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Impact of a Fair Value Financial Reporting System on Insurance Companies

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A Survey

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Foreword

The International Association for the Study of Insurance Economics, or by its short name "The Geneva Association", is a unique world organisation comprised of 80 chief executive officers (which is the statutory maximum) from the most important insurance companies in the world (Europe, North and South America, Asia, Africa and Australia). It is a non-profit organisation. Its main goal is to research the growing importance of worldwide insurance activities in all sectors of the economy. It tries to identify fundamental trends and strategic issues where insurance plays a substantial role or which influence the insurance sector. In parallel, it develops and encourages various initiatives concerning the evolution - in economic and cultural terms - of risk management and the notion of uncertainty in the modern economy.

The Geneva Association also acts as a forum for its members, providing a worldwide unique platform for the top insurance CEOs. It provides a framework for its members to exchange ideas and discuss key strategic research issues, especially at the General Assembly where once per year the top insurance CEOs gather. The Geneva Association serves as a catalyst for progress in this unprecedented period of fundamental change in the insurance industry. It seeks to clarify the key role that insurance plays in the development of the modern economy.

Following its 29th General Assembly in Washington in June 2002, attended by over 60 of the CEOs of the most prominent insurance companies worldwide, it was decided to establish a special Task Force on Accountancy. This Task Force is chaired by Mr Claude Bébéar (President of the Surveillance Board, AXA Group) and Drs Jan Holsboer (Former President of The Geneva Association). Its aim is to research the critical accounting issues facing the insurance industry and to help facilitate the dialogue with other concerned/interested parties. It is to this end that the Task Force has appointed a Rapporteur, in Professor Gerry Dickinson, who has carried out extensive research into the issue of financial reporting standards for insurance, supported by the Task Force Members (usually the CFOs or Chief Accounting Officers of our members' companies). Professor Gerry Dickinson wrote a first report in February 2003 entitled "The Search for an International Accounting Standard for Insurance" that highlights the historic development of financial reporting standards for insurance and discusses the key challenges that any further development would face.

This second report to The Geneva Association's Task Force is a joint collaboration between Professor Gerry Dickinson and I. The report provides an empirical analysis of the views of insurance companies on the likely

impact that an international financial reporting standard based on a full fair value methodology, if it were to be introduced, would have on a number of their key corporate policy areas. In our opinion, the best way to assess empirically whether business decisions will be affected by a major change to a new reporting system is to ask top management who makes these decisions. Hence to collect this information, a questionnaire was sent out to the CEOs of a sample of leading international insurance companies during 2003. The questions were designed (and the design verified by third parties) in an unbiased way so that management could give positive or negative views on a fair value accounting system. These questionnaire responses were supplemented with information from follow-up interviews and discussions with a selection of senior management within the companies that had replied. These discussions allowed an elaboration of the points raised in the questionnaire and provided additional insights.

It is very important to note that this report is not a Geneva Association or insurance industry position paper. There are no Geneva Association position papers since this organisation is concerned with research only and abstains from any lobbying whatsoever. It is a research document that has been elaborated by The Geneva Association, namely Professor Gerry Dickinson and I, with the help of the Task Force. While the members, and especially Board Members of The Geneva Association, support the general idea of advancing the discussions in this area, they do not necessarily agree on each and every single point of the report. They are free from taking any personal and/or company positions now and in the future. However, their dedicated support and willingness to sponsor the analytical work underlines the seriousness and relevancy of the issue to them. They hope to open up the dialogue with other stakeholders and increase understanding of the issues at hand and raise the quality of the debate through the creation of solid analytical research work.

It is hoped that the findings of the research investigation, based on survey results, will be of value to policymakers, users of financial statements, regulators, and the IASB itself, and help to ensure that any new international financial reporting standards for insurers that eventually emerge are economically sound and feasible.

Patrick M. Liedtke
Secretary General
The Geneva Association

Executive Summary

This second report to The Geneva Association's Accountancy Task Force provides an empirical analysis of the views of insurance companies on the likely impact that an international financial reporting standard based on a full fair value methodology, if it were to be introduced, would have on a number of their key corporate policy areas.

The survey of a sample of leading international insurance companies and the follow-up interviews with CEOs, CFOs and other senior staff reveal a number of important issues:

- First, no insurance company in the forty international insurance companies that participated in the survey currently uses a full fair value system as a general accounting model for internal planning and control, nor would any company wish to do so voluntarily.

- Secondly, senior management in insurance companies consider that they would be under some pressure to change their internal accounting systems over time to realign them more with a new financial reporting system. This is in part to be consistent with investor and other user perceptions and in part because it would be costly and confusing to have two very different accounting systems running side by side.

- Thirdly, the introduction of a full fair value reporting system would significantly change the business strategies, corporate policies and systems over time in a way that most companies consider would reduce their competitiveness.

- Fourthly, there is a high degree of agreement that the higher volatility of reported earnings would increase the cost of capital of insurers and that it would be more difficult to provide earnings' forecasts or forward-looking information to the investment community.

- Fifthly, most insurers consider that measuring the fair value of insurance liabilities (insurance contracts) would be very subjective and there might be compliance problems under the Sarbannes-Oxley Act.

- Sixthly, a majority of companies perceive that the disclosure of fair values of insurance liabilities, even if they could be measured credibly, would be unlikely to increase the transparency of financial statements to users, but a significant minority, all outside of the United States, consider that it would increase transparency to some degree over the prevailing national reporting standards. However, nearly all companies consider that this

increase in transparency should be provided in the notes to the accounts rather than distorting the primary financial statements.

- Seventhly, there is a broad consensus that a full fair value reporting system would have some adverse impact on the risk transfer role that the insurance industry plays within the wider economic system.

Impact of a Fair Value Financial Reporting System on Insurance Companies: A Survey

by Gerry Dickinson[1] and Patrick M. Liedtke[2]

1. Introduction

This research report is a sequel to our earlier report: 'The Search for an International Accounting Standard for Insurance'. It is hoped that the findings of the research investigation, based on survey results, will be of value to policymakers, users of financial statements, regulators, and the IASB itself, and help to ensure that any new international financial reporting standards for insurers that eventually emerge are economically sound and feasible.

2. Neutrality of financial statements and consistency with internal accounting systems

To assist the quality of decision-making by investors, financial analysts, and other users of financial statements, reporting standards should ideally reflect the internal accounting systems that preparers employ internally to run their businesses. In developing reporting standards this ideal cannot always be achieved, but if there is too great a disconnect then financial statements will fail to meet one of their main purpose: 'the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions' (see International Accounting Standards Board's 'Framework for the Preparation and Presentation of Financial Statements', F12-14, which accepted the IASC's Framework issued in 1989). The Financial Accounting Standards Board, the US standard setter, focuses even more on the shareholder and creditor needs: 'to provide information that is useful to present and future investors and creditors and other users in making rational investment, credit, and similar decisions (Concepts Statement No.1 'Objectives of Financial Reporting by Business Enterprises' (FASB, 1978). If internal financial systems differ significantly from those used for external reporting in the published accounts, investors and other users will find it harder to monitor trends in the underlying financial performance of preparers over time and to assess company earnings' forecasts and other financial forecasts.

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[2] Secretary General of The Geneva Association.

There are commercial incentives on company management to ensure that the needs of investors are kept as a central focus, and those of other users of published accounts, such as creditors, financial analysts, regulators and rating agencies. How performance is reported through financial statements, and how management expects investors and other users to respond to this information, can influence the way that management run their businesses. When a financial reporting system deviates significantly from what companies prefer to use internally, if based on best management practice, this potential distortion is likely to be greater. The difference between internal and external accounting systems and the extent to which management change their policies in response to an external reporting system are both questions that require empirical analysis and verification. This is especially so when there is a major change in the financial reporting system, as would be the case if the IASB (as the IASC before it) sought to implement its long-term ambition of a financial reporting system for all financial instruments measured at fair values (see Issues Paper on Insurance (1999) and Financial Instruments Joint Working Group's Draft Standard (2000)).

A financial reporting system should not change significantly the strategies and operating policies of companies; as its name implies, it should report objectively on a company's financial performance, providing users with relevant and objective information to allow them to make informed decisions. The potential impact of an induced change in businesses practices from a change in financial reporting practices could have a wider economic impact when these enterprises are insurance companies and commercial banks. This is because insurance companies and commercial banks perform a key underpinning role within the wider financial and economic system. The relevant questions here are: would a mark-to-market reporting system, which is short-term by nature, cause insurance companies and commercial banks to shorten the planning horizons for their corporate strategies and operating policies; reduce the duration or risk transfer characteristics of the financial products that they offer to consumers; or place an undue short-term emphasis on their own risk management policies? If any of these were to occur to a significant degree, these financial intermediation roles could be undermined, with attendant costs to the wider economic system.

3. Aims of the research report

The report provides an empirical analysis of the views of insurance companies on the likely impact that an international financial reporting standard based on a full fair value methodology, if it were to be introduced, would have on a number of their key corporate policy areas. The report aims to:

(a) Assess the potential impact on the strategies and business models that management use to run their companies.

(b) Assess the potential impact on existing product offerings, and on future product development.

(c) Assess the potential impact on investment policies and asset allocation decisions.

(d) Explore the extent to which internal financial management systems used by within insurance companies would be influenced over time

(e) Explore the consistency between current internal asset-liability risk management systems with those based on a fair value approach.

(f) Estimate the direct and indirect cost associated with the introduction of a new reporting system based on full fair value.

(g) Obtain views on how full fair value reporting would affect the ability of insurers to provide earnings' forecasts to the investment community.

(h) Assess whether insurance companies perceive that their cost of capital would be affected by the higher volatility of reported earnings under a full fair value reporting regime.

(i) Ascertain the views of insurers on the transparency and objectivity of a fair value reporting system compared to current financial reporting systems.

(j) Obtain views on whether the risk absorption role of the insurance industry as a whole would be affected by a change to a full fair value reporting system.

4. Information sources

The only way to assess empirically whether business decisions will be affected by a major change to a new reporting system is to ask top management who make these decisions. Hence to collect this information, a questionnaire was sent out to the CEOs of a sample of leading international insurance companies during 2003. The questions were designed in an unbiased way so that management could give positive or negative views on a fair value accounting system. Tests for potential bias were made by having the questions reviewed by independent third parties, and where there was any possibility of bias, the questions were amended. The questions differentiated between life insurance operations and non-life (P&C) insurance operations, and there were a few additional questions on reinsurance.

The questions were based on the scenario of a full fair value measurement system. A full fair value system was defined in the questionnaire in a way consistent with what the IASC/IASB has defined it to be: (i) all financial assets and liabilities (including insurance contracts) are measured in the primary balance sheets at their fair values (i.e. market values or estimated

market values); (ii) all changes in the fair values of financial assets and liabilities between accounting periods are recorded directly into the primary income statements (profit and loss accounts); and (iii) all equalization and catastrophe provisions are not considered as accounting provisions, and deferred acquisition costs are not considered as assets.

These questionnaire responses were supplemented with information from follow-up interviews and discussions with a selection of senior management within the companies that had replied. These discussions allowed an elaboration of the points raised in the questionnaire and to obtain additional insight. There were also discussions with some of the members of the Accountancy Task Force of The Geneva Association on specific points.

5. Survey respondents

Respondents to the questionnaire were 40 leading international insurance and reinsurance companies, representing the companies of the members of The Geneva Association. The respondents were leading international companies headquartered in seventeen countries: Austria, Belgium, Bermuda, Brazil, Denmark, France, Germany, Ireland, Italy, Japan, the Netherlands, Portugal, Spain, Sweden, Switzerland, the UK and the United States. Of these 40 companies, 26 supplied both life and non-life insurance, 9 were specialist life insurance companies and 5 were specialist non-life insurance companies or most of their business was non-life insurance. Most of the respondent companies have extensive international operations, as they include many of the world's leading international insurance and reinsurance groups.

The questionnaire was sent to the CEO in each of these companies who gave it to a member of senior management to complete, sometimes the chief financial officer.

6. Impact on corporate strategies and business models

Corporate strategies and business models are based on internal management accounting and actuarial systems. These internal systems have been designed and developed over time to support decision-making processes and to ensure adequate controls are in place, including internal risk management systems. In theory, external reporting systems may or may not differ much from those used internally for management purposes. And even if they do differ, they may or may not have a significant impact on the corporate policies and business models that management adopt. The answers to both of these questions can only be determined empirically, by asking the senior managers who run companies.

The questionnaire revealed that none of the forty insurance companies in the survey currently uses an internal accounting system based on full fair value, nor would they voluntarily choose to do so. Hence there is a potential for some mismatch between internal and external accounting systems. A few companies stated that they had recently tried to estimate the fair value of their assets and liabilities as one method of measuring the size of their equity capital, but no more than this. Embedded value models are increasingly used by European insurance companies for their life insurance operations for strategic planning purposes, but it was stressed that embedded value models are not fair value models.

The other general point that was brought out in the survey findings, and in the accompanying discussions, was that there is a general tendency for management accounting systems to be aligned over time to a prevailing financial reporting standard. This is because senior managers considered it important to benchmark their performance against the information that they present to investors, financial analysts, creditors, rating agencies and other users. Financial statements are considered to provide a key source of information on which the various users of published accounts decide whether a company is performing well or not. A theoretical view sometimes advanced (based on the assumption on the information efficiency of capital markets) is that investors and other users can always see behind any deficiencies in published financial statements since they possess other sources of information to assess management performance. If true, the published accounting data would be less critical. But these theories still recognize that financial statements provide an important set of information, even if they are incomplete. Irrespective of how critical the information contained in financial statements is to well-informed participants in stock markets and in other user markets, if managers actually change their behaviour because they *believe* that how they report their financial position does matter, this in itself makes the issue of potential economic and commercial significance.

The first set of questions included in the questionnaire were open-ended and sought to obtain views on whether corporate strategies and business models would be affected by the introduction of a full fair value reporting system over time, and if so, the extent to which they would be affected, positively or negatively.

The responses on the likely impact on corporate strategies and business models were clustered around five main themes: (a) areas of corporate policy that would be most affected; (b) the time horizon over which business planning decisions were carried out; (c) propensity to assume risk; (d) new investment in systems, staff retraining and changes to external communications; and (e) the impact on their competitive position in the wider financial services market. These are discussed below in more detail.

(a) Changes in corporate policies

It was considered that a full fair value reporting system would have the most influence in the following corporate policy areas and operations: (i) product offerings and product development; (ii) how funds are invested on capital markets; and (iii) internal systems for financial planning and control. The impact on these policy areas, including differences in emphasis between companies, will be discussed later in the report, as these were covered in other parts of the survey.

(b) Shortening of planning horizons

There was a widespread view that the introduction of a full fair value reporting system would shorten business planning horizons over time. This was because fair value reporting systems is a mark-to-market system. It was stated that the activities of the insurance industry are long term in nature. This applies not only to life insurance, with its focus on long-term saving and pension provision, but also to non-life insurance, especially catastrophe insurance, liability insurance and reinsurance, because of the period of time over which claims are paid. It was felt that there would be pressure under a fair value reporting system for stock markets to reward business activities with shorter pay-back periods. One view expressed was that the stock market was already myopic and a fair value reporting system would further encourage this myopia. Fair value is essentially a 'fresh start' measurement basis – being based on the value of assets if they were sold and liabilities if they were settled at the balance sheet date - and hence it was considered as inconsistent with managing a long-term business on a going-concern basis. The view was expressed that investors when they value and buy insurance shares do so as going-concerns, and not from a 'fresh start' perspective.

(c) Reduced risk appetite

A significant number of insurance companies considered that a switch to full fair value reporting would reduce their risk appetite or increase their risk aversion. One cause of this is the short-term risk emphasis implicit within a mark-to-market measurement system. Insurance companies seek to diversify risks that they assume not only cross-sectionally but also over time. This willingness to diversify risks over time is seen by insurers as a key aspect of their commercial role. Another stated cause arose from the higher cost of capital that was expected to occur from the increased volatility of reported earnings. If the cost of capital increased, this would put a downward pressure on the level of capital that management would wish to hold and hence reduce their risk absorption capabilities, especially during periods of economic uncertainty. Life insurers said that they would be more inclined to pass on insurance and investment risks to policyholders by offering contracts with fewer guarantees and less flexibility on surrender options and other embedded

options. A few companies said that they would have a reduced appetite for insurance where the potential losses have a low frequency over time but have a high severity when they do occur, such as natural catastrophes and terrorism risks.

