

Reserving for General Insurers

– *Current Challenges and Future Opportunities*

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Friday, 22 September 2006

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Australian Insurance Accounting

– A Prelude to IFRS Phase II ?

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Agenda

- An Introduction – IFRS for Insurance
- Related developments in IFRS
- Other Issues on the Horizon
- Where we are now ?
- Impact for Australian Non-Life Insurers ?

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Insurance – Phase II

- Original Insurance Project started in 1997
- DSOP presented in 2001
- Project couldn't complete by 2005 → 2 phases
 - IFRS changes too much for a “single bite”
 - Some areas of change needed more clarification and debate (e.g. FASB viewpoint, fair value principle)
- Phase I – completed by issue of IFRS 4 in March 2004 and implemented (in Aust) through AASB changes from 1 Jan 2005
- Phase II – re-ignited in late 2004 (Std: 2009+ ?)
- Influence of parallel projects

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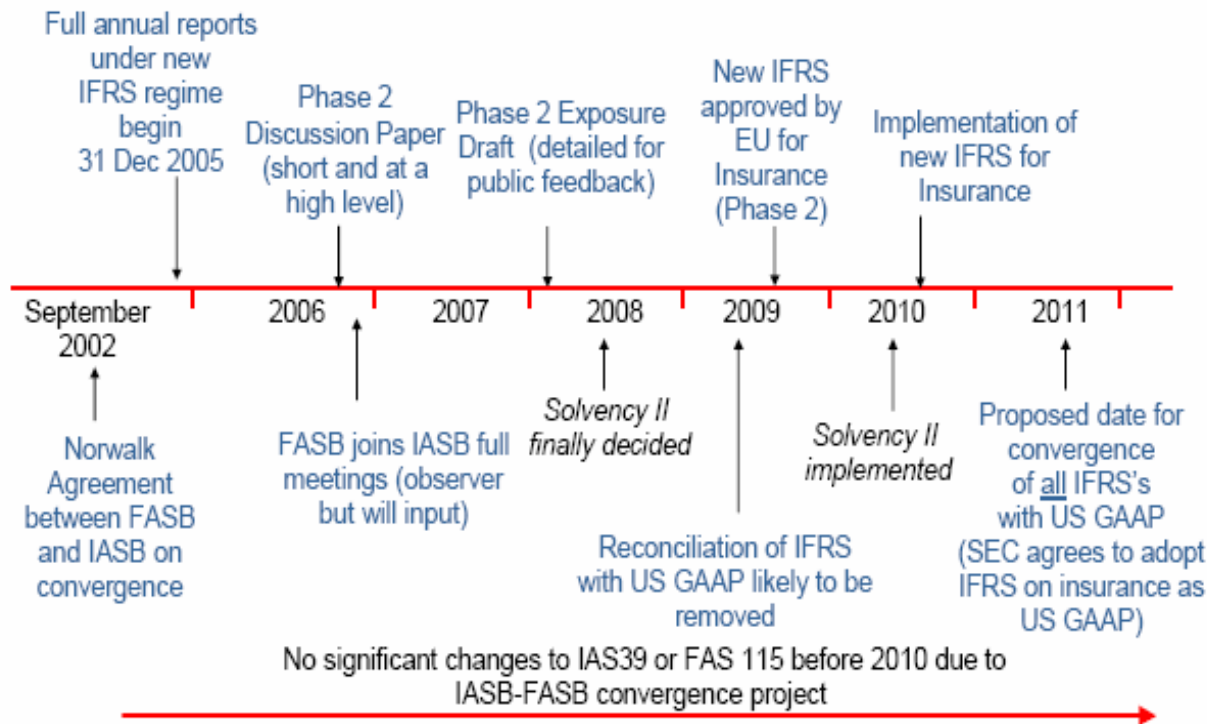


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Probable Time Scale for the Major Changes Ahead



