

Recent Developments in International Accounting Standards for Insurance Contracts

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1. Introduction

On July 31, 2003, the International Accounting Standards Board (IASB) published Exposure Draft (ED 5), which contains proposed interim accounting standards for insurance contracts. Comments on the draft, which were received from approximately 130 companies and associations by the October 31 deadline, are available for viewing on the IASB's website.

This paper discusses the accounting problems at issue for insurance, and offers a prediction on the future course of deliberations.

But first, two points must be noted for those not familiar with the IASB:

- ① Since international accounting standards are not compulsory, countries are not required to automatically apply them. However, from the perspective of harmonizing international accounting standards, Japan unquestionably needs to take action of some kind. Thus concerned parties in Japan have been actively contributing their comments and concerns into the standards formulation process.
- ② Mutual aid, being identical in function to insurance, is in principle also subject to the accounting standards.

2. Accounting for Insurance Contracts

1. Insurance Liabilities

The international accounting standards in question apply to accounting practices for insurance contracts, and not to other areas of accounting at insurance companies. Thus pros and cons aside, what is at issue is how to account for insurance contract liabilities (obligations to pay benefits as stipulated by contracts); the standards do not comprehensively cover all assets, liabilities, and equity of the insurance industry.

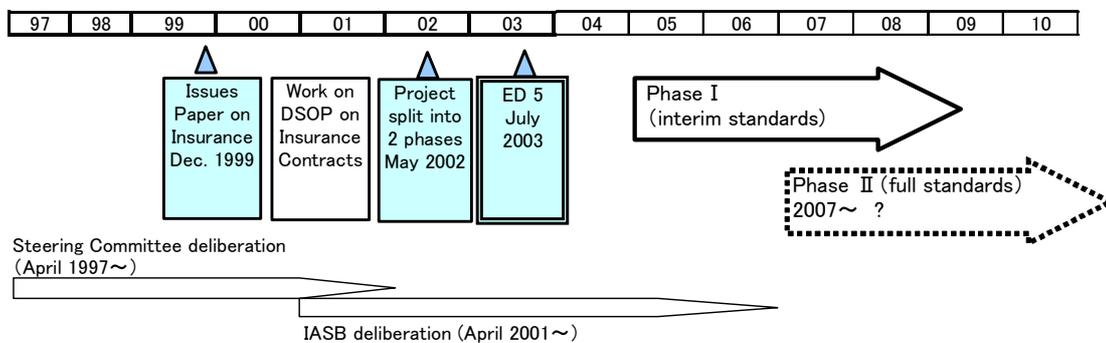
In general, insurance liabilities (called policy reserves in financial statements) are evaluated as follows:

- (Present value of insurance-related benefits & expenses in the future)
- (Present value of insurance-related income in the future)

As long as the corresponding amount of assets are held, future benefits and expenses can be sustained. The accounting issues that arise are:

- how to estimate insurance-related benefits & expenses in the future (death benefits, maturity benefits, etc.),
- whether to include insurance-related operating costs,
- estimating how long insurance contracts will remain in force, and
- how to set the discount rate for calculating present value.

Figure 1 Schedule for Adoption of International Accounting Standards



2. Valuation of Insurance Liabilities in Japan

The basic approach to valuation in Japan is as follows. The basic rates used in premium calculation at the time of issue subsequently remain unchanged (such as the mortality rate and guaranteed yield). Thus regardless of current interest rate levels, the initial interest rate is fixed or “locked-in,” as opposed to the “lock-free” method, in which rates are recalculated at the time of valuation.

However, to recognize losses early, future balance predictions are required. Thus if the predicted future balance indicates that current policy reserves are insufficient to sustain benefits in the future (that is, if future losses are recognized), additional provisions are made to policy reserves.

Basically, the policy reserve is calculated using a net level premium method, which excludes cost from premium income on the assumption that future income and expenses will be balanced.

Figure 2 Comparison of Insurance Liability Valuation Methods

	Method used in Japan	Fair value measurement
Basic rate for valuation	Mortality and standard rates are stipulated by law	Not stipulated
Change in basic rate	Set at inception (lock-in method)	Changed on valuation date (lock-free method)
Loss recognition	Additional provisions are recognized based on analysis of future balances	Performed automatically
Future profit recognition	Not recognized at inception	Recognized at inception

3. IASB Aims for Fair Value Measurement of Insurance Liabilities

Most members of the IASB believe that insurance liabilities are best evaluated using fair value. Under this method, liabilities are evaluated using the current interest rate and mortality rate at the time of valuation.