In addition, a few companies said that there would be some market pressure on management to adopt measures to stabilize short term movements in their reported profits and the reported equity (capital and reserves), through the use of hedging strategies, including the use of new derivative or financial products that would probably be developed by the investment banks in response. This hedging would be used to minimize the perceived adverse signaling effect on investors and on other users of accounts from this increased volatility, some of which was considered to be spurious volatility since it was not related to the real risks in the underlying cash flows of the business. This induced hedging activity was recognized to be unnecessary and costly to policyholders and shareholders.

At the same time, a few insurance companies considered that a move to fair value accounting might increase market discipline and so encourage insurance prices to be set and maintained at economic levels. This also related to the pricing of guarantees and embedded options within life insurance contracts which were viewed as having been under-priced in the past. On the other hand, two companies felt that the discounting of non-life liabilities under a fair value regime could have the opposite effect by weakening underwriting standards and thus leading to uneconomic pricing. However, all companies considered that actual pricing consequences would depend on the wider competitive responses across the insurance market, which were difficult to predict.

(d) Increased investment in systems and communications

Another factor, mentioned by a number of insurers, was the increased complexity of the new reporting system and its associated internal and external costs. There would be a need to invest more in new information systems, software and staff training. In addition, several respondents said that the new reporting systems, with its higher level of volatility and subjectivity, would require more spending on external communication. This was because it was felt that investors, especially non-institutional investors, and life policyholders would be confused without these explanations. These extra costs would be mainly incurred in explaining profit or earnings figures, which would vary much more over time than at present, and would have to be accompanied by a detailed set of assumptions and qualifying statements.

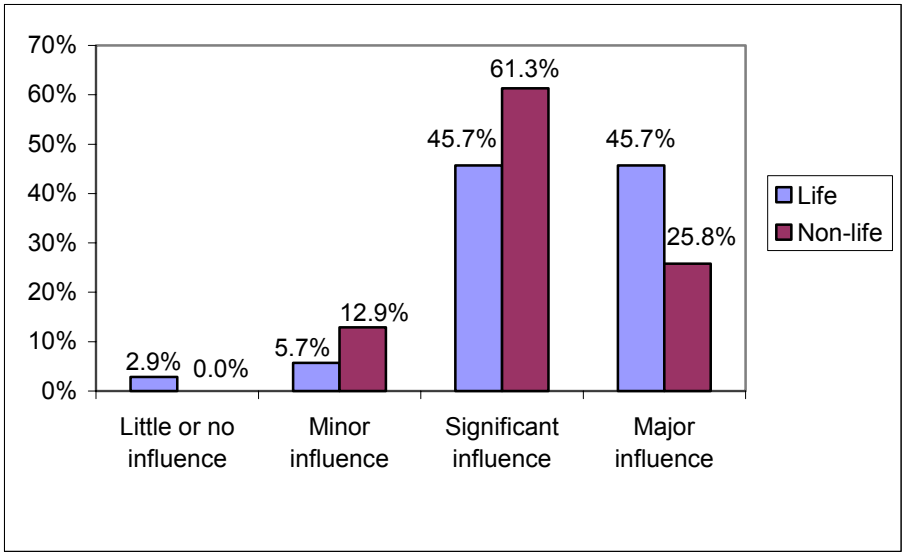
(e) Potential competitive disadvantage

There was a widespread view that if there were to be a full fair value reporting regime for financial instruments, competitors in the financial service sector, particularly commercial banks, would gain major exemptions for it. This was because the commercial banks, on both sides of the Atlantic, had been very effective over the last decade in lobbying against full fair value proposals and that they had the influential Basel Committee supporting their position. If this were to occur, a non-level competitive playing field would be created, with product arbitrage opportunities arising. This position is captured in the comment by a leading US life insurer: 'We believe that a move to full fair value could drive a change in the amount and type of products we market. If we are constrained by having a fair value system, while our competitors are not, this could impact our market share'.

Figure 1 shows the responses on the degree to which the introduction of a full fair value system would influence management thinking and the corporate strategies and business models used to run their companies. Separate responses were sought for life insurance operations and for non-life insurance (property and casualty) operations. Only one life insurer and no non-life insurer considered that the introduction of a fair value system would have 'little or no influence'. Thirty-two of the 35 life insurers, 91%, considered that its introduction would have either a 'significant or major influence', while 27 out of 31 non-life insurers, 87%, considered so.

Figure 1

Influence on corporate strategy and business models

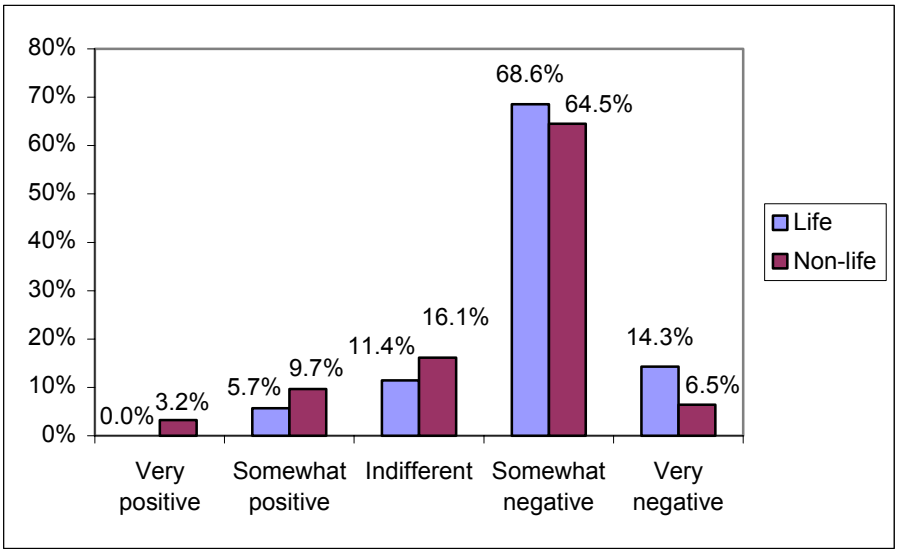


	Life	Non-life
Little or no influence	1	0
Minor influence	2	4
Significant influence	16	19
Major influence	16	8
No. of Responses	**35**	**31**

A commonly-stated reason why internal systems used to plan and measure performance in their business models would be affected by the external reporting system was the greater emphasis that management now placed on seeking to meet shareholder expectations. The trend towards quarterly reporting and the demand for more frequent information, sometimes unexpected, from the financial analysts, investors and others was also viewed as a factor reinforcing this convergence pressure. Moreover, it was considered costly, and potentially confusing in a decentralized international group, to have two different accounting systems running in parallel: one for internal use and one for external reporting.

Figure 2

Impact on corporate strategy and business models



	Life	Non-life
Very positive	0	1
Somewhat positive	2	3
Indifferent	4	5
Somewhat negative	24	20
Very negative	5	2
No. of Responses	**35**	**31**

The related question on whether management considered that the impact on their overall business strategies and business models would likely be positive or negative is given in Figure 2. For life insurance operations, there were 2 responses stating a positive effect, with 29 stating a negative effect, 6% and 83% respectively. For non-life operations, 4 companies (13%) considered the overall impact would be positive, while 22 companies (71%) considered the impact would be negative. While the overwhelming majority considered the effects would be negative for reasons discussed above, it is worth noting that there were a few companies that considered that the effect might be 'somewhat positive'. The two main reasons for this view were: (a) a fair value methodology would be consistent with their internal pricing methods; and (b) it would help reinforce their asset/liability matching policies.

A representative selection of comments made by the respondents in the questionnaire is given below:

- 'We would not voluntarily choose full fair value as currently proposed as a basis on which to manage our operations.' French insurer.
- 'We use embedded value/achieved profits internally to measure the value created by our life operations. We do not consider the IASB proposals represent true economic fair value.' UK insurer.
- 'IASB's fair value reporting proposals neglects the need to balance a portfolio of risks over time.' German insurer.
- 'Corporate strategies would change to maximize current year profit recognition.' US insurer.
- 'It is possible that the risk absorption capacity might be compromised, if insurers become concerned with the appearance of the financial statements, as under fair value one can have a negative capital base.' Japanese insurer.
- 'The anticipated volatility could discourage insurance companies to write certain types of products. On the other side, we believe that such a model could also lead to a more careful approach to the setting up of pricing assumptions.' European reinsurer.

- ‘The main effect would be on the financial reporting process with the need to explain artificial results and the impact of short term volatility.’ Portuguese insurer.
- ‘There could be significant competitive issues if banking products are not subject to the same accounting requirements.’ Dutch life insurer.
- ‘Capacity of direct insurers and reinsurers to absorb risk would be significantly reduced by the increased apparent volatility of results under a full fair value system.’ US insurer.
- ‘The degree of impact will depend upon how credible the fair value basis is perceived to be. However, as the IAS will be the main account it can be expected to affect corporate strategies and business models to some degree.’ UK insurer.
- ‘Full fair value would change internal accounting practices at a high strategic level.’ German insurer.
- ‘We believe that a move to full fair value could drive a change in the amount and type of products we market. If we are constrained by fair value, while our competitors are not, this could impact our market share.’ US life insurer.
- ‘There would be an adverse impact on profit profiles which will not reflect the true economic value creation and there would be the need to pass on an increased cost of capital to consumers.’ UK insurer.
- ‘Corporate strategies would change to maximize current year profit recognition.’ Italian insurer.
- ‘We would not only expect our product mix to change but the management of the assets supporting the insurance liabilities to become more closely linked to business results. With potentially more volatile financial statements, particularly if assets do not move in tandem, we would focus on minimizing that volatility.’ US life insurer.
- ‘The introduction of full fair value could lead to new hedging products to minimize volatility in the P&L account of insurance companies.’ Swiss insurer.

7. Impact on existing and future product offerings

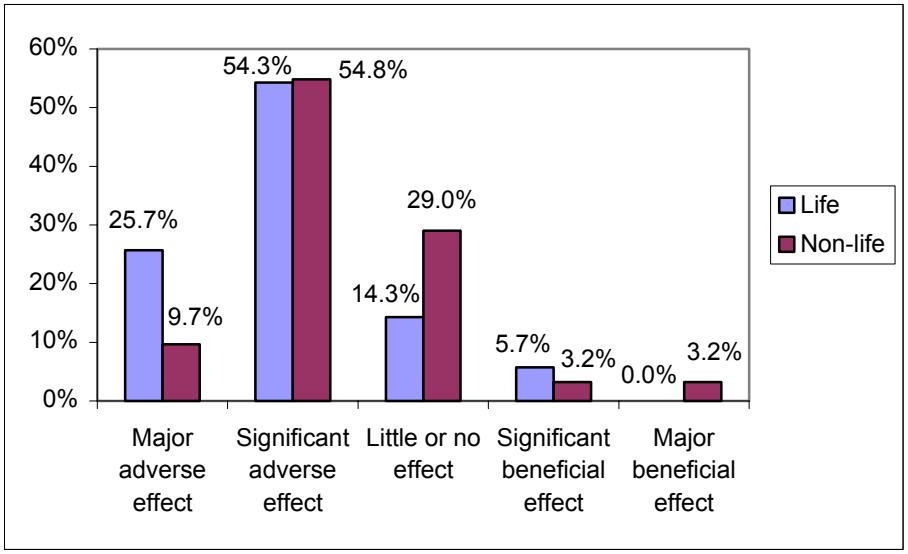
The product offerings of insurance companies are determined by the interplay of the forces of supply and demand and by regulatory restrictions on what they are allowed to supply under national insurance legislation. But what product range an insurer chooses to supply will depend, in the last analysis, on its expected profits and attendant risks. If company management considers

how it is required to report these profits and risks in its financial statements matters, this will in turn influence its product offerings over time.

The survey sought to elicit management views on whether a full fair value reporting system would be likely to impact on its existing product range, on its future product development decisions, and indeed whether some current products might be eliminated. Questions also sought to identify which products would be most affected and the degree of impact that the reporting system would be likely to have. The findings are given in Figure 3.

Figure 3

Impact on existing product range



	Life	**Non-life**
Major adverse effect	9	3
Significant adverse effect	19	17
Little or no effect	5	9
Significant beneficial effect	2	1
Major beneficial effect	0	1
No. of Responses	**35**	**31**

Eighty-six per cent of life insurers considered that the change in reporting system would have a 'significant or major' effect on their existing product range, with 14% stating the impact would be minor. A slightly less polarized position was evident among non-life insurers, with 71% of non-life insurers considering that the reporting change would have a 'significant or major'

impact, with 29% considering it would have 'little or no effect'. Of those companies viewing the change as minor, the most stated reason for this was that consumer demand, not accounting, was the main driver of product policy. One explanation for this difference between life and non-life products, a difference also evident in companies writing both classes of insurance, is that many life products are savings products and hence how financial performance is reported feeds back more directly to consumers as they are also investors.

There was a high level of agreement between companies on the types of insurance products that would be affected. In life insurance, there would be pressure to move away from long-term products, such as annuities and pensions, towards shorter term protection and saving products. Some companies observed that there would be pressure to move further away from with-profits or participating life insurance contracts towards linked-life products. There would also be a deterrent to providing consumers with guarantees, as the reported cost of valuing these embedded options would be high and the increased volatility of reported net income would be a further disincentive. On the cost of guaranteed surrender values, some companies considered that the new reporting system would assume much higher levels of surrenders than their own internal information would suggest was prudent.

There was also a broad pattern of agreement on which non-life insurance products would be affected. There would likely be a move away from longer term insurance, especially liability insurance, accident and disability insurance and workmen's compensation insurance business. One main reason for this move away from longer term contracts relates to the increased volatility in reported profits and the associated perceived increase in the cost of capital. A few companies stated that there was also an indirect potential cause. This was that discounting of non-life insurance liabilities, which is a feature of fair value reporting, would tend to put a downward pressure on insurance prices and hence decrease profitability and the attractiveness of supply. Only two companies held the view that the explicit discounting of claims might induce more economic pricing, rather than less. However, another company noted that the ability to discount liabilities for long-tail non-life insurance would allow them to underwrite this business without the capital strain under the current reporting system, providing the regulatory capital requirements in the future did not offset this advantage.

Some companies stated that catastrophe risks on property insurance would be affected as the uncertainty of placing a market value on these risks could be high and subject to major swings in value in balance sheets and income statements, as market sentiment changed over the underwriting cycle.

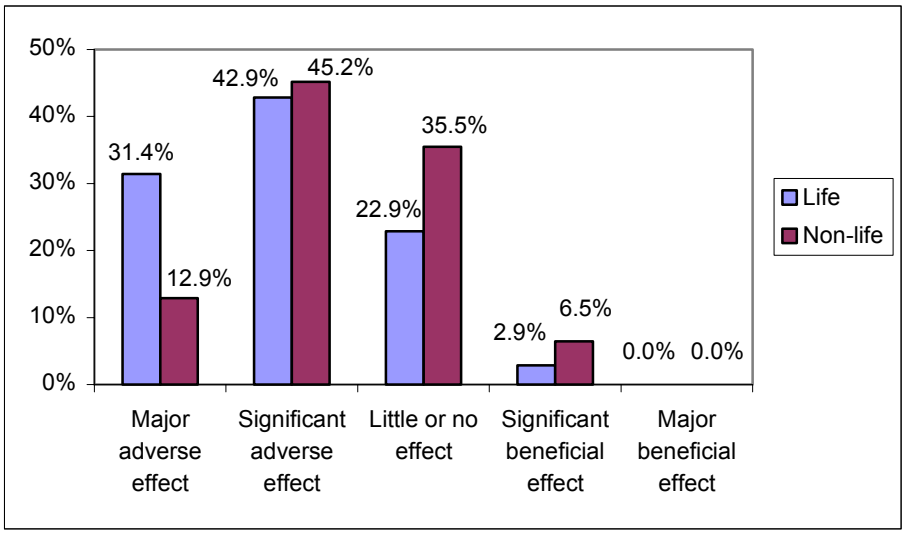
Financial reinsurance products, and some finite insurance products, would become less attractive from buyer and seller perspectives. This arose directly

from the fact that non-life insurance liabilities would be discounted and hence the accounting arbitrage opportunities arising from these products would decline.