Financial Performance Reporting standards for all companies (FASB & IASB) unlikely before 2010. IASB & FASB currently prefer a single 'Statement of Earnings and Comprehensive Income'

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User Needs Survey

- Survey used by CFO Forum to assess users' views on key needs
- Identify priorities of users including investors, analysts, hedge funds and rating agencies
- 50 responses from 220 invitees covering Europe, USA, Japan and Australia

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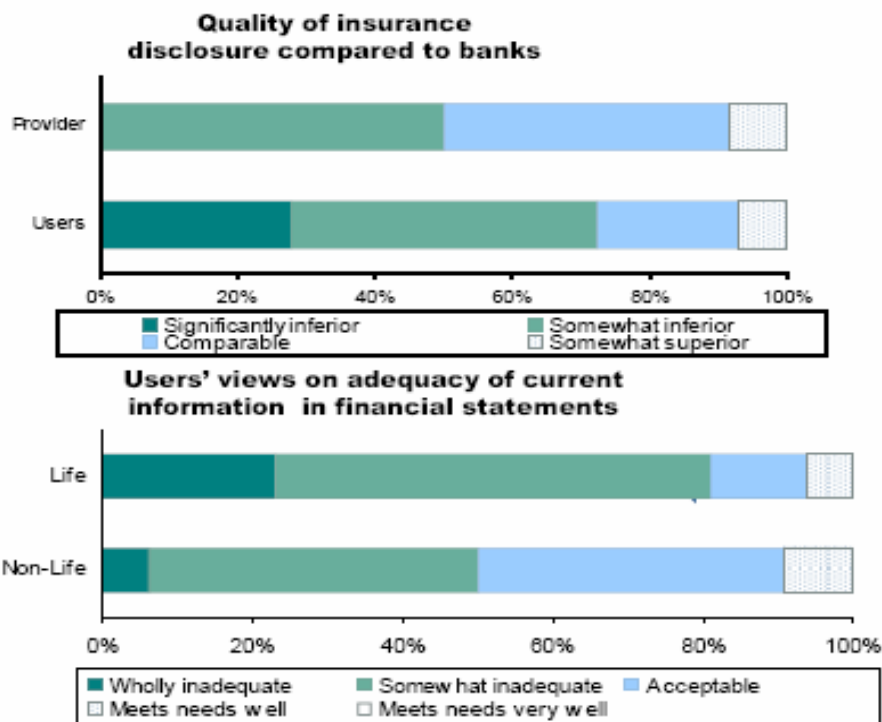


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Current situation – major difference in views between insurers and users on adequacy and quality of financial reporting and disclosure



Users consider current financial reporting by banks to be better than by insurance companies

Users are unhappy with current financial reporting by life insurers, but reasonably happy with reporting by non-life insurers

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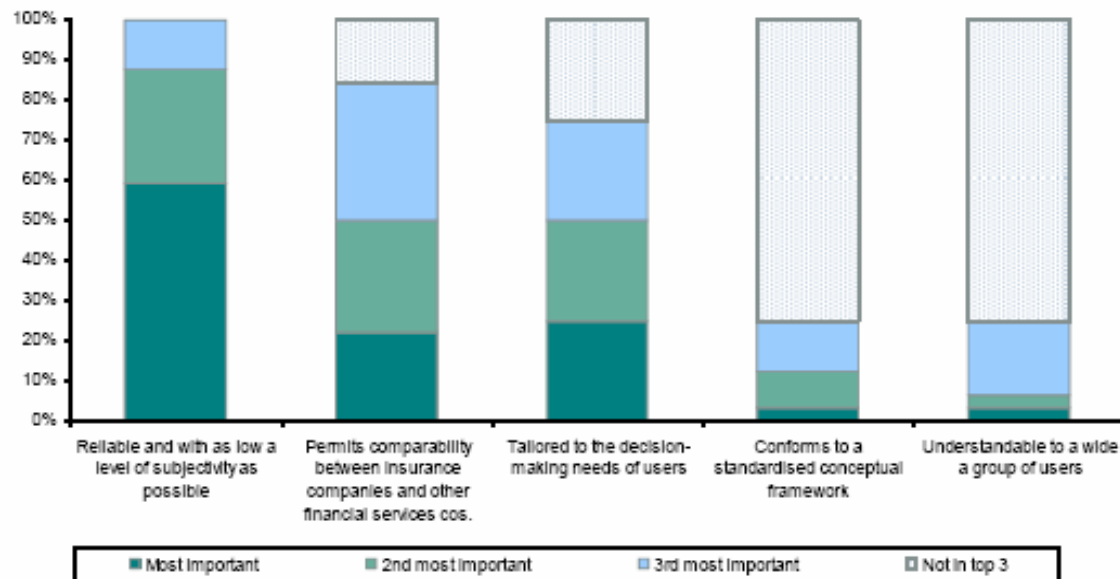


