Back to the drawing board for Phase 2

- Tentative conclusions not much changed
- So actuarial profession's reactions unlikely to change much either
- Fair value per IAS39: "The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction"
- Problem: Fair value concept applies most easily to traded things. Insurance and reinsurance is created by a contract which cannot be exited at will by one of the parties. There is no second-hand market to speak of. Insurance contracts are not financial instruments

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## Discussion: Phase2 may work if

- Assets and liabilities valued consistently
- For reasonably matched cash flows, accounting results are not very sensitive to changes in asset prices (e.g. moves in yield curve)
- Accounted liability values do NOT closely track the insurance cycle. Methodology has to be suitable for highly cyclical markets
- Same liability given same value, whoever the insurer carrying the liability is. (Big, small, solvent or not.)
- Principles of application are clear and simple

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## Discussion: Phase2 may NOT work

- If risk margin approach results in violation of common sense
  - Note risk margins not essential to make accounting coherent
  - Risk margins almost a matter of personal belief!
  - Risk margin approach needs to be simple to apply and not capable of manipulation
  - Whether to have risk margins is probably the biggest decision for phase 2
  - Cost of capital approaches look promising, but better ideas may exist

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## Cost of capital approach for risk margins

- Attractive in principle, but not easy in practice
- Needs sound basis of determining notional capital requirement per unit of liability
- Calibration to a "typical" size of company for each line of business – so large companies  will be over-providing compared to risk of ruin type targets and vice-versa for small companies
- May need international consensus on rate of return on capital to use, and how / whether it responds to financial markets – as well as on notional capital requirements

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