When asked whether the impact of the change in the financial reporting system would be adverse or beneficial, 80% of life insurers considered the impact would be adverse, compared with about 6% life insurers considering it beneficial. Over half of all life insurers viewed that the change would have a major adverse effect. For non-life insurers, 55% considered the effect on their existing product range would be adverse, with a little over 6% considering it beneficial.

Figure 4

Impact on new product development



	Life	**Non-life**
Major adverse effect	11	4
Significant adverse effect	15	14
Little or no effect	8	11
Significant beneficial effect	1	2
Major beneficial effect	0	0
No. of Responses	**35**	**31**

A broadly similar set of responses was given for the likely impact on new product development, both reflecting shorter time horizons and an expected reduced risk appetite. These responses are given in Figure 4. New product development would probably focus more on life and non-life insurance

contracts with reduced durations than at present. For life and pension products, there would be a preference to supply contracts where the risks could be transferred to consumers and a lower willingness to provide guarantees, especially investment guarantees. The likely switch away from equities and other price volatile investments also induced by the new reporting regime was viewed as a factor that would drive the design of new savings products. It was recognized that in the last analysis, if there is a strong market demand for any product this would override any supply preferences. But the observation was made that experience shows that consumers are less likely to purchase life insurance policies if it is not clear to them how profits are measured, which would be the case under fair value reporting. In general, the increased cost of a complex reporting system would have the effect of reducing the range of products and place a higher priority on explaining performance to consumers.

It was also considered that the earlier profit recognition under fair value would encourage the life products to be developed that would reflect this pattern of profit recognition. The removal of deferred acquisitions costs (DAC) as an asset and its amortization over time was seen by some companies as a key issue and would probably lead to changes in marketing policies and commission payment systems, with uncertain commercial consequences.

The following are a list of comments provided by respondents to the questionnaire:

- 'Life products likely to be affected are those with long term guarantees as they could have considerable volatility of earnings.' French insurer.
- 'We believe that we might simplify our product offerings to reduce the number of options and guarantees embedded in our products.' US life insurer.
- 'It will lead to a change in distribution strategies for financial advisers and the reorganization of the new product department.' Italian life insurer.
- 'Logically companies should continue to sell products based on their contract value but there may be more pressure to sell products with higher initial profit contributions on an IAS basis.' UK life insurer.
- 'Fair value influence on P&C product range will be mostly indirect, as FV front-loads apparent profitability of long-tail liability products and therefore might encourage naïve capacity by lowering pricing into seriously unprofitable zones.' US insurer.

- ‘A positive effect will be more pressure to judge all parameters in pricing, but the very negative effect will be that economically sound products will be eliminated if their reporting effect becomes critical.’ German insurer.
- ‘Discounting could change the reporting of certain long-tail P&C business. A minor change in assumptions, such as discount rates, would result in a significant change in earnings pattern of these products. Without catastrophe and equalization reserves, catastrophe reinsurance treaties will be an area of concern.’ European reinsurer.
- ‘Yes, this would influence our new product development decisions with the company. We expect that products would be altered to fit the most advantageous accounting desired. Current US GAAP earnings’ recognition is rather close to the pricing used by our actuaries. Fair value does not relate earnings to either premiums, fees or investment spreads.’ US life insurer.
- ‘Much of the redesign of products will depend upon the yet to be decided impact of the issue of ‘unbundling’ of insurance contracts. Some products will be redesigned to meet the classification as investment contracts to take advantage of the amortized cost accounting afforded under the proposed IAS 39.’ US life insurer.
- ‘Some reinsurance products will be eliminated or drastically changed.’ US reinsurer.
- ‘Certain finite risk products could be eliminated by this accounting standard.’ European reinsurer.
- ‘We do not believe that products will be eliminated because of the accounting system, but capacity for certain product lines may well be affected.’ European reinsurer.
- ‘Certain long tail liability insurance and catastrophe exposure covers may be withdrawn.’ UK insurer.
- ‘We write high risk aviation business which might prove to be too volatile for us to write.’ US reinsurer.
- ‘Certain long tail liability insurance and catastrophe exposure covers may be withdrawn.’ European reinsurer.
- ‘Traditional life products that rely on investment in the stock market will be much affected.’ Austrian insurer.
- ‘Unless the accounting regime and market education is at an appropriate level, there is a risk of investor suspicion of the results and a tendency by companies to focus on products that are easier to explain to a wide audience.’ UK life insurer.

- ‘Investment and saving products will be most affected where the policyholder participates in the investment return.’ French insurer.
- ‘Longer term products where shareholder value is crystallized after many years might be adversely impacted.’ UK life insurer.
- ‘Discounting of loss reserves would allow for longer-tail products to be offered without a negative accounting impact on capital.’ Swiss insurer.
- ‘It does not measure economic value creation and will lead to repricing and possibly cause us to stop selling certain insurance products, including pensions and annuities.’ UK insurer.
- ‘The introduction of a full value reporting system is likely to induce the development of new products. However, it is difficult to predict whether it will have positive or negative effects. If deferred acquisition costs do not qualify for capitalization, commission rates could be structured in a different way to allow for the desired accounting result.’ Swiss insurer.
- ‘We might be more conservative when underwriting longer term and fixed benefit insurances because they would be more susceptible to changes in assumptions. However, these types of insurance are our main products and as long as consumer demand exists it is difficult to imagine that the product line would be eliminated due only to the introduction of this new accounting system.’ Japanese life insurer.

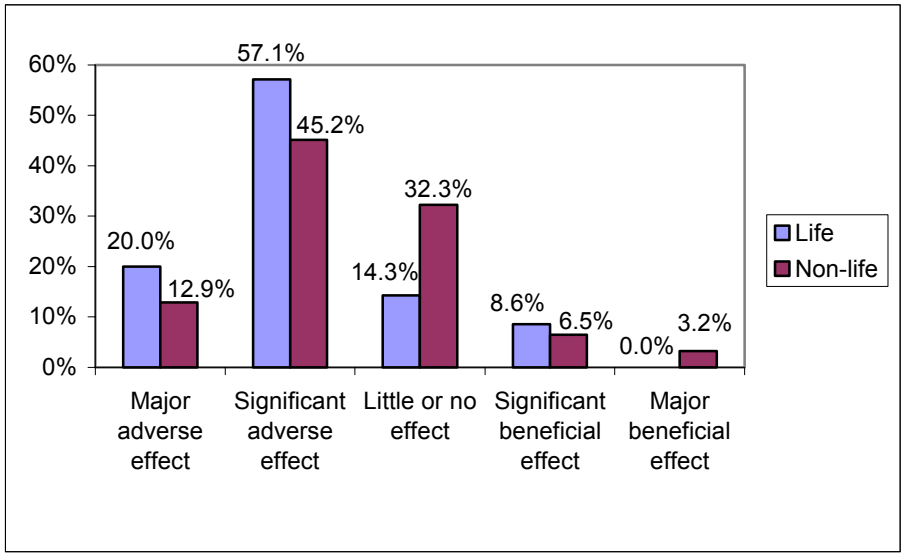
8. Impact on investment policies and asset allocation decisions

A central aspect of the management of an insurance company is its investment policy. A high proportion of the total profitability from insurance operations arises from the investment returns that are earned on financial asset holdings. This applies to both life and non-life insurance operations, but it is much more important in life insurance because of the long-term nature of policyholder liabilities and because a significant proportion of business represents long-term contractual savings. In many countries of the world, insurance companies are the largest institutional investors. If the introduction of a full fair value reporting system were to induce significant changes in these investment policies, this would not only have implications for shareholders and policyholders but also for the structure of capital markets.

The questionnaire sought to determine whether a move to a full value system would be likely to influence the investment policies and financial asset allocation decisions of insurers. And if so, how investment policies might change and what degree of change would likely occur. The questionnaire also sought to ascertain the extent to which any such change would cause a minor or major reallocation of financial asset holdings over time.

Figure 5

Impact on investment policies and asset allocation



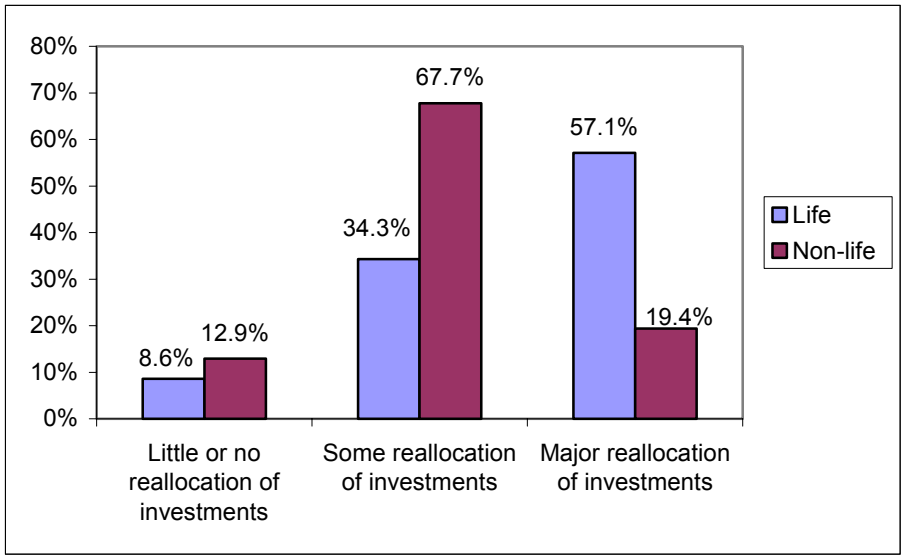
	Life	**Non-life**
Major adverse effect	7	4
Significant adverse effect	20	14
Little or no effect	5	10
Significant beneficial effect	3	2
Major beneficial effect	0	1
No. of Responses	**35**	**31**

The results of the survey findings are presented in Figures 5 and 6, with separate responses for life insurers and non-life insurers. The first point to observe is that about 86% of life insurers considered that there would be a 'significant or major' effect, but there was a significantly lower figure for non-life insurers at 68%. This difference can be ascribed to the fact that life insurers hold much longer term investments. Since non-life insurers have shorter duration of liabilities and hence also hold investment portfolios with shorter durations, there is a lower volatility of asset values under a mark-to-market accounting system. The observation was made by a number of life insurers that although they seek to match the durations of their assets and liabilities against interest risk changes, they would still have volatility concerns under a fair value system: (a) because the durations of available bonds and other fixed rate assets are currently less than the duration of their liabilities and are likely to remain so for the foreseeable future; and (b)

because stocks and shares and other investments are held that are not closely correlated with interest rate changes.

Figure 6

Extent of changes in investment portfolios over time



	Life	**Non-life**
Little or no reallocation of investments	3	4
Some reallocation of investments	12	21
Major reallocation of investments	20	6
No. of Responses	**35**	**31**

For life and non-life insurers considering that there would be an impact, there was a strong balance of opinion that the influence would be adverse rather than beneficial. As can be seen in the graph accompanying Figure 5, 77% of life insurers considered the impact would be adverse against just under 9% viewing it beneficial, with some 20% stating that there would be a major adverse impact. A less polarized position is evident for non-life insurers, with 58% viewing the impact as potentially adverse compared to about 10% considering it as potentially beneficial.

Consistent with other findings in the survey, there was a widespread view that investment horizons would tend to shorten. The most common response was that there would be a shift out of equities into bonds to avoid the extra volatility. There was some concern with the increased volatility of equity in

balance sheets, but a much higher degree of concern with the volatility in profit and loss accounts (income statements).

A number of life insurers made the observation that a fair value reporting system would probably put pressure on them to pursue a closer matching of their assets of liabilities positions at all times. It was considered that pursuing a more matched position would lead to more conservative investment policies with lower rates of return, including lower returns for policyholders on their savings. A few respondents made the point that any change in investment policy would be accompanied by a change in product policy, with both moving to shorter durations. One respondent observed that attempts to reduce this induced volatility into financial statements could have a distorting effect in managing a life operation and on its wider commercial role: 'there was a clear risk of the tail wagging the dog'.

Non-life insurers also considered that their investment holdings would change, with a switch to shorter-dated investments. Since there are no explicit interest rate guarantees in non-life insurance contracts, a move towards shorter-dated bonds could be achieved more easily than in life insurance, and there was not the same degree of concern with asset-liability matching, apart insurances with long claims run-off patterns. Many non-life insurers invest a significant proportion of the capital and reserves (shareholder funds) in stocks and shares at the present time. A number of companies stated that there would be some switch away from stocks and shares to avoid volatility in balance sheets and profit and loss accounts. As there would be a new source of volatility from having a mark-to-market valuation of insurance liabilities, this could also cause some rebalancing of investment holdings to reduce asset volatility further. Moreover, as all unrealized investment gains and losses between balance sheet dates would be recorded in the profit and loss accounts (income statements) under a full fair value system, a move away from stocks and shares and longer-dated bonds would help to stabilize reported earnings, especially as profits from non-life underwriting, which were intrinsically volatile, would appear even more volatile if insurance liabilities (contracts) were also to be measured at fair value.

One respondent observed that his company might wish to reduce the volatility of investment holdings through holding more financial assets with no or limited secondary markets, because it was felt that valuation rules for financial assets with low liquidity would be measured as having less volatility. This comment raises a key measurement question in the application of a fair value system when a financial asset (or financial liability) has a limited or thinly traded secondary market: how can one measure liquidity risk, as distinct from market risk, objectively and consistently? Indeed, economic theory has not yet produced a satisfactory answer to this measurement problem.

Three companies stated that the introduction of a full fair value system, where both realized and unrealized investment gains and losses would be recorded in the profit and loss accounts (income statements), might change the timing of when they realized investment gains and losses. A position advanced by the IASB, and others, in favour of full fair value reporting is that by including both realized and unrealized investment gains and losses in profit and loss accounts, 'gains trading' would be reduced, i.e. a policy where management chooses the time when to realize gains on investments to enhance reported profitability, hence giving a distorted view of underlying financial performance. One company said that it currently followed a conservative policy of buy and hold on many of its investments and hence it might be persuaded to adapt a more active investment policy. In a subsequent discussion with one executive, it was observed that his company, in common with other companies, has adopted an active investment policy for many years and hence the argument behind 'gains trading' was somewhat overstated. In reality, insurance companies that have pursued active investment policies, including the buying and selling of investments to rebalance matched asset-liability positions for hedging purposes, already have brought up the book values (purchase price) of most securities close to their market or fair values. Hence there is now less potential for 'gains trading' to cause a reporting distortion, with the gap between market and book values becoming smaller over time with active investment management.

On the changing composition of investment portfolio over time, there was a broad consensus that the reporting change would itself cause reallocation effects. As Figure 6 shows, 57% of life insurers considered that there would be a major reallocation, 34% felt that there would be some reallocation, and just under 9% considered that there would be little or no reallocation effect. The views of non-life insurers were less extreme, with 19% considering that there would be major reallocation, 68% some reallocation and 13% little or no reallocation. The direction of the reallocation would be, as noted above, away from equity investments towards bonds. Within bond portfolios, there would be some pressure to move towards shorter durations, but for life insurers this would be within their asset-liability matching constraints. These shifts in asset holdings were viewed as probably leading to a lower risk-return outlook for the shareholders and participating life policyholders in the longer term, and for non-life policyholders possibly higher insurance prices. It was observed that if a major shift from equities to bonds were to occur, as expected, this would also influence the long term pattern of financing within the economy and possibly stock market levels, given the size of the investment holdings of insurance companies.