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Most important characteristics of information in financial statements of insurers



Source: User Need Survey on International Accounting

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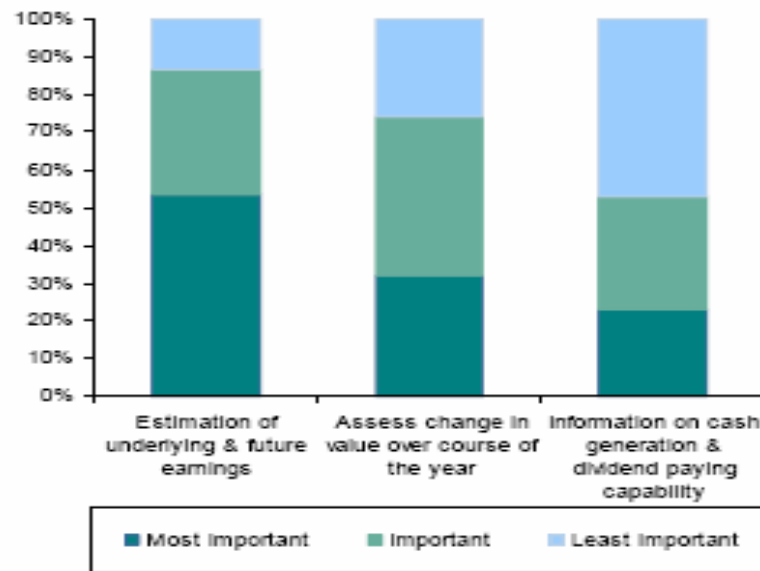


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Most important use of insurers' income statements



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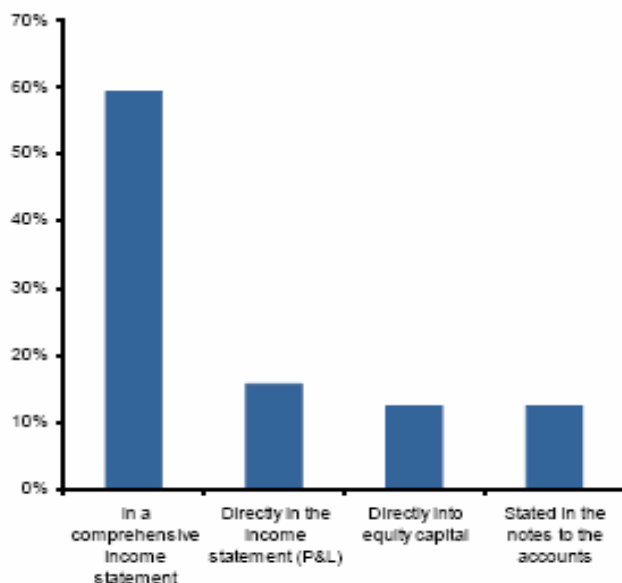