In recent years, the orientation toward fair value accounting has strengthened for liabilities (especially financial liabilities). For example, under IAS 19, SFAS 87, and the method used in Japan, retirement benefits are valued by predicting the value of future retirement benefits, and calculating the present value with a discount rate conforming to the current interest rate. Also, still fresh in our memory is the widespread opposition and rejection of full fair value accounting of all financial assets and liabilities regardless of the holding intention, proposed in December 2000 by the Joint Working Group, an unofficial group of the IASC (predecessor of IASB).

Since insurance contracts share some characteristics with financial instruments, the overall trend has been one that aims to implement fair valuation for insurance liabilities as well. However, as will be explained below, the biggest point of dispute is that not all participants agree on the appropriateness of fair value measurement for insurance contracts due to differences from other financial instruments.

3. Outline of Interim Standards (Phase I)

1. Accounting Standards for Insurance Contracts to be Introduced in Two Phases

The IASB (and its predecessor, the IASC) began work on establishing insurance accounting standards in April 1997 (Figure 1). However, many problems have arisen in trying to adopt the same fair value approach used for other financial instruments, mainly for two reasons: the approach is not currently used for insurance contracts in any country, and unlike other

financial instruments, insurance contracts are not traded in markets.

Meanwhile, from 2005, the EU will require all listed companies including banks and insurance companies to adopt IFRS (international financial reporting standards) for consolidated financial statements, making it necessary to create uniform standards even in the interim phase. For this reason, the IASB decided in May 2002 to divide the deliberation process into two phases, prioritizing the establishment of interim standards to meet the 2005 deadline (Phase I), and finalizing the standards in 2007 (Phase II).

2. Phase I Interim Standards—Exposure Draft 5 (ED 5)

The exposure draft for the interim standards (ED 5) was published on July 31, 2003. Its contents are briefly described below.

1. Basic approach

To avoid the practical burden of revising standards twice, the interim standard basically adheres to the current accounting standards of each country. However, it proposes to abolish in principle those practices that do not conform with the IASB's conceptual framework for financial statement compilation and reporting. For example, as will be discussed below, since catastrophe and equalization provisions are not defined as liabilities, they should not be recognized as such.

2. Loss recognition test

While adhering to current standards, to ensure appropriate insurance liability valuation, insurance companies must perform a loss recognition test. If small relative to future cash flow estimates, liabilities must be increased and losses recognized.

3. Reporting and disclosure

Disclosure will be strengthened with three disclosure principles:

Principle 1: disclosure to identify and explain amounts related to insurance contracts reported in the balance sheet, income statement, and cash flow statement;

Principle 2: disclosure to users of the estimated amount, timing, and uncertainty of future cash flows from insurance contracts;

Principle 3: disclosure of the fair value of insurance assets and insurance liabilities.

Of the above, the majority of criticisms have been aimed at the third principle's fair value disclosure of liabilities slated for 2007, which would begin in the fiscal year starting on or after January 1, 2006.

4. International Response to Interim Standards

1. Summary of Comments

As of the October 2003 deadline, comments had been received from approximately 130 companies, associations, and individuals. The main points are summarized as follows:

1. Almost all comments oppose the fair value disclosure of liabilities starting in January 2006.
2. Many also oppose the sunset provision (nullifying the IFRS that excludes insurance at the end of Phase I, without waiting for the end of Phase II deliberations).
3. Many express concern regarding the mismatch of valuation methods for assets and liabilities.

In addition, many comments go beyond the interim standards in the exposure draft and address the direction of the final standards. Opinions regarding fair value measurement by country (limited to life insurance) are as follows:

1. The U.K., Canada and Australia basically support fair value measurement of liabilities.
2. Japan, the U.S., and Germany oppose fair value measurement.
3. The International Association of Insurance Supervisors (IAIS) does not take a position, but emphasizes that the model should be adaptable to supervisory purposes and needs.