Below is a selection of statements made in the questionnaire:

- 'Investment in bonds might become much preferable. Investment in stocks will require additional scrutiny.' Japanese life insurer.
- 'The actual accounting rules for bonds held to maturity, now held at amortized cost, will change to market value with the impact on the profit and loss account from unrealized capital gains and losses. The company could change its investment strategy to more short term, instead of having a long term view.' Portuguese insurer.
- 'Action will be taken to reduce volatility, this will be done by re-weighting the investment portfolio away from equities towards bonds and a greater use of derivatives.' UK life insurer.
- 'Very possible that it could force a major reallocation over time away from equities.' Irish life insurer.
- 'The impact of the proposals on insurers' appetite for equities may be considerable. Investors may be forced to decline good investment opportunities in the long-run to their reduced ability to absorb volatility.' European reinsurer.
- 'Major move away from equities and attempt to reduce volatility, including use of costly hedges.' German insurer.
- 'Investment policy would be affected by changing investment mix, especially equities and the timing of the realization of gains and losses.' UK insurer.
- 'There would be a reallocation of investment policy towards low risk assets.' French insurer.
- With the increase in earnings volatility, insurance companies will have to decide how much equity risk they want to accept in addition to insurance and interest rate risk embedded in the liabilities and in addition to the earnings volatility from discounting cash flows on uncertain assumptions. The perception and acceptance of volatile results by external parties will significantly impact investment decisions.' European reinsurer.
- 'Investment policy will be influenced by the full fair value reporting system in a way that investment policy will be very risk averse and short term. Under a full fair value measurement unrealized gains and losses from changes in assets would be shown in the income statement at the balance sheet date. As there would be no compensation effect over time in the income statement, this would have a great influence in investment policy.' French insurer.
- 'Volatility of the FV-balance sheet may cause insurers to shorten investment durations to "match" liabilities, reducing investment income

and the attractiveness of insurance business. There will be penalties to investment in equities whose market movements would both flow through the income statement and not offset FV-induced liability volatility.' US insurer.

- 'Preference would be given to assets of shorter duration. Assets of low liquidity may also be preferred to match long term liabilities, if assets with low liquidity can be valued on a less volatile basis.' Brazilian life insurer.
- 'Some shift away from price volatile assets as volatility in earnings is not rewarded by shareholders.' Dutch life insurer.
- 'Fair value for all assets will mean a move towards bonds in with-profits business to achieve a smoother profit distribution for policyholders.' Portuguese life insurer.
- 'With the increased volatility in earnings, there would be a greater matching of investments to liabilities in duration and in currency especially for longer-tail business.' UK non-life insurer.
- 'At the margin, there may be reallocation but all assets are volatile (except cash) and ultimately asset allocation should be determined by product and risk issues.' UK life insurer.
- 'There would be reduced reliance on higher risk investment.' US reinsurer.
- 'The investment policy will be influenced by full fair value reporting in that the investment policy will be very risk averse and short term.' German insurer.
- 'The values of assets, such as bonds and the values of life liabilities shift the same way with changes in interest rates. However, other types of investment, such as stocks and shares, are affected by other factors. Given that the fair value accounting might produce more volatile accounting figures, these non-bond investments will be more difficult to manage properly.' Japanese life insurer.
- 'We will move away from equity investments and volatility will be reduced through costly hedging.' German insurer.
- 'In Denmark the full fair reporting is applied to investments and so there would be no effect. The Danish Financial Supervisory Authority also accepts fair value for investments.' Danish non-insurer.
- 'Likely to move away from equities. Very possibly it will force a major reallocation over time.' Irish life insurer.
- 'Strategic long-term investment holdings are likely to be replaced.' German insurer.

- 'There would be less emphasis on realizing gains at the maturity of investments and more active realizations in the portfolio through time.' Austrian insurer.

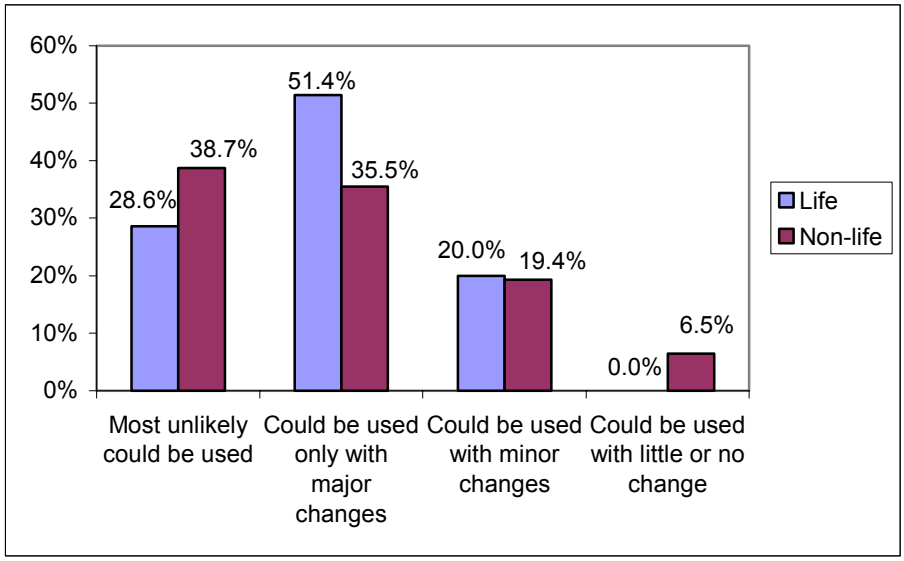
9. Use of fair value for internal financial management and its potential impact

Financial management represents the broad range of internal financial planning and control systems used to implement and monitor the corporate strategies and business models chosen by senior management. If management wishes to have coherence between its internal performance and external performance measures, one would expect that there would be a link between these internal accounting and actuarial systems and the external reporting system. The degree to which management considers that there should be coherence is an issue of some economic significance. The survey sought to ascertain: (a) whether the fair value methodology could be used for internal financial management purposes; and (b) if it were introduced as the reporting standard, what would be the likely impact on financial planning and control decisions and processes.

The survey findings revealed that no company uses a fair value system as a general methodology for its financial planning and control, nor did any company plan to do so voluntarily. Some companies said that some aspects of the fair value methodology were employed in pricing decisions and in profit testing for some life products, but it was not used as a general management tool. Companies were asked whether they could envisage adopting a full fair value system for their internal financial management purposes. As can be seen in Figure 7, close to 80% of life insurers said that this was most unlikely or could only be used if major changes were made to it. On the other hand, 20% of respondents stated that they might be able to use the methodology with only minor changes, but no company said that they would be able to adopt it without change. Views among non-life insurers were similar, with about 74% saying that it was unlikely that a full fair value approach could be employed without major change, if at all.

Figure 7

Fair value methodology and internal financial management



	Life	**Non-life**
Most unlikely could be used	10	12
Could be used only with major changes	18	11
Could be used with minor changes	7	6
Could be used with little or no change	0	2
No. of responses	**35**	**31**

Several companies commented on the fact that the IASB, and its predecessor the IASC, has not been able to come up with a credible and objective method for measuring the fair value of insurance contracts (insurance liabilities) in the four years since its preference for full fair value reporting for insurance was first officially announced in the 'Issues Paper on Insurance' published in November 1999. In addition, little progress has been made to date on the related accounting standard on performance reporting. These delays, after so much effort, were seen as revealing the inherent difficulty in developing a full fair value methodology in practice.

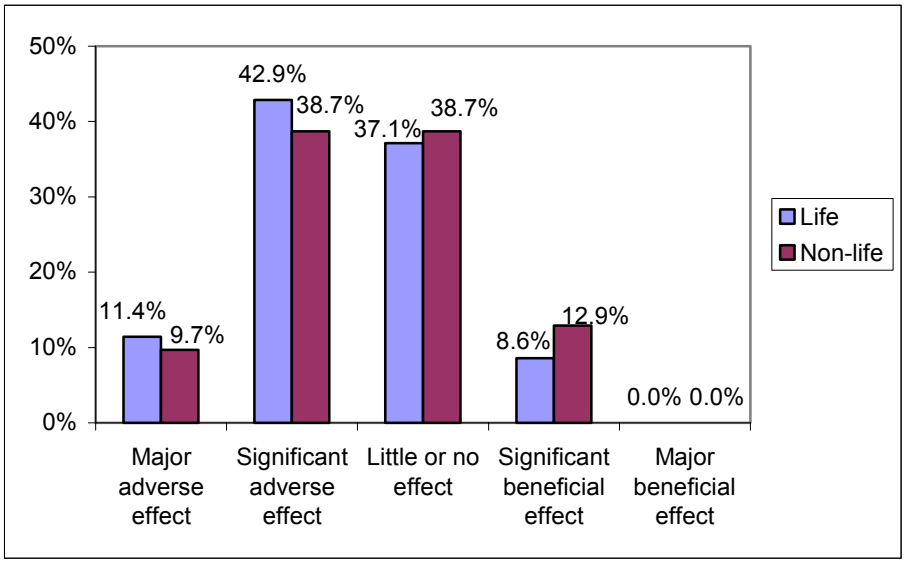
However, an overwhelming majority of companies expressed the view that they would be under pressure to gradually change their internal financial systems towards a full fair value approach, if it were to eventually emerge as the international reporting standard. These views are consistent with the other findings in the study, which is that external financial reporting requirements

tend to influence many aspects of corporate policies, processes and internal measurement systems over time; the form and content of information presented to their shareholders and other users in their financial statements are seen by senior management as important.

The survey also obtained views on the perceived impact of a full fair value reporting system on internal systems for financial planning and control, if it were introduced as the international reporting standard. Thirty-seven per cent of life insurers and 38% of non-life insurers said the change would have little or no effect: a few companies considered that reporting systems were not so important, but most viewed that the gap between a full fair value system and their preferred internal financial systems as too wide and hence they would be forced to accept some degree of disconnect between internal and external system in order to run their businesses effectively. Of the majority of companies who stated the effect would be significant or major, a much higher proportion expressed the view that the impact would be adverse rather than beneficial, as can be seen in Figure 8.

Figure 8

Impact of fair value reporting on internal financial management systems



	Life	Non-life
Major adverse effect	4	3
Significant adverse effect	15	12
Little or no effect	13	12
Significant beneficial effect	3	4
Major beneficial effect	0	0
No. of responses	**35**	**31**

Management views on the nature of the impact covered both broad policy issues and narrower operational concerns. A common response, especially among life insurers, was the effect that full fair value reporting would have on the timing of profit emergence. It was considered that the inherent tendency of fair value measurement to bring forward future profit recognition to the present time, even with unwinding of discount rates and risk adjustments, would not produce an accurate reflection of profit emergence compared to their internal financial models. All US life insurers covered in the survey said that they had developed internal models, which were based on the deferral and matching principles and which were reasonably consistent with US GAAP, and that these allowed them to manage their operations effectively and which produced more economically defensible profiles of profit emergence than fair value would. Some US life insurers had done some modelling internally of the two approaches in coming to these views, and they also referenced the ACLI-IAA Joint Research Report submitted to the IASB in June 2003.

An increasing number of European life insurance companies are using embedded value/achieved profit methodologies internally to manage their operations and they considered that these embedded methodologies, especially with recent improvements in the valuation of embedded options and guarantees, captured well the creation of shareholder value. These embedded value/achieved profits methodologies used internally were now being included more and more in financial statements as supplementary accounts. This process is likely to be extended further with the publication of the 'Principles for European Embedded Value' that has been agreed by many leading European insurers, launched in May 2004, to ensure a more consistent approach when producing these supplementary life insurance accounts. Existing national reporting standards (GAAPs) are not seen by European life insurers as providing a sufficiently sound base on which to build an internal financial management system.

For non-life insurance, there is a closer relationship between existing reporting standards and internal systems in most countries, with profit being measured on deferral and matching principles. A fair value system would alter useful metrics, such as combined ratios, used in planning and controlling the core underwriting business. Forecasting of future claim payments and

ensuring adequacy of claims provisions were a key aspect of financial management and these would be undermined by attempting to estimate what claims provisions might be sold for, or settled at, in hypothetical markets. It was also considered that valuing claims liabilities on an estimated mark-to-market basis, which were not directly related to the underlying claim payment cash flows, would make it more difficult to plan and monitor underwriting operations.

The minority of companies that viewed that fair value could have a beneficial effect focused in their replies on the fact that a fair value reporting system would be consistent with their internal pricing policies; the observation was made that if a fair value reporting system were to encourage more economic pricing policies across the insurance market, this would ensure more consistency in profitability over time. A number of respondents also stated that balance sheets based on fair values might provide a useful input into the valuation of companies in take-over or merger situations. On the other hand, companies that considered fair value would have an adverse effect took a different view on these two issues: (a) while consistency with pricing was important, it should not be the main driver of the overall financial management system; and (b) internal financial systems should place a greater emphasis on what was best for managing the organic growth of the business rather than on measuring infrequent corporate consolidations.

There was general agreement that a wide range of processes associated with financial planning and control would be affected. These ranged from information systems and new software development to human resource requirements and staff retraining. It was also observed that internal systems used to allocate capital across the group would have to change. Profit planning and forecasting systems would require re-engineering, as these processes would become more complex under a mark-to-market measurement system.

In countries where the published profit and loss accounts are used as the basis for determining corporate tax levels, tax payments would change, probably increase, because of the removal of equalization provisions and the inclusion of unrealized gains (losses), and hence these changes would have to be factored into pricing and profit planning decisions.

Below is a selection of quotations from respondents on: (a) the potential use of fair value for internal financial management; and (b) the impact on internal financial management systems if fair value reporting were to be introduced:

Views on potential use of full fair value for internal financial management

- 'Our internal control systems should be coherent with what we report to the outside world. We would not really have an option if full fair value were adopted.' Belgian insurer.
- 'Internal financial planning and control will most likely follow external reporting. The entire financial planning and control system will be affected.' Dutch insurer.
- 'We would have no choice. We would adopt full fair value for internal financial management purposes only because we would be required to report on an IAS-basis externally. We would not voluntarily choose full fair value as a basis on which to manage our operations.' French insurer.
- 'It seems most unlikely that the IASB's view of fair value, as outlined in its DSOP will be useful. However, improvements to embedded value techniques will allow it to be used more, with improvement in certain areas e.g. embedded option.' UK life insurer.
- 'We do not envisage adopting the fair value model as an internal planning and control mechanism. We look to US GAAP earning recognition in meeting our long- term growth objectives. Some of our divisions from time to time worked with fair value concepts and our Canadian company complies with Canadian reporting practices that are a feature of fair value. In no case does senior management spend any time reviewing these reports for other than purely regulatory compliance.' US life insurer.
- We would not use a fair value framework as it does not recognize the critical concept of underwriting profit and confuses the issue of measuring the adequacy of loss reserves. In addition, fair value inappropriately front-loads apparent profits.' US non-life insurer.
- 'We use fair value concepts, based on discounting methodology, currently for profit testing and for planning some particular lines of business. Its introduction would cause all internal control systems to converge to fair value.' Swiss life insurer.
- 'We already have several methods for financial planning and control. It is unlikely, except at the margin, that full fair value as defined by IASB will be used.' UK life insurer.
- 'At present it does not offer a 'complete' value model for planning life operations and so would not be useable.' Irish life insurer.
- 'We use embedded value/achieved profits internally to measure the value created by our life operations. We do not consider the IASB proposals represent the true economic fair value.' UK life insurer.

- ‘There would certainly be some interaction of external and internal reporting systems. We would generally not expect the external reporting to significantly change the internal financial planning or capital allocation decisions.’ European reinsurer.
- ‘A move towards fair values will lead to a consistent approach to valuing the business on an economic basis. However, the extent to which the ‘market noise’ can be eliminated from the results by users will be key.’ Spanish insurer.
- ‘We focus on US GAAP earnings’ recognition over the life of contracts being written and earnings that are due to revenues less expenses. Earnings are not assumed up-front, but rather recognized in relation and expenses. Thus our internal financial systems are at odds with fair value assumptions.’ US life insurer.
- ‘Ideally internal financial planning tools should follow external reporting.’ French insurer.