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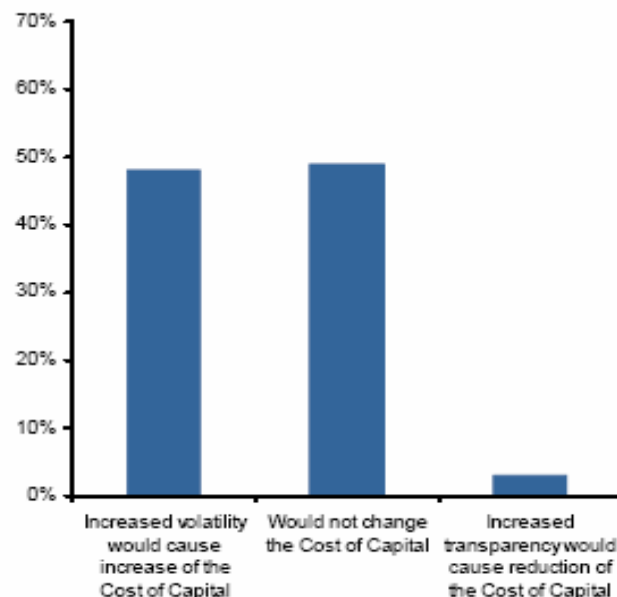
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Where should changes in market value of unrealised gains/losses be reported?



Expected effect on cost of capital of increase in volatility of reported earnings



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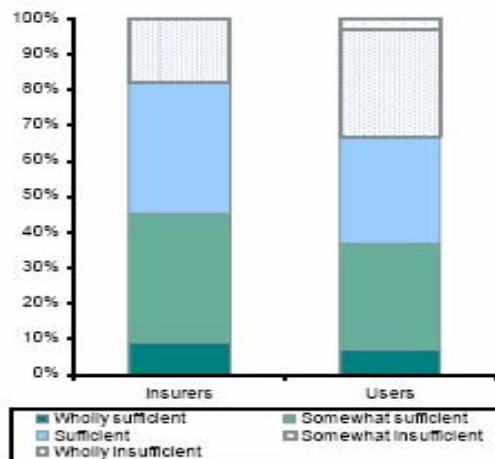
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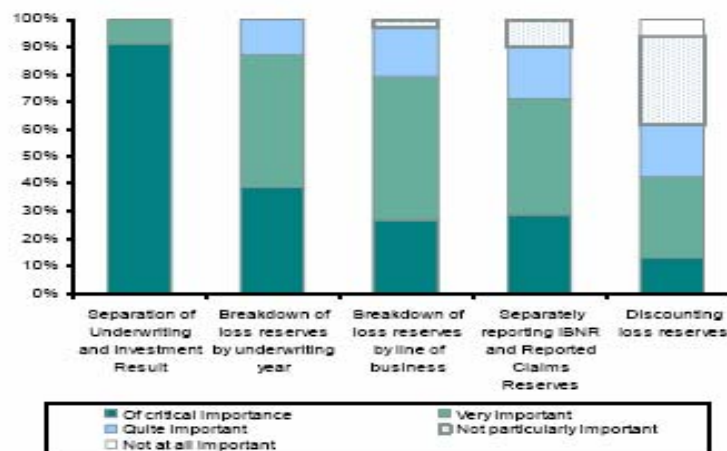
Non-Life – current information broadly adequate, but greater detail required in disclosure of loss reserves /claims provisions

Current deferral/matching approach for underwriting P&L broadly adequate



Source: User Need Survey on International Accounting

Importance of different components of Non-Life P&L and Balance Sheet



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Conclusions from Survey

- There is a significant mismatch between the actual and preferred quality of financial statements
- There is also a significant mismatch between the views of users and preparers on this issue
- More detailed disclosure is needed of information relevant to users
- Users are generally concerned with understanding the key drivers which will allow them to improve forecasts for the future performance of the business
- Reliability of information should be improved and made less subject to subjective management decisions