2. Outstanding Issues

1. Fair value disclosure of liabilities from January 2006

Opposition to this measure is almost unanimous for the following reasons:

- since agreement on fair value is unlikely and no detailed guidance is provided, disclosure is premature, and
- practical implementation is difficult if comparisons with the previous fiscal year's results become necessary.

In response to strong opposition, the IASB retracted the fair value disclosure proposal at its November meeting.

2. Mismatching of assets and liabilities

Another important issue is how to deal with the mismatch in valuation method for assets and liabilities. All countries currently use the amortized cost method for liabilities (which is not significantly influenced by interest rate trends). If assets are valued using IAS 39 (*Financial Instruments: Recognition and Measurement*), a mismatch occurs between assets

and liabilities, increasing the volatility of equity (assets minus liabilities). The concern is that this mismatch would misrepresent the profit and equity conditions of life insurance companies, whose business has a long time horizon.

In fact, the only major countries that have adopted IAS 39 as a basis for fair value accounting of financial instruments are the U.S. and Japan. Both countries have thus already been exposed to the increased risk of volatility of equity.

In the U.S., while debate surrounded the introduction of FAS 115 (to which IAS 39 and Japan’s fair value accounting method for financial instruments conform), no major problems subsequently arose. This is attributed to two factors: (1) after the introduction, interest rates declined gradually and have not risen significantly, and (2) since common stocks comprise only 2-3% of assets held in the general account, stock price fluctuations have a relatively small effect.

In Japan, a new asset category has been established for life insurers called “debt securities earmarked for policy reserve” (DSR) to enable appropriate interest rate risk management. Previously, when amortized cost was applied to bonds held to maturity, even a partial sale of these bonds led to their reclassification as other securities. Since this constraint was deemed inappropriate, a special “available-for-sale and carried at amortized cost” asset category was established for insurance companies on the condition that durations are matched (so that the ratio of the duration of bonds held to duration of policy reserves lies within a certain range).

To alleviate volatility caused by the mismatching problem, the IASB has considered two proposals: (1) relax the criteria for assets in the held-to-maturity category (so that under certain conditions, a partial sale would not prompt a reclassification), and (2) establish a new category of assets held to back insurance liabilities. However, the IASB maintains that ED 5 cannot recognize both proposals. Comments of major associations are shown in Figure 3.

Figure 3 Comments of Trade Associations Regarding the Mismatching Problem

Association	Comment
Joint comment of insurance associations in Japan, U.S., Austria, and Germany	Reconsider both proposals
Association of British Insurers (ABI)	No comment
Federation Francaise des Societes d’Assurances (FFSA)	Create new category of fixed-maturity assets
International Association of Insurance Supervisors (IAIS)	Create new category of fixed-maturity assets
European Financial Reporting Advisory Group (EFRAG)	Relax criteria for classifying an asset as held-to-maturity
International Actuarial Association (IAA)	Reconsider both proposals
American Actuarial Association (AAA)	No comment

In November, the Board considered the Japanese DSR precedent. However, its decision was postponed to December.

3. Catastrophe and equalization provisions

These liabilities, which aim to provide for damages and losses from catastrophic events and to equalize loss-claims over time, are reported mainly for casualty insurance. However, on the basis that the provisions are not very relevant to present policyholders and also fail to meet the criteria for liability reporting, the IASB proposes not to recognize these provisions as a liability (but instead as equity).

In response, the joint letter of the insurance associations of Japan, the U.S. and Germany maintains that the decision to eliminate the provisions is premature and should be deferred until measurement criteria are discussed in Phase II. The provisions, they argue, are important because they allow insurers to equalize loss-claims and balance out the required risk premium over time. Moreover, other comment letters agree that it is premature to simply alter one part of the liability structure in Phase I.

4. Liability valuation of investment contracts under IAS 39

By definition, in an insurance contract, the insurer undertakes material insurance risk by agreeing to compensate the insured or beneficiary if a specified and uncertain event (insured event) inflicts a detrimental effect on the insured party or beneficiary. But if the investment component of the contract far outweighs the insurance component, the contract is recognized as a financial instrument and subject to IAS 39.

However, since IAS 39 currently excludes insurance contracts, there is no established valuation method for the insurance component of these contracts. Many comments were received on this point particularly from life insurers in the U.K., where unit-linked life insurance products are common. This matter will also be addressed in Phase II.