Views on the impact on internal financial management systems

- ‘There would be an adverse impact on profit profile which would not reflect the true economic value creation and there would be the need to pass on an increased cost of capital to consumers.’ UK life insurer.
- ‘If full fair value becomes the basis for the primary external reporting, it will affect our monthly management controls (budgets, management information systems), capital allocation models and tax planning.’ UK insurer.
- ‘Fair value is inappropriate for internal planning and control, because it does not appropriately reflect the core business of insurance. However, if fair value is implemented it will affect our cost of capital and our reported product profitability so it will substantially affect how we take capital allocation decisions over time.’ US non-life insurer.
- ‘Not appropriate for setting underwriting controls in non-life business.’ Italian insurer.
- ‘All financial management would be affected. We would no longer be reporting results on business earned but would need to predict the future at an unnecessarily early stage.’ UK non-life insurer.
- ‘The use of a fair value approach would have a favourable impact to the extent that it facilitates comparisons of actual results with expectations in our pricing. We routinely price business on an economic basis and so there would be only minor changes needed to our financial planning and control systems.’ Swiss non-life insurer.

- ‘The areas of financial planning and control systems that would be most affected are: required capital levels, measuring profit profitability, assumptions used in calculations mathematical reserves, such as future claims and discount rates used.’ Dutch life insurer.
- ‘We have developed a model similar to fair value, including for capital measurement, but with some differences such as tax and the cost of capital. But it is important to note that this is one of a number of tools that we use to manage our business.’ Swiss insurer.
- ‘There would be difficulty in forecasting results and it would be inappropriate as it stands for underwriting controls.’ UK non-life insurer.
- ‘If there are changes in the income statement, then there must also be changes in the financial control system that is used.’ German insurer.
- ‘There is likely to be a significant beneficial impact on our capital allocation decisions. In particular, if we move to a risk-based capital system across the group.’ UK life insurer.
- ‘It would result in a lot of changes in the financial control and budgeting areas.’ Spanish insurer.
- ‘Capital adequacy would be a guess.’ US reinsurer.
- ‘This drastic day-to-day valuation approach does not take the complex qualities of the insurance market into consideration. Hence it could not be used for life insurance planning and could only be used with major changes for planning in non-life operations.’ Austrian insurer.
- ‘A change in the reporting methodology will obviously influence all key operational aspects and therefore will also affect capital allocation decisions.’ Spanish insurer.

10. Consistency with internal asset-liability risk management systems

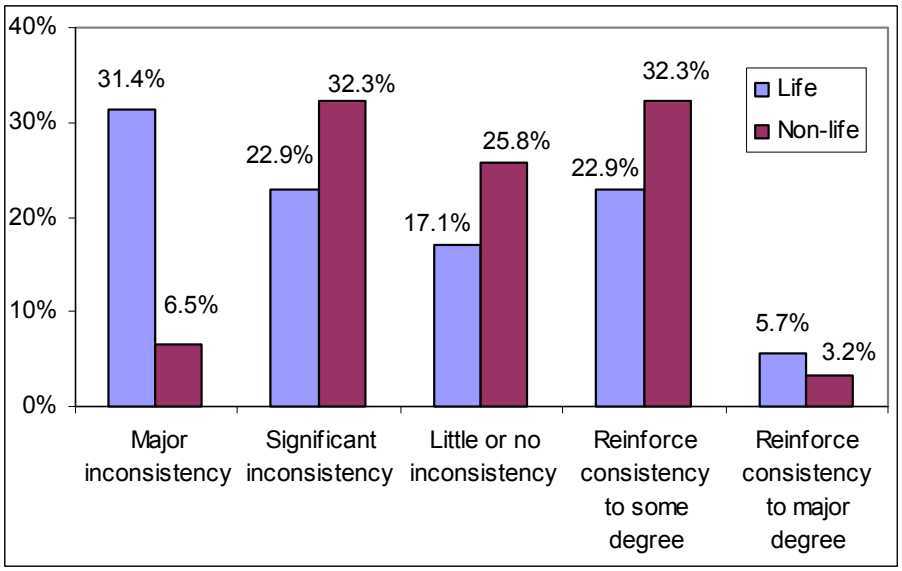
Internal asset-liability risk management has grown in sophistication within insurance companies during the last decade as new financial and actuarial modelling frameworks have been developed. Expenditure on these new modelling capabilities has been driven by a concern by top management to have in place a more integrated risk management process and more efficient capital management systems to meet the risks that insurers face, particularly in the core operations of insurance and investment. The greater use of asset-liability risk management modelling has also been stimulated by increasing corporate governance requirements and by a greater emphasis by insurance supervisory authorities and rating agencies on the quality of internal controls as an indicator of corporate security.

Internal asset-liability risk management policies interact closely with financial planning and control systems and with investment management decisions. The particular focus in the questionnaire was whether insurers viewed the fair value framework as being consistent with, or helping to reinforce, their asset-liability risk management systems.

There was a significant diversity of views on the issue of consistency between the fair value framework and internal asset-liability risk management modelling. This can be seen in Figure 9. Non-life insurers were about equally divided on whether fair value reporting would be inconsistent or reinforce consistency with their internal models, with a quarter of respondents stating that there would be little or no inconsistency or that it would not make much difference in practice. In contrast, life insurers were twice as likely to consider that there would be inconsistency, with 31% considering that it would result in a major inconsistency; life insurers were also less inclined than non-life insurers to say that there was little or no inconsistency or that it would not matter.

Figure 9

Consistency with internal asset-liability risk management



	Life	Non-life
Major inconsistency	11	2
Significant inconsistency	8	10
Little or no inconsistency	6	8
Reinforce consistency to some degree	8	10
Reinforce consistency to major degree	2	1
No. of Responses	**35**	**31**

In their replies, some respondents focused on balance sheet issues, while others saw fair value more widely in the context of stochastic cash flow models. Most companies considered that essential features of sound internal risk management systems were: (i) consistency in the measurement of assets and liabilities, which would also provide a reliable measure of equity capital; and (ii) the measurement system should be market-related but with an appropriate time horizon. The fair value methodology was seen as possessing these features to some degree and hence in principle it had some merit. But its general weakness identified by many insurance companies was its focus on short-term market risk. Most respondents said that their existing internal asset-liability risk management models took into account the long-term nature of their business and their ability to diversify risk over time. It was also stated that there is now a greater use of stress-testing (resilience testing) in risk models: to stress-test fair (market) values was considered to be a much less meaningful exercise compared to stress-testing of future cash flows.

The respondents reiterated their doubts about the ability of the IASB to come up with credible measures of fair value for liabilities, mainly because there are no traded markets to provide objective benchmarks. It was observed that insurance risks are not widely securitized on capital markets, and hence the nearest relevant markets into which insurance liabilities could be settled were reinsurance markets. Non-life reinsurance prices are subject to major cycles, as has been evident recently, with prices falling up until 2001 followed by sharp price rises in the following two years. A mark-to-market liability measurement system would exhibit major fluctuations in values from period to period unrelated to the underlying claim payments flows. Hence fair value would not produce sensible numbers in determining the value of insurance liabilities for use in internal risk management models. It was noted that under a fair value measurement system there would be two sources of short term volatility, one on the asset side and the other on the liabilities side, with the correlations between these two sets of values at a particular balance sheet date being largely unknown or subject to a high degree of estimation error. For life insurers, the problems were much greater as the long-term asset-liability positions were their real concern. As one respondent observed one can have a situation, under a fair value regime, where a company can have strong net cash inflows, from its combined in-force and new business, and at the same

time have negative equity capital just because of temporary adverse sentiment (i.e. a temporary increase in risk aversion) in capital and/or reinsurance markets. It was observed that it would be better if the IASB had tried to measure the fair value of liabilities through the discounting of future cash flows rather seeking to measure them on the basis of market value margins, since discount rates, and the associated risk premia, could at least incorporate longer term market expectations, hence minimizing short-term market noise.

A number of companies stated that a fair value approach had some merit and might help reinforce existing internal risk models. One advantage was that it provided a consistent measurement of asset and liabilities, albeit under one economic scenario. One respondent commented that the fair value approach could provide a useful market-related estimate of an insurer's equity capital at a point in time. Another company said that this framework might be a useful first step for companies that did not already have an asset-liability risk management system.

It was observed several times that published balance sheets in many countries, under national GAAPs, do not currently provide consistent measures of assets and liabilities. This was one reason for the disconnection between current financial statements and the internal models used for asset-liability management. But it was considered unlikely that a reporting system based on fair value would change this, because of its short-term focus.

A further observation was made that external users of financial statements do not always have a clear idea of the quality of the internal risk management systems. To solve this problem, it was suggested that the notes to the accounts were the best way to provide this supplementary information, as it could provide details of hedging strategies, degrees of mismatching, and risk metrics, such as value-at-risk, stress testing and sensitivity analysis. A number of companies now provide this supplementary information in the notes, but it was suggested that this should become a more widespread practice. The general view was that primary financial statements should retain their focus on their central role of providing information on financial performance and stewardship.

One respondent observed: 'the real danger would be that less informed market participants might consider that a fair value reporting system gave them a picture of the asset-liability risk management position of an insurance company, when it did not'.

A few companies made the observation that they considered that risk management systems based on fair values, as currently defined, would not be compatible with regulatory requirements, and within Europe with Solvency II as it emerges. This was mainly because of the lack of objectivity and potential

lack of prudence when measuring policyholder liabilities on a mark-to-market basis, and the failure to capture real mismatching of assets and liabilities, especially in life insurance. It was observed that the International Association of Insurance Supervisors had already stated their concerns over accounting systems based on fair values for use in their own solvency assessments.

A selection of company quotes is given below:

- 'Most inconsistent for the asset-liability risk management of our life operations, but our P&C business is fairly short term so there would not be as big an impact.' US insurer.
- 'A fair value is in itself not necessarily inconsistent with asset-liability risk management policy. It depends on how it is applied.' Japanese insurer.
- 'Will result in closer asset-liability matching.' Swiss life insurer.
- 'It would increase consistency as long as the IASB does not prescribe an artificial fair value accounting for insurance liabilities as at present, but uses an economic fair value.' UK life insurer.
- 'Fair value is inconsistent with effective asset-liability management in non-life insurance because of its undue focus on short-term market volatility to the detriment of longer term financial results.' US non-life insurer.
- 'Asset-liability management will be made more important under a fair value reporting system.' Spanish insurer.
- 'We think that the full fair value reporting system is inconsistent with an effective asset-liability risk management because it disagrees with the fundamental idea of the insurance business i.e. risk balancing over time and ignores the link between assets and liabilities.' German insurer.
- 'While IASB views insurance risk and investment risk independently, we believe that aggregated exposure measurement is key to assessing the capital adequacy of entities. But for those firms operating an integrated risk assessment programme, these issues will be already apparent.' UK non-life insurer.
- 'We have an effective A/L risk management policy which is independent of the accounting model. Asset-liability models do not use accounting numbers. Such an accounting model may force you to make inconsistent A/L choices and this would be very bad.' Irish life insurer.
- 'Could be useful for companies without an ALM system.' Italian insurer.

- ‘A full fair value reporting system could lead us to match assets and liabilities to a greater extent to deal with increased volatility. This could lead to increased consistency. There is, however, a general problem to find the perfect asset match for specific insurance liability. This is particularly true for life insurance business where matched assets are not available for long durations.’ European reinsurer.
- ‘We believe that a full fair value reporting system would be inconsistent with an effective ALM policy. ALM is based on long term cash flows, while fair value is based on short term changes in market conditions.’ US life insurer.
- ‘Sensible asset-liability risk management is difficult without intelligent performance reporting. The IABS does not appear to have given any thought to these performance reporting issues in their version of a fair value accounting regime.’ UK life insurer.
- ‘Asset-Liability risk management is based on a long-term horizon.’ French insurer.
- ‘Fair value system and asset-liability management have in common the concept of cash flow predictions and monitoring and to this extent there is some degree of consistency.’ German insurer.
- ‘We consider that a fair value model approach will result in potentially much more volatile financial statements, particularly if assets do not move in tandem with liabilities, we will focus our strategies on minimizing that volatility.’ US life insurer.
- ‘ALM is based on the underlying cash flows streams and risk. The essential parts of the analysis are independent of the accounting rules.’ Danish insurer.
- ‘There is an artificial separation of assets and liabilities in the fair value framework that is not consistent with sound ALM modeling.’ Brazilian insurer.
- ‘Asset-liability management using fair value methodology is inconsistent with long term horizons of life insurance.’ French insurer.
- ‘The management of assets and liabilities from a risk perspective should be consistent with the financial position on a fair value approach.’ US reinsurer.
- ‘Major inconsistency in asset-liability management due to inappropriate mechanics being forced in the insurance industry.’ US life insurer.
- ‘The fair value approach is inconsistent with our ALM policy. The risks are not the same.’ French insurer.

11. Estimated costs of converting to a fair value reporting system

Insurance companies can be expected to incur additional costs from the introduction of a completely new reporting system. These reporting costs for international insurance groups would cover their worldwide operations, including operations in emerging countries, as global consolidated accounts have to be produced. The questionnaire sought views on the type and level of costs that management would expect to incur. The first of these costs was the more direct costs associated with the collect and collation of the financial information to prepare these published accounts, and the associated auditing fees. The second of these costs was the indirect expenses and increased investment to restructure internal systems and processes either to reconcile existing systems to the new system, or having to run two systems side by side where the fair value system was deemed to be inappropriate for internal purposes.

When the questionnaire was being designed, it was clear that companies would only be able to provide very approximate cost estimates, since fair value reporting was only a hypothetical possibility. To permit comparability between companies, respondents were asked to provide their cost estimates as a percentage of a relevant benchmark, even though a percentage would itself be only an approximation, since these costs would have fixed and variable components. In estimating the direct reporting costs, companies were asked to express these as a percentage of their current reporting costs. In a second measure, companies were asked to provide a broader cost estimate which would include these direct reporting costs as well as the variety of indirect costs associated with changing internal systems and processes. Companies were asked to benchmark these broader cost estimates as a percentage of their total operating costs (excluding sales commissions and fees). Since initial set up costs were likely to be higher than when systems are up and running, two sets of cost estimates were requested, one for initial set-up costs and another for ongoing costs. Separate cost estimates were requested for life and for non-life operations.

Only about two-thirds of the companies were able to provide estimates of these costs. Among the companies that were able to do so, there was a high degree of variation in the responses, due to differences in assumptions and differences in the scale of companies.

On the direct reporting costs, the most commonly stated estimate was that there would be an initial increase of about 35% for life insurance and 30% for non-life insurance. A few companies said that for the first two or three years it would be necessary to run the existing accounting system side by side with the new system to provide investors and other users to allow them to reconcile the two sets of information. In these cases, the initial costs were expected to

be over twice the current level. It was anticipated that the financial reporting costs would fall after a few years. But the general view is that the reporting costs, even when systems had been put in place and experience gained, would still remain higher than at present, because of the complexity of the system and the need to provide more detailed explanations of assumptions due to the greater subjectivity in the fair value measurement of insurance liabilities. These longer term cost estimates were about 30% and 20% of current reporting costs, for life and non-life operations respectively.

Companies considered that the major costs in complying with a new reporting regime would be associated with the changes to existing systems and processes. These internal costs were identified as follows: expenditure on the development of new software, retraining of staff and the need to recruit with expertise in stochastic modelling, and hiring of external consultants. Some of these expenditures on new systems could be used in other areas of operations, but most would be additional; this was because they were likely to be limited synergies, at least in the medium term, with internal management systems.

One cost that was mentioned by a few companies was the extra communication costs needed to explain to investors and consumers the new formats and measurement systems, which could be confusing due to their more complex and subjective nature. There would be a requirement to provide these explanations and clarifications under the more stringent regulatory and governance environments that now exist. It was considered that these communication costs would be higher for life insurers, as consumers were also investors.

A typical estimate of the increase in total operating costs (excluding sales commissions) from a switch to full fair value reporting was about 5% for life insurance operations, with a slightly lower figure of 4% for non-life insurance operations. As might be expected, these estimates varied a lot between companies, falling mainly in the range from 3% to 10%.