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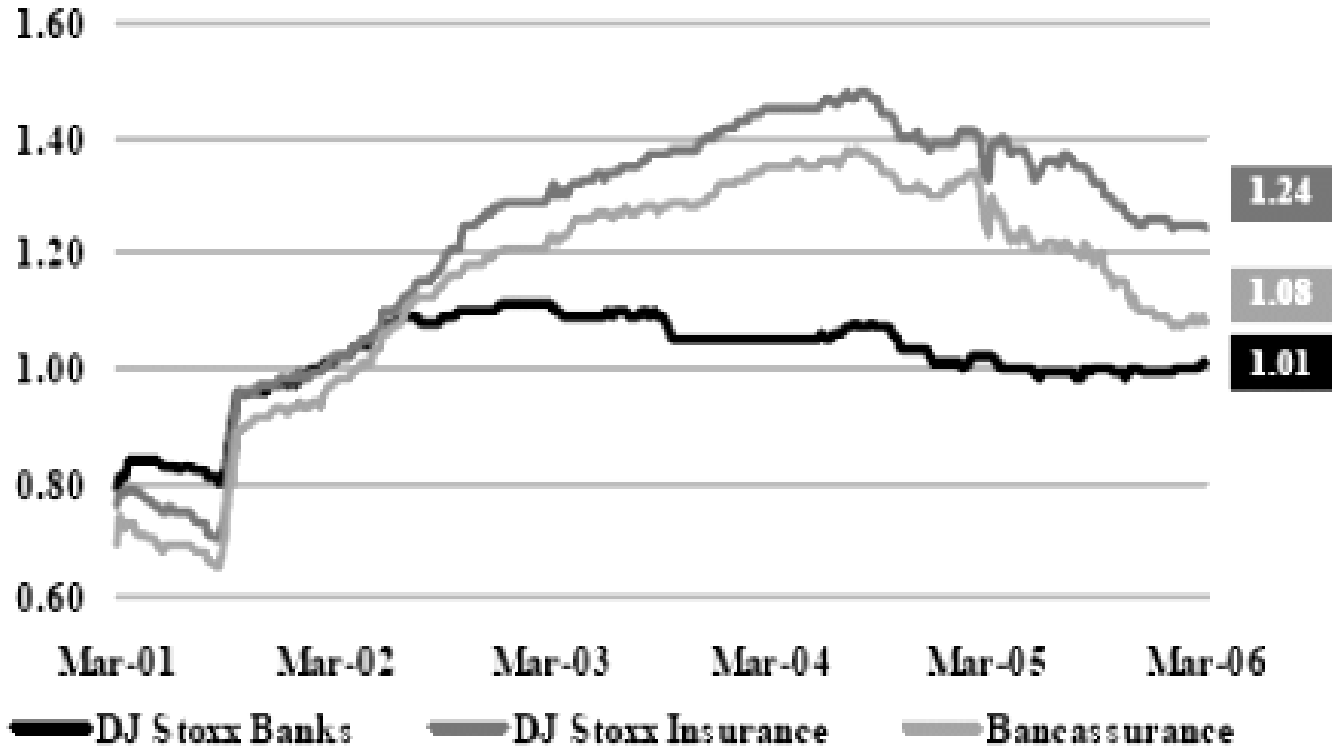


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Beta of European Insurers, Banks and Bancassurers ⁽¹⁾