5. Treatment of unallocated surplus under fair value measurement

IAS 39 stipulates that the difference in fair value between assets and liabilities be reported as equity. U.K. life insurers, however, have conventionally reported this amount in an intermediate category between equity and liabilities. However, ED 5 does not recognize the intermediate account, raising the issue as to how to report the unallocated surplus. Although the prevailing view has regarded equity as belonging to shareholders, U.K. life insurers now favor creating a second equity category unaligned to either policyholders or shareholders, and have cited the need to separate results into two categories—ordinary contributions to shareholders' equity, and changes in the unallocated surplus.

5. Does Fair Valuation of Insurance Liabilities Function Effectively?

With the IASB retracting its proposal for fair value disclosure of liabilities in 2006, the major issues in Phase I will shift to the finer points of the mismatching problem and disclosure. Looking ahead, the IASB will mainly aim to establish Phase I standards, and is scheduled to resume full-fledged deliberation of Phase II in May 2004.

While the issue of fair value measurement of liabilities has been settled for all practical purposes, IASB Chairman Sir David Tweedie has publicly stated that valuation methods for insurance policies have yet to be determined (*Nikkei Shimbun*, June 26, 2003). Many associations have expressed opposition to fair value measurement (including the joint letter mentioned earlier), and the preeminent issue in the future will likely be whether fair value measurement for insurance contracts is truly useful as accounting information. Extensive debate on this issue is desirable. Below we introduce several perspectives on the issue.

1. Purpose of Fair Valuation

While there are many objectives in insurance accounting, some of the main objectives are: (1) evaluating business activities for the fiscal year, (2) understanding disparities between initial plans and actual results, and (3) measuring solvency.

1. Relationship between fair value of liabilities and profits

In considering the first objective, we need to examine how the valuation of liabilities affects profits each year. The explanation below is limited to that part corresponding to death benefits.

When calculating premiums, the predicted death rate usually adds a margin of safety to historical death rates. This margin allows for uncertainties that may occur, and if the actual mortality rate is lower, dividends can be allocated.

$$\text{Policy reserves} = \text{PV of future benefits \& expenses} - \text{PV of future premium income}$$

To take an extreme case, if a safety margin is calculated into future premium income but not into future benefits & expenses, the starting policy reserve will be negative. As a result, a large profit is reported in the first year.

While this future profit is illusory, from an internal accounting perspective, the profit stream generated from product sales is meaningful as a measure of sales performance. This approach is consistent with embedded value accounting (EVA), a value-based accounting approach that is growing in use. As a profit indicator, EVA undoubtedly has information value and is useful for screening insurance companies for investment purposes. However,

EVA cannot be adopted as the primary accounting system—not only is the future profit illusory, but the embedded value information itself must be derived from another accounting system.

On this point, the method adopted in Japan recognizes profit as the necessary safety margin diminishes with each passing year. Thus the Japanese method fits the purpose of profit valuation.

For liability valuation, the IASB initially disregarded the basic rates used to calculate premium levels, instead taking an approach based on estimated mortality rates and market interest rates. However, debate ensued regarding the appropriateness of the approach, which recognizes future profit when the contract is issued. As a result, the IASB came to emphasize the basic rates used for premium calculation, concluding that “an insurer would not recognize a net gain at inception of an insurance contract, unless such market evidence is available.”

This could be construed either as moving a step toward the deferral and matching model proposed by Japan, or as reaching a compromise with proponents of full fair value accounting. In either case, there is concern that ambiguities will arise later due to the lack of theoretical consistency.

2. Appropriateness of using fluctuating interest rates to value long-term liabilities

Ordinarily, financial liabilities are mostly short-term instruments. However, insurance liabilities are long-term (long duration), and thus significantly affected by interest rate fluctuations. It is doubtful whether valuations containing such large fluctuations are compatible with the essential objective of insurance accounting. That is, profit and loss arising from interest rate fluctuations should not be treated in the same way as the ordinary business results of insurance operations. Profit should be separated into basic profit generated from business activities, and unrealized profit that is more volatile, with emphasis placed on the former. In that case, it would seem appropriate that information regarding volatility be limited to inclusion in footnotes.

3. Solvency measurement

From the perspective of solvency, while fair value measurement is partially compatible with the objectives of accounting information, immediate disclosure as financial accounting information is inappropriate, as will be discussed below.