Below is a selection of the statements given by respondents:

- ‘We are not in a position to quantify the costs of compliance with such a new standard, however, they will be very significant.’ UK insurer.
- ‘A major effort will be required to develop new information systems and abilities to model and track impact of changes in assumptions under fair value. Fair value may not be as expensive for non-life insurance compared to life operations. There would be investment on the liability side, less on the asset side.’ US insurer.

- ‘There would be two systems being run for some time, resulting in additional resource costs in reconciling two systems.’ UK non-life insurer.
- ‘There will be a need for additional staff and increased spending on IT and staff and training.’ German insurer.
- ‘A major cost will be the need to explain to policyholders artificial results and the impact of short term volatility.’ French insurer.
- ‘Need for new staff with sophisticated actuarial and accounting know-how. Investment in IT-related expenses and more education and training for staff and consumers.’ German insurer.
- ‘The impact on reporting cost is likely to be substantial, including additional actuarial, systems and consulting costs on an ongoing basis.’ European reinsurer.
- ‘Very difficult to assess until detailed proposals are finalized. Data collection and analysis are likely to be a major issue for life insurers.’ UK life insurer.
- ‘Our belief is that the costs would be considerable because of the expense of developing new stochastic models necessary to operationalize a fair value model.’ US life insurer.
- ‘There would be an increase of personnel in the accounting, actuarial, risk management areas. And increase in IT and consulting costs, as well as audit fees.’ Swiss insurer.
- ‘Costs for many aspects of our life insurance operations would be substantial.’ Dutch insurer.
- ‘We assume that the costs in the P&C area would be higher than in the life area, as the life business has substantial experience with embedded value model where there are some overlaps.’ European reinsurer.
- ‘Initially an accounting system at fair value would have to be run along side our the existing systems, hence the high costs.’ Austria insurer.
- ‘A comprehensive change to reporting would require new systems for collecting information.’ Swiss insurer.
- ‘Additional costs will primarily relate to actuarial systems development and modelling capability.’ UK life insurer.
- ‘Systems would need to be modified to give us more fair value data.’ US reinsurer.
- ‘The main areas of additional costs will be in testing product profitability and the development of new actuarial software.’ Swiss life-insurer.

- ‘If both fair value and US GAAP are required, significant extra manpower will be needed.’ US insurer.

12. Impact on ability to provide earnings’ forecasts

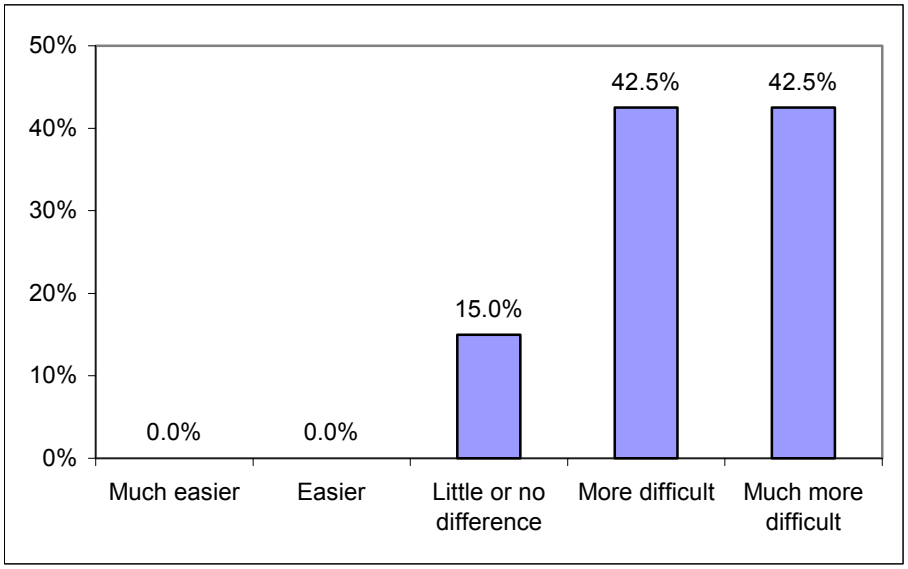
The level, growth and stability of earnings of a company over time are important measures, perhaps the most important comparative measures, of management performance. Institutional investors and financial analysts calculate their own earnings’ forecasts, or earnings per share forecasts, as one of the key metrics in their buy/sell/hold decisions or recommendations. Stock markets and securities’ regulators in most countries encourage companies to supply forward looking information to investors to allow them to make more informed decisions, providing the information is soundly based and widely distributed. In the United States, many listed companies, including some insurance companies, provide earning per share guidance figures, which indicate the range of values within which their earnings per share is expected to lie, usually on a quarterly basis. And on most stock markets, insurance companies are expected to provide information to allow investors to form expectations about current and future earnings, in addition to other information to judge company and management performance.

Many insurance companies, especially non-life insurers, do not provide earnings’ forecasts, because of the inherent riskiness of their businesses. However, they provide financial analysts and investors with information that will allow them to make their own forecasts. Since companies in most other sectors, with which insurers compete for capital, give earnings’ forecasts, the management of insurance companies have to be in a position to have internal forecasts of earnings so that they can supply forward looking information and respond to requests from analysts and investors in the press and at briefing sessions, even if they do not formally make earnings’ forecasts.

The questionnaire sought to assess whether a move to a full fair value reporting would affect the ability of insurers to make earnings’ forecasts, either for public disclosure or at least to inform their discussions with users of financial statements. As can be seen from Figure 10, 85% of insurers stating that producing earnings’ forecasts would be more difficult than at the present time, with half of these saying that it would be much more difficult. Fifteen per cent stated that it would make little or no difference, while no company said that it would be easier. Specialist life insurers, specialist non-life insurers and companies supplying both classes of insurance all held similar views.

Figure 10

Impact on management's ability to provide earnings' forecasts



Much easier	0
Easier	0
Little or no difference	6
More difficult	17
Much more difficult	17
No. of responses	**40**

The reasons that management gave for this increased difficulty relates to the inherent volatility and uncertainty under a full fair value system, where the measurement of earnings is defined as the change in equity capital, with appropriate adjustments for new capital raised, dividends paid, etc. As the change in equity capital from period to period would be based on the market value, or estimated market value, of financial assets and on the estimated market value of policyholder liabilities, earnings would include not only all realized and unrealized investment gains and losses on investments but also the estimated unrealized gains and losses on policyholder liabilities. This double source of volatility, and inherent subjectivity of estimating market values for non-traded financial assets and liabilities, would make forecasting difficult.

The point was raised that the practice in some countries of including unrealized investment gains and losses in their income statements already made forecasting earnings difficult. Several companies expressed the view

that earnings' forecasts, and indeed earnings themselves, should emphasize information about whether management are developing a profitable business and not overemphasize external events that were outside of management's control.

It was observed that if the management of insurance companies were less able to provide forward looking information on their potential earnings in a clear way, while management of other listed companies did so, this could adversly affect the demand for insurance shares over time. While financial analysts and institutional investors were sophisticated enough to make allowance for this, individual investors, who were less financially aware, might well be less sympathetic to the inability of management to provide such information.

A further comment was made that both the IASB and FASB had standards on how listed companies should calculate their earnings per share figures consistently in the financial statements to help ensure comparability. It was considered that it would be difficult to reconcile these standards with a full fair value system for financial instruments as the reported earnings of insurers, and other financial services companies affected, would be made much more volatile and hence less comparable with the earnings per share figures of most other listed companies.

A few insurers mentioned the related issue of dividend policy under a full fair value reporting system. It was observed that investors and financial analysts also need to have relevant and reliable information to help them form expectations about the future dividends that are likely to be paid by insurance companies, and there was a greater focus on dividends when interest rates are low and stock market levels are depressed. Earnings under a full fair value system would give a very poor indicator of dividend-paying ability. One respondent commented: 'As corporate earnings measured on a fair value basis are not directly related to cash flows, they do not form a sound basis for dividend policy decisions. Investors cannot spend fair value earnings'.

A selection of comments from insurers:

- 'We do not provide earnings' forecasts, only key drivers of results. We would have to provide more information to shareholders and financial analysts so that they could up their own estimates.' Swiss insurer.
- 'Forecasts will have to take into account different assumptions on the development of capital market values and insurance market values, making it much more difficult to provide earnings' forecasts.' French insurer.

- ‘Fair value accounting would make earnings’ forecasts for non-life insurers impossible, as future income will depend, among other things, on unknowable market interest rates movements.’ US non-life insurer.
- ‘Increase in uncertainty and volatility due to the balance sheet approach will make earnings’ forecasts impossible.’ UK insurer.
- ‘Forecasting volatile fair values would be extremely difficult. For their own earnings’ forecasts, some analysts are likely to avoid using fair value numbers.’ Japanese life insurer.
- ‘Profits would be very difficult to forecast, because they will mainly depend on exogenous factors and little on what the company can control.’ German insurer.
- ‘Impossible – crystal ball mentality.’ US reinsurer.
- ‘Preparation of earnings’ forecasts under a full fair value model would be much more difficult due to the volatility of results from assets and liabilities.’ US life insurer.
- ‘Earnings’ forecasts would depend more on movements in the capital market and less on our ability to write insurance contracts.’ Austrian insurer.
- ‘Earnings’ forecasts would be based on volatile parameters instead of long term trends as at present.’ French insurer.
- ‘Earnings will be highly volatile. Hence the need for a credible performance reporting.’ UK insurer.
- ‘Volatility of earnings would be greatly increased, thus reducing the reliability of earning statements significantly.’ UK non-life insurer.
- ‘Earnings will be far more volatile and therefore much more difficult to predict with any degree or accuracy. Future market changes are difficult to predict.’ German insurer.
- ‘For our life insurance operations, it would be extremely difficult to tell earnings’ recognition from changes in interest rates, changes in assumptions which may be overly optimistic or pessimistic. The current US GAAP process requires insurers to match earnings to revenues. While assumptions do cause timing differences in earnings’ recognition currently, it is only over the current period, not many years into the future which may be in many cases a guesstimate.’ US life insurer.
- ‘Earnings’ forecasts will need to make assumptions about future volatility in capital market and reinsurance markets. Explaining these interrelationships to shareholders and analysts and how they impact our internal models will be a challenge.’ UK life insurer.

13. Perceived impact on the cost of capital

Insurance companies need to hold capital to absorb the risks that they assume. There are also regulatory requirements on insurers to hold capital to reduce the probability of insolvency and these capital adequacy rules often require insurers to hold more capital than management, and their shareholders, consider necessary. Hence capital is a key constraint on the supply of insurance. If the cost of capital is high, this will increase the cost of insurance and/or discourage the level of supply. Moreover, since there are substitute products to insurance, including ART and self-insurance, if the cost of capital for insurers is higher than that facing these alternative suppliers, insurers will be less able to compete.

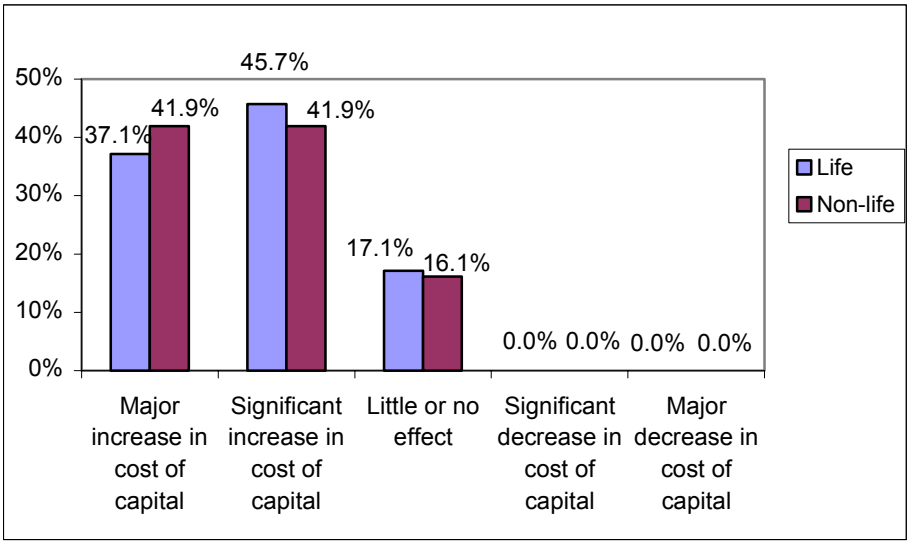
If capital markets are fully information efficient, the way that companies report their financial performance should not matter. Capital market participants would determine the share prices of insurance companies, and hence their cost of equity capital, based on expected growth and stability of future earnings' streams, and other relevant factors. The available evidence suggests that capital market participants are risk averse and so companies with a higher level of expected (relative) volatility in their earnings, for the same growth of earnings, face a higher cost of capital. If the volatility in profit and loss accounts (income statements) and balance sheets under a full fair value approach reflected real volatility, this volatility would be factored into share prices in an information efficient capital market. However, if a full fair value reporting system provides information 'noise' unrelated to real volatility of the underlying cash flows, as could well be the case where there are highly subjective estimates of market prices for non-traded insurance liabilities and/or the underlying asset-liability relationships are not accurately captured, then this could lead to the mispricing of shares, even in an information efficient stock market (with the exception of the strong form of market efficiency). And the case for assuming the information efficiency of capital markets is not as compelling as it once was, in the light of asset prices bubbles. Hence there is a theoretical case for arguing that reported volatility, real or otherwise, will lead to lower share prices and a higher cost of capital. On the other hand, the cost of capital is likely to be influenced by other aspects of a financial reporting system, such as its transparency and objectivity, but the reported earnings volatility will clearly be one of the key determining factors.

The survey sought to ask senior managers of insurance companies if they considered that the higher volatility in earnings that would arise under a full fair value reporting system would cause their cost of capital to increase or decrease or have little or no effect. These are clearly opinions, unlike other questions in the survey which relate to their own policy decisions and hence have a firmer basis. However, as senior management in insurance companies

and close observers of capital markets as major institutional investors, their opinions should carry some weight, even though no definitive conclusions can be drawn from their statements. Clearly, whether the cost of capital might change or not is an empirical question, requiring more detailed analysis.

Figure 11

Perceived impact of more volatile reported earnings on cost of capital



	Life	**Non-life**
Major increase in cost of capital	13	13
Significant increase in cost of capital	16	13
Little or no effect	6	5
Significant decrease in cost of capital	0	0
Major decrease in cost of capital	0	0
No. of responses	**35**	**31**

The responses are given in Figure 11. Since it was unlikely that respondents would view an increase in volatility, which would arise under a full fair value model, as leading to a decrease in the cost of capital, the relevant statistic is the number of companies that perceive it would increase compared to those that perceive it would have little or no effect. The responses were divided into life and non-life operations, even for companies writing both classes of insurance, since the cost of capital might differ for life and non-life. Close to 83% of life insurers considered that the cost of capital would rise, while 17% considered it would not change much. There was a similar pattern of responses for non-life insurers, with about 84% viewing that the cost of

capital would rise and 16% viewing that there would be little or no effect. No company thought the cost of capital would fall. Thirty-seven per cent of life insurers and 42% of non-life insurers perceived that there might be a major increase.

Most companies considered that the stock market did not like volatility in reported earnings and would demand an extra risk premium, thus increasing the cost of capital. Two contributing factors were advanced for this: (i) much of the volatility of reported earnings of insurance companies, especially for their life operations, would be spurious in view of the long term nature of insurance; (ii) companies in other industries, including commercial banks, were likely to be allowed to continue reporting their earnings on a deferral and matching basis, and hence an unlevel playing field would be created.

In addition, it was observed that a fair value reporting system was more likely to cause insurers to raise capital at the wrong time, i.e. when it was more costly. This was based on the following scenario that was advanced by one respondent. A temporary fall in asset prices, especially if accompanied by an increase in the fair value on insurance liabilities' induced by the same negative sentiment in the market, would depress the reported equity capital level of an insurer. As a result the insurer could be forced to raise new capital in these depressed stock market conditions either due to pressure from insurance supervisors or rating agencies, or to restore confidence with brokers, corporate consumers and other insurance market participants.