Source: Lehman Brothers

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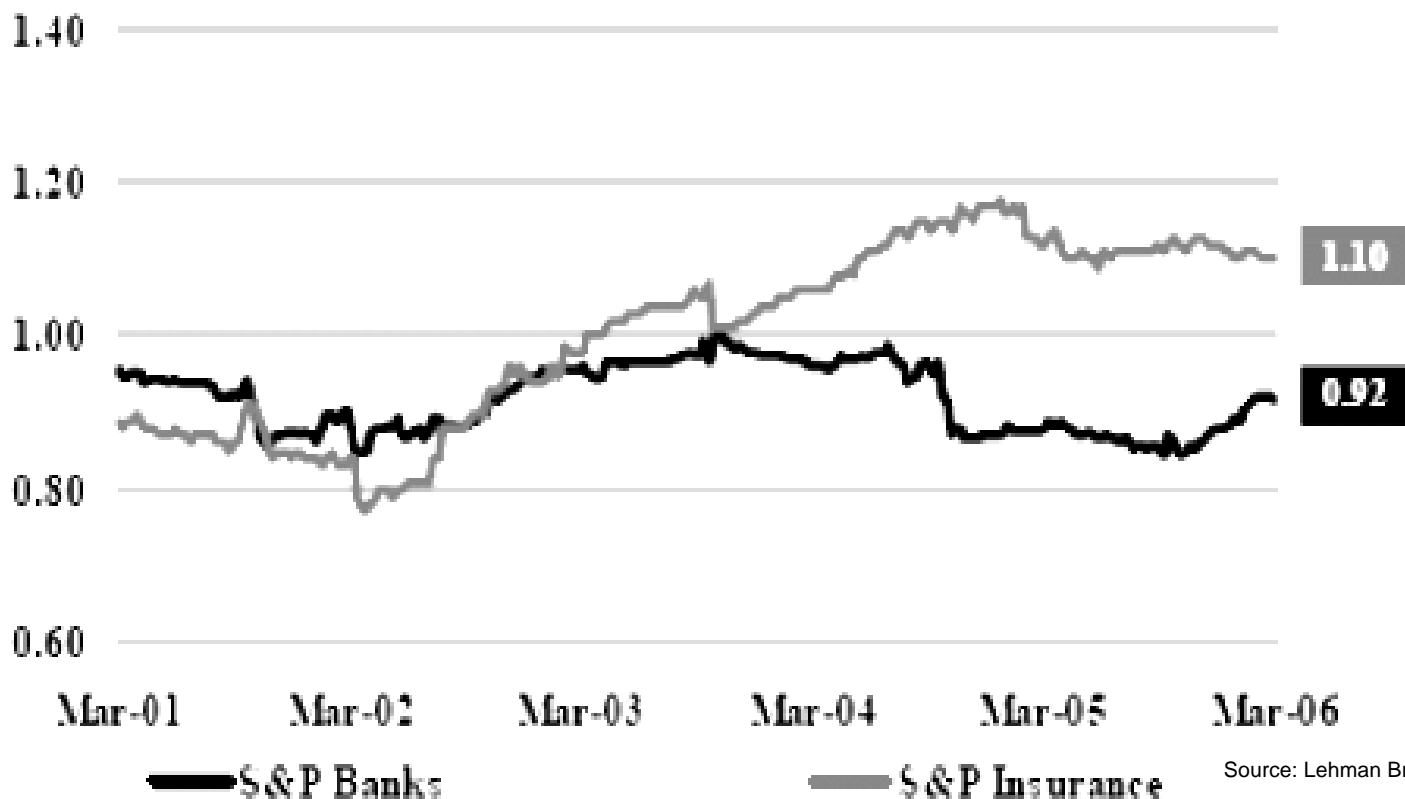


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Beta of US Insurers and Banks



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IASB Concepts & other Projects Related to Phase II

- Accounting Framework changes
- The philosophy of “Fair Value”
- Financial Instruments – IAS39
- Revenue recognition – will insurance be the “tail wagging the dog” ?
- US GAAP and IASB convergence

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Phase II – The Accounting Framework

- The outcome needs to reflect the Accounting Framework – i.e. allow for transparent, prospective view of measurement of risk
- Consistency of accounting treatment for assets and liabilities vs. potential impact of IAS 39

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Conceptual Accounting Frameworks

- **FASB (in “Concepts Statement No 1”)** :
“...Financial reporting should provide information to help investors, creditors, and others assess the amount, timing and uncertainty of prospective net cash inflows to the related enterprise” (para 39)
- **The IASB framework:**
“The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation” (para 15)