2. Reliability of Fair Value Measurement

Unless reliability is assured, valuation methods can impair our ability to compare financial

conditions of companies, and be subject to arbitrary manipulations.

1. Interest rate used for valuation

In fair value measurement, the prevailing risk-free interest rates are used, differentiated by length of term. In practice, however, due to the insufficient supply of long-term assets corresponding to long-term insurance liabilities, it is difficult to estimate the interest rate level reliably.

2. Safety margin level

In the past, some have argued by analogy with other financial markets that the insurance market provides the necessary information to determine safety margins. However, since the liquidity of the secondary insurance market is extremely low even overseas, the fact is that risk levels cannot be derived from the insurance market. Thus other factors must be considered in determining the safety margin.

3. Valuation of insurance related options

Insurance contains a variety of options. For the insured, options include cancellation, renewal (under the same conditions as the current contract), guaranteed yield, and minimum death benefit guarantee. Because of these many options, insurance contracts cannot be valued in the same way as ordinary financial instruments. The problem stems not from poor valuation methods so much as from the low liquidity of the insurance market, which makes it difficult to apply valuation methods ordinarily used in finance.

3. Consistency with the Conceptual Framework (Suitability of Asset/Liability Model)

Two accounting models exist for insurance contracts: (1) the asset-liability model, which directly measures insurance assets and insurance liabilities, and (2) the deferral and matching model, which defers revenues and expenditures, and recognizes profit or loss over time. At present, all countries use the deferral model. But despite numerous calls from associations to continue using the deferral model, the IASB has tentatively decided to switch to the asset-liability model based on its compatibility with the IASB conceptual framework.

However, the conceptual framework requires that financial statements satisfy the conditions of suitability of purpose, reliability, and comparability. When we consider insurance contracts from the perspective of being service contracts, further verification seems warranted as to whether fair value measurement of insurance contracts sufficiently satisfies the above conditions.

4. Perspective of Insurance Supervision

According to one view, fair value measurement of policy reserves would enable solvency to be measured more directly than at present, and thus be useful from the perspective of insurance supervision and risk management to protect policyholders and verify solvency. However, if future cash flow is calculated using the current low discount rate of 1%, for example, and this amount is taken as the current value of liabilities, the underlying assumption must be questioned—whether that interest rate level will persist over the next 20 to 30 years. Such pinpoint measurement of accounting data, even if accompanied by sensitivity data (for example, the effect of a 1% change in interest rates), can produce implications in financial statements that are too strong.

Of course, this is not to deny the usefulness of fair value measurement in areas such as internal management accounting. But instead of drastically altering the framework, we need to realistically address operational issues related to fair value measurement, such as refining assumptions for predicting future income and expenditure, and considering tax issues (loss recognition for provisions to policy reserves).

Insofar as the IASB insurance contract project deals with financial accounting, it would be a mistake to think that insurance supervision will not be affected in some way. The impact is particularly large for Japan because insurance accounting, financial accounting, and supervisory accounting are not currently separated. The time may have arrived for Japan to decide whether to continue the present insurance accounting framework, or to separate out financial and regulatory accounting. In this sense, the IASB deliberations are critically important and highly influential.

6. Conclusion

Many outstanding issues remain regarding the fair value measurement of insurance liabilities, including one not mentioned in this paper—whether it should reflect the credit risk of insurance companies. While the IASB has approached insurance accounting on the premise that insurance is a financial instrument, we need to keep in mind that insurance has distinctive and unique features. As Phase II deliberations go into full swing, it will be increasingly important to persuade proponents of full-fledged fair value measurement on this point.

In addition, as Professor Kawakita of Chuo University points out, another fundamental issue to consider is how accounting information is received. Since common wisdom is not necessarily familiar with the volatility of fairly valued insurance liabilities, disseminating

asset and liability valuations based on specific assumptions could cause misunderstanding and confusion, instead of increasing transparency.

Obviously, it is risky to adopt a method that no insurance company in any country currently uses for financial accounting. If fair value measurement is to be introduced, it should be adopted in the accounting system only after adequately studying the characteristics of the valuation method and results from the perspective of internal management accounting and risk management.

The insurance contract project, which began in 1997, appears to be making steady progress as Phase I takes shape. But with the real debate on fair value measurement only just beginning, further developments at the IASB will be followed with keen interest.