A selection of comments from insurers is given below:

- 'Due to increased volatility of results the stockholders of equity will demand a higher risk premium. The raising of capital may arise at the time of the disclosure of unfavourable results, and hence timing of capital may be at the worst time and outside the hands of management.' Austrian insurer.
- 'There would be a major increase in the cost of capital because of artificial volatility. There will be an unlevel playing field with banks.' US reinsurer.
- 'Increased volatility will make earnings of life insurers much less predictable, including earnings per share. As a result, many investors will most likely be confused by the results and may not be able to value insurance stocks in this environment and there is a real danger of investors shifting the investment away and so increasing the cost of capital.' US insurer.
- 'While the cost of capital will likely increase significantly, there may be timing benefits because any problems will be more apparent earlier.' Swiss life insurer.

- ‘Although reported results would be more volatile, economic value of organization would remain unchanged and so there would be little effect on the cost of capital.’ Swiss insurer.
- ‘Fair value will increase income statement volatility and therefore the required cost of capital relative to other industries in the stock market. We see a major increase in our cost of capital.’ Dutch insurer.
- ‘Major increase in the cost of capital as there would be a misunderstanding of the real situation of the insurer’s operations by the investor.’ French insurer.
- ‘Capital market volatility on balance sheets would require insurance companies to raise capital when it is at its most expensive.’ European reinsurer.
- ‘The necessity of raising new capital may arise at the time of disclosed unfavourable results, timing will be less under management control.’ German insurer.
- ‘Increase in cost of capital because of increased volatility of earnings and less reliable and transparent financial statements.’ Spanish insurer.
- ‘Could result in capital being raised at the wrong time.’ UK non-life insurer.
- ‘Due to changes in EBT (earnings before tax) caused by a swing in the capital markets the rating of insurance companies will suffer.’ Italian insurer.
- ‘Lack of understanding of results will lead to negative investor sentiment and a significant increase in our cost of capital.’ US life insurer.
- ‘Stock market will perceive greater differentiation among companies on their capability in managing increased volatility.’ Italian life insurer.
- ‘There will be a risk premium on the cost of capital due to increased uncertainty and volatility.’ UK insurer.
- ‘Higher volatility will require more capital to be held as well as the cost of capital increasing.’ French insurer.
- ‘Initially more volatile profits would lead to an increase in the cost of capital as market participants gain experience with fair value statements. A performance reporting which separates operational changes from changes in valuation could help users. Spreads between analysts may be smaller and it could lead to a reduction in agency costs and a lower cost of capital in the longer term.’ European reinsurer.
- ‘Volatility in equity/net income will alarm capital market participants, especially it they are non-insurance specialists.’ German insurer.

- 'Higher volatility of balance sheets will require more capital and the cost of capital will increase.' Portuguese insurer.

14. Views on subjectivity of the measurement of insurance liabilities (insurance contracts)

Financial statements should possess the primary qualities of being understandable and provide information that is beneficial to users in their decision-making processes. The quality of decision usefulness depends on the information contained in financial statements being reliable, relevant and comparable. All of these qualities are embodied in the conceptual frameworks of the IASB, FASB and many other national accounting standard setters.

Reliability requires that financial statements are based on objective measures that provide accurate information and hence can be trusted by users and confirmed by external audit. Fair or market values of financial assets and liabilities that are traded usually provide more relevant information to users than values that are based on cost or purchase price. However, if financial assets or financial liabilities are planned to be held over long periods of time, short-term market values can provide less relevant information to users. But, in general, there tends to be a trade-off between relevance and reliability. Comparability is a useful attribute for users of published accounts as it allows them to identify differences and similarities in assessing management performance between companies, but this is not a unique attribute of a particular reporting system.

Financial assets that are traded in deep markets possess objectivity to the extent that there is a market benchmark, but market or fair values of assets are not fully reliable, due to 'price bubbles' and changes in market sentiment (risk aversion) over time. Estimates of the fair values of financial assets with no or limited traded markets are more subjective and hence have a lower level of reliability.

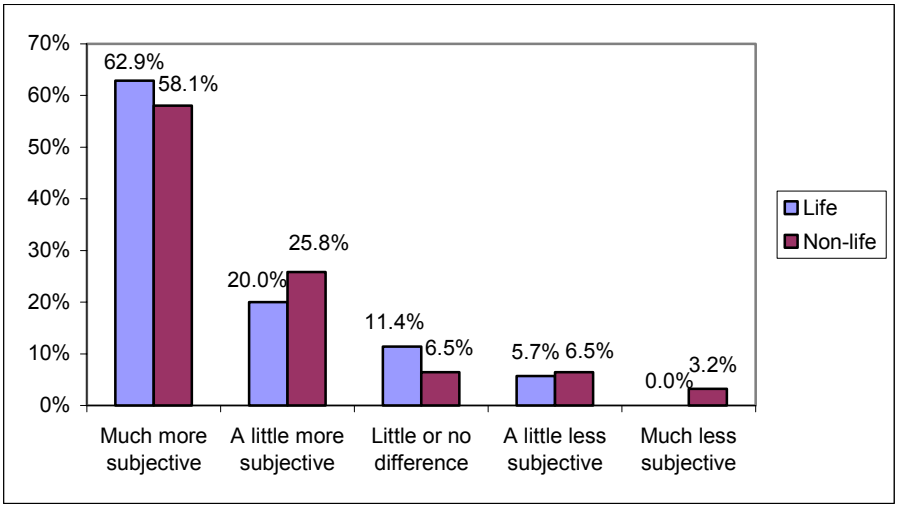
The measurement of insurance liabilities is inherently unreliable from an accounting standpoint, because the level and timing of future payments to policyholders are not known and have to be forecast on the basis of assumptions, some of which are subjective in nature. Hence attempts to place a fair value on insurance liabilities entails two levels of unreliability: (a) those associated with forecasting future payments to policyholders; and (b) the subjectivity associated with placing a market or fair value on these liabilities when there are no traded markets, or only very limited traded markets, to benchmark them against.

The questionnaire sought to ask insurance companies about one aspect of the reliability of financial statements, on which they could be expected to be well-

informed: the degree of subjectivity in measuring their insurance liabilities. More particularly, they were asked whether they considered that calculating insurance liabilities on a fair value basis would be more or less subjective compared to the measurement system used under their current national reporting standards. The results are given in Figure 12. As can be seen, over 80% of life and non-life insurers considered that the subjectivity in using fair values would be greater, with close to 60% viewing it as much more subjective. Only 9% of non-life insurers and 6% of life insurers considered that fair values would be less subjective.

Figure 12

Subjectivity and the measurement of insurance liabilities (contracts)



	Life	Non-life
Much more subjective	22	18
A little more subjective	7	8
Little or no difference	4	2
A little less subjective	2	2
Much less subjective	0	1
No. of responses	**35**	**31**

The main reason for the higher level of subjectivity in measuring the fair value of insurance liabilities (insurance contracts) was attributed directly to the difficulty of determining values when there is no traded market to compare them against. It was observed that this subjectivity would also be imparted to reported earnings, as earnings would be defined under full fair

value as the change in financial assets and liabilities between accounting periods.

The few companies stating that fair value reporting would be less subjective stressed the higher degree of comparability that would occur between insurers than at present. It was generally recognized that the issue of comparability between the accounts of insurance company accounts is an issue of user concern, and this was why the search for workable international reporting standards has wide support across the insurance industry. But in the discussions accompanying the survey, the point was emphasized that comparability should extend to all listed companies. As non-financial firms would continue to report under the international financial reporting standards (IFRSs) on a traditional deferral and matching basis, and probably commercial banks too, any potential increase in comparability between insurers under a fair value system would be at the expense of lower comparability across the wider capital market.

It was observed by a few respondents that there was a potential for less scrupulous companies to manipulate their reported values under a fair value reporting system, especially as the estimated market values of liabilities would be so subjective and difficult to verify externally. Hence a greater responsibility would be placed on auditors. It was mentioned by some companies that the Sarbannes-Oxley Act (2002), introduced following the Enron and WorldCom failures, now placed a greater emphasis on the objectivity of financial statements. Under the Act, CEOs and CFOs of all listed companies in the United States have to personally certify to the Securities and Exchange Commission that their financial statements, and accompanying disclosures, give a fair representation of the operational and financial condition of their companies. Many leading insurance and reinsurance companies headquartered outside the United States are listed on the US stock market, because of its size, and hence the Act has a wide reach. The following quote from one insurer reflects the view of a number of other companies in the survey: 'No CEO/CFO will be at ease to comply with the Sarbannes-Oxley Act declaration requirements with the high degree of subjectivity in determining the fair value of assets and liabilities'. Another respondent expressed the view that a full fair value reporting system might fail to meet the objectivity requirements of the Act and that management might wish to have a legal ruling to confirm their position before signing these declarations.

A selection of views on subjectivity of fair value reporting compared with current reporting system:

- ‘Determining the fair value of non-life liabilities would be much more subjective than present measures, as they are dependent on many more assumptions and do not have an objective standard for comparison. The standard for fair value is market values, and traded markets *do not exist* for insurance liabilities.’ US non-life insurer.
- ‘Results will be highly dependent on the assumptions, sensitivities and interdependencies, hence it will be much more subjective than the current reporting system.’ UK life insurer.
- ‘Measuring insurance liabilities, regardless of the accounting model used, requires management to use assumptions and make estimates. Most current accounting models are well established and there is experience in their use. The proposed fair value model would have some elements that require similar judgments as current models. Some elements, however, will be new, such as market value margins, the valuation of options and guarantees provided to policyholders, or the capitalization of future cash flows. In general, with fair value measurement, more variable estimates will have an impact on the valuation which increases subjectivity.’ European reinsurer.
- ‘The amount of subjectivity in measuring liabilities may be so vast that not only transparency, but comparability between players will be lost.’ Spanish insurer.
- ‘With so many subjective assumptions, the new financial statements might turn out to be much less transparent.’ French insurer.
- ‘The fair value of liabilities will be much more subjective: there are no active markets to determine fair value and there would be a lot of assumptions needed to determine a fair value.’ German insurer.
- ‘Due to the highly theoretical approach and in the absence of a true market for insurance liabilities, fair value will necessarily be very subjective, e.g. market-value margins, and lead to inconsistent application.’ UK insurer.
- ‘We believe that the assumptions and estimates necessary for the anticipated implementation of a fair value model will cause more subjectivity in the measurement of insurance contracts (insurance liabilities) than the current measurement system under US GAAP.’ US life insurer.
- ‘No CEO/CFO will be at ease to comply with the Sarbannes-Oxley Act declaration requirements with the high degree of subjectivity in determining the fair value of assets and liabilities.’ Brazilian insurer.
- ‘Fair value measurement of where there is no traded market is based upon assumptions in the future. Each of these assumptions is subjective.’ Belgian insurer.

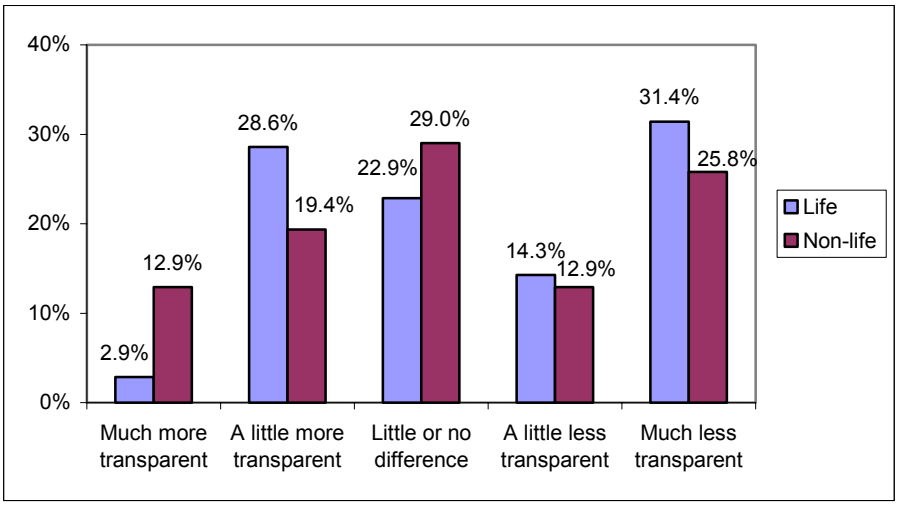
- ‘It would be much more subjective and some insurers would be able to more easily manipulate results than under the current US GAAP. It would be difficult to separate a company’s performance from external noise due to changes in interest rates, etc.’ US life insurer.
- ‘There will be more subjectivity as estimates of long term future conditions will be required compared to the current reporting regime.’ Austrian insurer.

15. Views on transparency of fair value measurement of insurance liabilities

Transparency is a more general requirement of financial statements, as it lies at the heart of disclosure itself. The information contained in published accounts should provide users with as much relevant and reliable information as they need to make their decisions, within appropriate cost and competition considerations; financial statements should not be opaque or hard to understand, and they should not hide any material information that the users need to know. At the level of the capital market as a whole, a high level of quality disclosure helps to ensure that markets operate efficiently and fairly; the overall cost of capital should be lower and there would be less scope for asymmetrical information to distort the pricing of securities.

Figure 13

Perceived transparency and the reporting of insurance liabilities (contracts)



	Life	Non-life
Much more transparent	1	4
A little more transparent	10	6
Little or no difference	8	9
A little less transparent	5	4
Much less transparent	11	8
No. of responses	**35**	**31**

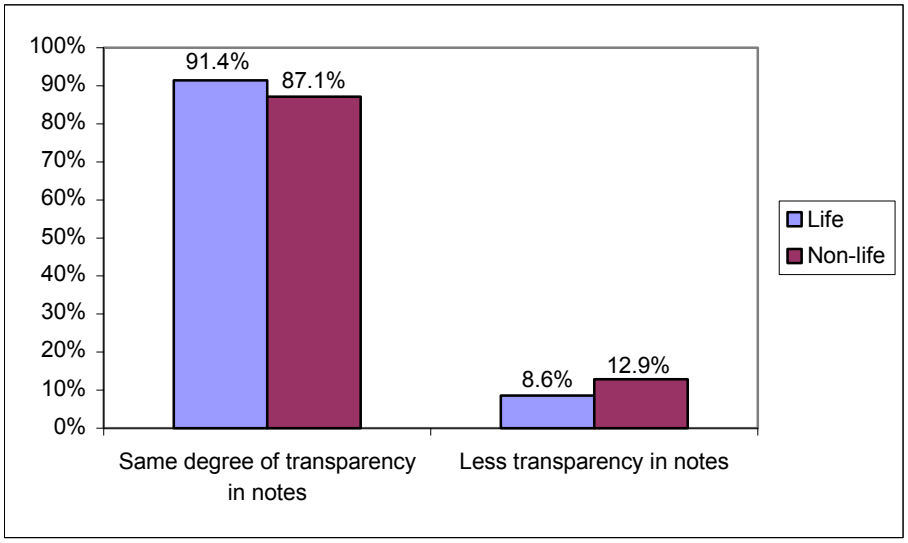
Companies were asked if they considered that fair value reporting of insurance liabilities would increase or decrease transparency, compared to that under their current national reporting standard. The answers to these questions were clearly opinions, as the issue of transparency can only be answered by users. But as insurance companies are major institutional investors, the senior management of insurance companies can be expected to have informed views on the subject. A related question was also asked on whether companies considered that there would be the same degree of transparency if the fair value of insurance liabilities were provided in the primary financial statement or in the notes to the accounts. The results are presented in Figures 13 and 14.

As can be seen in Figure 13, the views on transparency were more equally divided among the respondents, but a higher proportion of insurers considered fair values of liabilities would be less transparent compared to the disclosures under their current national reporting systems. Forty-six per cent of life insurers viewed fair value reporting to be less transparent, compared to 32% viewing it more transparent; the corresponding figures for non-life insurers were 39% and 32%, respectively. The US insurers were unanimous in their view that fair value would be much less transparent, while other insurers with their head offices in other countries were more divided in their opinions. This difference can be attributed to variations in the quality of national accounting standards. A view expressed by a few respondents was that national accounting standards in Europe were less transparent than under US GAAP, in part because of the changes in national accounting standards within Europe to implement the EU Insurance Accounts Directive in the mid-1990s, which tended to emphasize accounting form rather than economic substance.