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Potential to manipulate

- **Is malleability a problem?**
 - Reliable numbers mean investors can make sound decisions
 - Bad numbers lead to loss of confidence in markets and shareholder loss
 - Concerns on “hidden” liabilities e.g. environmental (carbon / water etc)0
- **Potential to manipulate increases**
 - As businesses become more complex and more “knowledge” based
 - Move to “fair value” accounting

Study from Harvard and Chicago University found ample evidence of tinkering at delicate moments before acquisitions, equity offerings and exercising stock options e.g. inflated assumed rate of return on pension fund assets thus flattering profits, health care liabilities, stock options not expensed, etc

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IFRS – Impacts on Corporates

Traditional accounting

Largely static and objective
But often irrelevant historical costs
e.g. derivatives, options, swaps

Fair value accounting

Updates items regularly in order
To try and capture current value
But more malleable

- In June 2005, America's SEC endorsed shift to fair value accounting which it thinks will
 - lead to more realistic accounts and
 - reduce firms interest in structuring transactions to meet accounting goals
- FASB release in late 2005 on guidance on how to apply fair value devising “hierarchy” of items based on hardness to value

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“Fair” Value - Issues and Risks

- **More volatile profits**

- Any change in Company's Balance Sheet is taken into Profit & Loss A/c

- **More reliance on estimates**

- Many items are not traded in liquid markets & lack verifiable price
- Determining “fair value” involves complicated models based on subjective estimates
- At best estimates are difficult for investors/auditors to verify or compare across companies
- At worst unscrupulous could manipulate models to flatter bottom line e.g. Enron

For example, research shows fair value of bank loans can vary widely depending on inputs/methodologies. Market values for lower-rated corporate bonds, one possible benchmark, can vary by as much as 2 – 5% giving managers leeway to fiddle with numbers

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Fair Value Solutions & Consequences

Potential solutions

- Disclose assumptions behind estimates
- Disclose how different assumptions would affect profits
- Reveal whether estimated values have altered over time & why
- For key items show historical cost & updated fair value explaining derivation
- Objectivity and independence of those making estimates and those verifying them
- Harder scrutinising of numbers by investors
- Better disclosure e.g. how much profits are based on facts compared to estimates, how previous estimates panned out

Similar issues
that actuaries
face

Consequences

- Encourage managers to value things realistically
- Highlights difficulty of measuring a firm's performance – a complex subjective notion which cannot be captured in a single profit figure
- Helps investors decide whether estimates are fair or foolhardy and to think harder about what a business is worth

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So - What issues does this raise ?

- When can we measure “Fair Value” reliably ?
- What do we do when we can't ?
- Are we monitoring and reporting risk issues adequately ?
- How are others dealing with problems we also have to deal with e.g. estimates, assumptions, judgements ?
- What impact will this form of reporting have on investment decisions ?
- What is the relationship between profits, risk and share value ?
- Are the rules resulting in appropriate outcomes and behaviours ?
- Are we considering all of the issues that we should be ?

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Phase II – Fair Value Issues

- “Full” fair value or compromise approach (based on latest IASB proposal)?
- Credit risk adjustments (discount rate)
- Disclosure requirements
- Source of “market value” risk margins – entry vs. exit calibration
- Reliability of assessment

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Phase II – Risk Adjustment

- **Non-Life vs. Life**
 - Progression – simple to complex
- **Stochastic approach issues:**
 - Choice of PoS/PoA vs “Cost of Capital” approach
 - Unit of Account ?
 - Diversification effects
- **Deterministic approach issues:**
 - Lack of transparency
 - Lack of consistency

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Phase II – Revenue and Contract Liability Recognition

Consistency in General Recognition Issues – e.g. identification of legal obligations and “constructive” obligations, recognising that legal and constructive definitions vary by jurisdiction

Other Detailed Recognition Issues

– DAC identification, differences by life/non-life etc (may encompass “Origination” costs rather than just “Acquisition” costs)

Substantial Cultural Differences

regarding various contractual forms based on civil law (Napoleonic) vs. common law (Anglo-Saxon) origins

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Phase II – Issues Specific to Life Insurance

- Policyholder Options and Behaviour
 - Including allowance for renewal premiums, other continuation issues and minimum deposit floor
- Performance Linkage
 - Non-guaranteed elements, discretionary par features (timing only or not), legal context etc.
- Participating Business
 - IASB debating – when is it equity vs liability ?
 - Answer appears to be “Equity” with some exceptions
 - IAA completing a survey of types of par business around the world

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Phase II – FASB and IASB “Modified Joint Approach”

- Background: Major differences in US GAAP and IFRS principles, which created opposition to change by FASB
- Solution: Discussion paper initiated by IASB to enable convergence in approaches
- Current progress: Slow – FASB has recognised difficulties caused by not splitting service from risk (because US GAAP includes no definition of “contract”)

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Phase II – Pressure on US GAAP

- Recent focus by US regulators on finite reinsurance
 - Contracts regarded as “bread and butter” (in the US) now being challenged for existence of risk transfer (e.g. General Re and AIG)
- SEC identification of the need for IFRS recognition
 - EU/SEC agreement on a “roadmap” for elimination of the need for companies using IFRS to reconcile with US GAAP by as early as 2007

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Phase II – The Australian Situation

- Phase I represented a positive step in the liability area e.g. Liability Adequacy Test, mandatory Risk Margins
- Australian approach to many Phase II issues appears to be finding favour with the IASB e.g. prospective accounting approach in general, using discounting and risk margins with appropriate disclosure - all supported by IASB conclusion for non-life business in May 2005. (No other jurisdiction uses this combination at present)
- Recent IASB decision appears to favour elimination of Unearned Premium and DAC concepts in favour of fully prospective approach (similar to APRA premium liabilities for non-life)

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Issues on the Horizon

- IAIS – International convergence on regulation (incl capital requirements)
 - Leveraging off IFRS + globalisation
- Review of IASB Framework ?
 - “probable” / “likely” → “probability weighted”??
 - “stand ready” obligations
 - IAS 37
- Insurance “risk margins” – how ?

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Risk Margins

- Liability must be based on unbiased estimate of the mean of expected outcomes
- Risk margin calibration will not be by simple use of Probability of Sufficiency
- Use of “Cost of Capital” concept likely

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Linking PoS With “Fair (Market) Value”

- Compared:
 - NPV of the Cost of Capital required to hold capital in excess of the central estimate of liabilities up to 99.5th percentile of outstanding claims distribution throughout the claims run-off, discounted at a risk free rate
 - Equivalent to initial capital needed less NPV of expected capital released as claims are settled over time
- Assumed:
 - Claims log-normally distributed (i.e. skewed outcomes)
 - CoV's constant over run-off of claims
 - Realistic returns required on capital
- Tested:
 - Short, “Medium” and Long Tailed classes
 - 1 year, 3 years and 10 years average term to run-off claims respectively



Linking PoS With “Fair (Market) Value”

Key assumptions (all considered realistic):

- CoVs used 10%, 20% and 30% for short, medium and long tail portfolios respectively
- Risk Free rate 5% p.a.
- Cost of Capital 9% p.a. & 11% p.a. (i.e. 4% p.a. and 6% p.a. over risk free rate)
- Examined various diversification effects between combinations of portfolios



Linking PoS With Market Value - Conclusions

- For classes modelled, the percentile of the liability representing a realistic result varies significantly by duration:
 - Around 55%-60% PoS for short tail
 - Around 65%-75% PoS for medium tail
 - Around 80%-90% PoS for long tail
- PoS equivalent of “Fair (Market) Value” varies according to the key risk attributes of a portfolio

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