As can be seen in Figure 14, most companies considered that an increase in transparency would be best provided in the notes to the financial statements rather than in the primary financial statements. Ninety-one per cent of life insurers and 87% of non-life insurers considered that the same degree of transparency could be achieved by disclosure of the fair value of insurance liabilities in the notes.

Figure 14

Fair value of insurance liabilities in notes or primary financial statements



	Life	**Non-life**
Same degree of transparency in notes	32	27
Less transparency in notes	3	4
No. of responses	**35**	**31**

Those insurance companies considering that there would be a decrease in transparency, gave the following main reasons in order of importance: (i) an increase in the number and complexity of qualifying assumptions that would have to be made was likely to confuse users; (ii) users would be less able to identify trends in the business because of 'market noise'; (iii) there might be an appearance of transparency but users may not appreciate the highly subjective nature of the measurements; (iv) the adequacy of technical provisions (technical reserves) would be less clear; and (v) for non-life insurance operations, core underwriting performance would be obscured. Companies that view that there would be some increase in transparency gave the following reasons in order of importance: (i) there would be a greater increase in the comparability of insurers' financial statements than under current reporting systems; (ii) for life insurance operations, there would be a clearer measurement of the value of guarantees and embedded options than at present; and (iii) there would be more consistency in the measurement of assets and liabilities in balance sheets than under current reporting systems.

A selection of opinions on transparency of fair value reporting compared with the current reporting system:

- 'We see it being a little more transparent, but we see the danger of overburdening detail of information, partly based on subjective estimates. Hence any disclosures should be in the notes to the primary financial statements.' German insurer.
- 'It would be much less transparent. The IASB's view that fair value methodology will be a transparent basis is a complete illusion. Its approach is fundamentally flawed.' UK life insurer.
- 'Overall we believe that transparency is not so much an issue of the accounting model used, but rather the additional disclosures and explanations provided to understand the financial statements. In theory, fair value measurement will provide more transparent information on insurance liabilities. However, we are concerned about the realization of a fair value system for the primary financial statements in practice. The system requires extensive information, and investors and analysts, may suffer from the complexity of the new approach.' European reinsurer.
- 'Fair value is much less transparent for insurance accounting in P&C insurance as it eliminates concepts of underwriting results and loss reserve adequacy (since liabilities are recorded at 'model pseudo-market value' as opposed to the anticipated cost of loss settlements.' US non-life insurer.
- 'We consider transparency would be much less. We do not think that fair values should be in the notes for our life business, even if they could be calculated. We would prefer embedded value disclosures instead.' German insurer.
- 'We prefer fair value information on insurance contracts (liabilities) to be disclosed in the notes. Primary financial statements should remain based in a deferral and matching approach. This would enable (re)insurers as well as analysts to gain experience with a fair value measurement. It should be noted that disclosures in the notes are also audited and provide useful information to investors.' European reinsurer.
- 'Fair value accounting increases the likelihood of early and imprudent recognition of profits which may be illusory and which do not accurately reflect the profitability of the business.' UK non-life insurer.
- 'If implemented correctly and consistently fair value disclosures may improve transparency.' Dutch insurer.
- 'As embedded options are not priced and do not exist on financial markets, so some of the parameters will have to be subjectively measured. But knowing the value of options embedded in life liabilities

will increase transparency and they should be in the notes to the accounts.' French life insurer.

- 'We would expect that the short term impact would reduce capacity in the industry until all operational issues and effects are understood by the stock market. We expect that in the longer term the adverse effects would be less, but still negative.' US life insurer.
- 'Capital will depend more on Solvency II within Europe. But Solvency II measurement of capital is planned to be based on the IAS standard.' German insurer.
- 'We consider that a fair value in the notes to the accounts could be useful to readers, but fair values in the primary financial statements will be less transparent.' Belgian insurer.
- 'The current system is non-transparent as it overstates liabilities, but one based on fair value will also be non-transparent as complexity and assumptions will prevent understanding.' German insurer.
- 'There would be more transparency for life insurance to the extent that it requires the pricing of embedded options.' French insurer.
- 'We think that a higher degree of transparency would be achieved if the information were disclosed in the notes because the information could be better adjusted than in the primary financial statements. It would be easier to read for the competent reader and others will not be confused with the volatility of the results.' German insurer.
- 'The danger with fair value is that it could lead investors and analysts to believe that it tells the truth.' French insurer.
- 'A full fair value system would provide greater transparency and hence greater possibility of making global comparisons.' Danish insurer.
- 'Full fair value reporting will impede users' ability to understand trends in profitability, the impact of operational decisions on performance, and company's own projections and modeling of future results. Any disclosure of fair value information should be in notes giving flexibility of users to employ or ignore the information according to their wishes and needs.' French insurer.
- 'Transparency would be about the same but in terms of comparability of accounts between insurance companies, it will be easier for the user.' Spanish insurer.
- 'We do not believe that transparency will be improved under a fair value model because of the amount of assumptions that must be used in the models to determine the fair value of life liabilities and the numerous changes to those assumptions that will have to constantly be made and the amount of disclosure that will be required to explain the

results. The requirements for fair value disclosure will only add to the confusion and potentially be misleading to the users of financial statements.' US life insurer.

- 'It is always more transparent to see the true effect of an implementation of a change in accounting standards on the face of the financial statements versus in the notes.' Swiss non-life insurer.
- 'There is likely to be a major confusion among users on the fair value of insurance liability and the required policyholder reserves.' Irish life insurer.
- 'Proper assumptions would be extremely important, however it might be impossible to avoid subjectivity in measuring life insurance liabilities. Thus, with more subjective assumptions, fair value financial statements might turn out to be much less transparent. It might not be relevant where you disclose the information because there might be much less transparency to start with.' Japanese life insurer.
- 'It would be less transparent, as it involves the use of a blacker 'black box'.' Swedish insurer.

16. Perceived impact on the risk transfer role of the insurance industry in the economic system

The insurance industry is the main private sector provider of risk transfer facilities to individuals and enterprises within the economic system. Through its risk transfer role and the risk management services that it provides, the industry not only helps to protect existing economic wealth but assists in the creation of new wealth by reducing some of risks associated with innovative commercial activity. This risk absorption role also has a social dimension since it provides psychological and financial security to individuals through the contracts it supplies; these contracts include long-term savings policies containing early death/longevity, and often investment risk, protection features. In fulfilling this risk absorption role, insurers must hold capital and seek to reduce the risks they assume through diversification and international risk sharing arrangements, such as reinsurance. Some of this risk diversification is achieved over time, through long-term contracts but it is also achieved by managements taking a long-term view of what is inherently an uncertain and cyclical business.

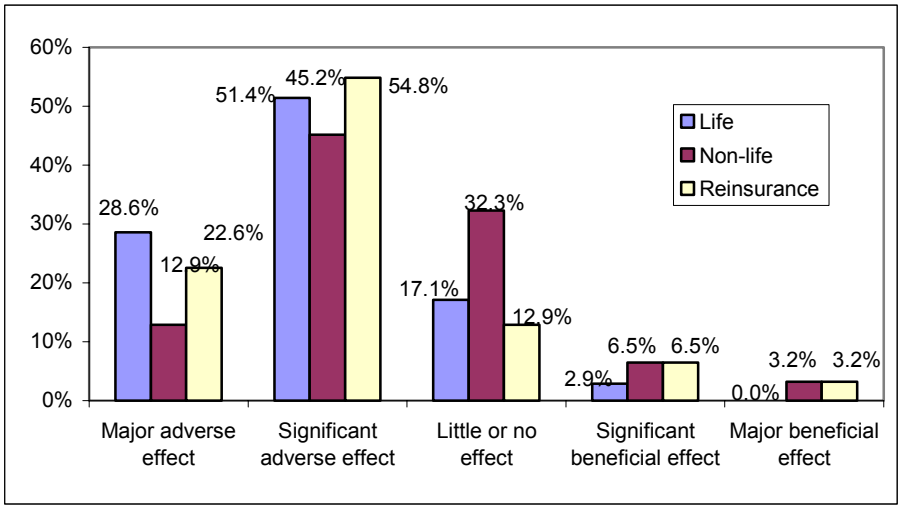
The survey sought to elicit views on the wider question of whether a move to a full fair value reporting system would impact on the capacity of the insurance industry to fulfill its risk absorption role within the economy. Although these views are only opinions on a broad and complex issue, they

do nevertheless represent a cross-section of experienced insights of senior management within forty leading insurers from seventeen countries.

Separate views were sought on the perceived impact on the life insurance market, non-life (P&C) insurance market and the reinsurance market. The overall findings are presented in Figure 15. As can be seen, 80% of life insurers, 58% of non-life insurers and 77% of reinsurers considered that the impact would be adverse, with only 3% of life insurers (i.e. one company) considering the effect as beneficial, but with about one in ten of non-life insurers and reinsurers also perceiving some beneficial effect. Approaching a third of non-life insurers perceived that the impact would be minor, but much fewer life insurers and reinsurers thought that the effect would be minor, perhaps because of the longer term nature of their business operations.

Figure 15

Perceived impact on the insurance industry's risk transfer role in the economy



	Life Insurance	**Non-life insurance**	**Reinsurance**
Major adverse effect	10	4	7
Significant adverse effect	18	14	17
Little or no effect	6	10	4
Significant beneficial effect	1	2	2
Major beneficial effect	0	1	1
No. of Responses	**35**	**31**	**31**

The main reasons advanced by those considering that the impact would be adverse focused around the following related issues. First, there would be a gradual pressure on management, from investors and other stakeholders, to shorten their time horizons, which in turn would influence a wide range of policy decisions, including product offerings and asset allocation policies. Second, the higher level of reported volatility in equity capital would tend to decrease managements' ability and willingness to take risk. Thirdly, the greater subjectivity in measuring insurance liabilities and the higher volatility in reported earnings would both tend to increase the cost of capital facing insurers, especially relative to other industries that were unlikely to adopt a fair value reporting system. Fourthly, it was considered that there could be an indirect regulatory impact if insurance supervisors were to base their statutory reporting for solvency and capital adequacy assessment on IASB standards, as has been stated in Europe (under Solvency II) and in some other countries; if the IASB were to introduce a mark-to-market accounting system, this would probably require insurers to hold a higher level of capital to meet these capital adequacy requirements, with the consequence that there would be a decrease in the industry's risk absorption capacity or an increase in the cost of insurance over time which would reduce demand.

It was observed that if non-life insurers and reinsurers were less willing to offer long-term insurances, such as product and general liability insurances, workmen's compensation and disability insurances, this would have adverse commercial repercussions on enterprises and individuals and hence indirectly on the wider economy. A reduced risk appetite by insurers and reinsurers to provide financial protection against low frequency/high severity events, such as natural catastrophes and terrorism risks, would clearly have economic consequences. The point was made that even if the reduction in capacity were minor, the impact could be major, since insurance plays a lubricating role within the wider economic system.

The view was expressed that if life insurers moved their product range away from long-term contracts and were less willing to offer guarantees and embedded options to consumers, this would reduce consumer choice, as other financial services firms would be less able to provide these contracts. It was also observed that these changes could influence the level of long-term saving in the economy and possibly undermine current attempts by governments to develop partnerships with the insurance sector to solve the problem of the increasing cost of social security provision.

A further economic repercussion mentioned by respondents was the potential capital market consequences if insurance companies were, as expected, to reallocate their investment holdings away from price volatile financial assets, particularly switching from equities to bonds. As these changes would be structural, and as life insurers are such major institutional investors, this was

viewed as having implications for the financing of industry over time. Moreover, it was observed that any sudden shift in asset allocations by insurers could cause falls in stock market levels, with potential increase in systemic risks within the financial system.

The few insurers perceiving that the impact might be beneficial said that a fair value reporting system would be more consistent with the economic pricing of risk. If fair value reporting had the effect of ensuring that prices remained more in line with risk costs, profitability tended to remain at appropriate levels and hence it would be easier to attract new capital and capacity would be increased. It was considered that this would likely be a longer term competitive scenario, as insurance markets would take time to adjust. This time adjustment would arise in reinsurance and non-life insurance because of the international risk sharing arrangements, and in life insurance because only a part of the reported profitability in a given year derives from new business.

One respondent pointed out the UK pensions industry provided evidence of how financial reporting system based on fair value concepts can have real economic impact. Under UK accounting standards, FRS 17, all companies, including insurers and banks, with occupational pension schemes are now required to use market values for their pension fund assets and to bring the difference between these asset values and the actuarial value of the pension liabilities directly into their balance sheets, hence causing large swings in the equity capital of some firms. This new reporting system for occupational pensions has been a significant factor, albeit not the only factor, in causing UK companies to switch from a defined benefit pension schemes to defined contribution schemes, thus reducing the guarantees provided to their pension members. This has been accompanied by a switch in the investment portfolios of pension funds from shares into bonds. It was observed that some lessons could be drawn from this for life insurers and their policyholders.

It was observed that under a reporting system that induced volatile accounting numbers, whether these volatile numbers reflect underlying real volatility or ‘market noise’, there would be the temptation on management to try to hedge the volatility in reported results, mainly earnings but possibly equity capital too. It was anticipated that investment banks would introduce new financial products that would be designed to manage this volatility. This might even make the reporting system even less transparent, as these new financial products would be engineered with the specifics of the financial statements in mind. Such hedging was considered unnecessary and would impose an extra cost on companies, which in competitive markets tend to be mainly passed onto consumers in the form of higher prices.

The following is a selection of statements by insurers:

- 'The capacity of the direct insurers and reinsurers to absorb risk will be significantly reduced. At present by having many products, especially long-term investment products, we can diversify risk. The market ability and willingness to supply will decrease as there will be more short-term in focus.' US life insurer.
- 'The impact would be major and adverse and we see the elimination of some high 'social utility' products, such as pensions and annuities. Because higher monitoring costs, fair value reporting would be incompatible with government proposals for low cost savings products in the UK market.' UK insurer.
- 'The ability for the market to pool risks over time will be reduced and therefore there will be limits placed on the assumption of large risk exposures.' French insurer.
- 'Apparent increased volatility in results will cause equity investors to increase the returns required from non-life insurers and reinsurers, reducing the ability of insurers to raise new capital and potentially increasing the amount of capital required to support a given level of insurance capacity.' US insurer.
- 'There will be a major adverse affect on the role of the insurance and reinsurance industry, as there will be a greater focus on the investment market with a shorter time horizon.' French insurer.
- 'Capital will be restricted within the entire direct and reinsurance industry.' US reinsurer.
- 'There will be an adverse impact on stock markets, as there will be a pressure to sell equities thus raising stock market volatility, as there would be pressures on insurers to sell at the same time.' German insurer.
- 'Insurance is not a day-to-day business which should help reduce the swings in the business and economic cycles. Full fair value will exaggerate these swings and undermine its economic role.' Italian insurer.
- 'In life insurance, it could encourage more economic pricing of guarantees as underpricing may become more apparent. With higher prices, supply would increase.' Swiss life insurer.
- 'If the insurance industry focuses more on linked-life contracts, without any investment guarantees, then its risk absorption role of the industry would not be fulfilled.' Spanish insurer.
- 'Capacity and capital requirements are normally driven by external reporting standards, such as US GAAP/IFRS, but uncertainty will have

an adverse effect. The impact would be dependent on any changes/reactions from regulators as a response to the changed accounting model. We see a risk of fair value external accounting requirements and the current regulatory reporting requirements being incompatible.' European reinsurer.

- 'A global insurance accounting standard adopted is intended to be adopted for regulatory reporting by many, if not almost all, jurisdictions. If full fair value does not meet the needs of regulatory authorities, this will be difficult for insurers.' US insurer.
- 'The introduction of full fair value reporting would lead to a limit on risks that would be assumed by insurers to avoid the volatility impact on asset risks and liability risks that will be exaggerated.' French insurer.
- 'It is possible that the risk absorption capacity might be compromised if insurers become concerned with the appearance of their financial statements, and the risk of negative equity capital that can arise under fair value balance sheets.' Japanese insurer.
- 'There is likely to be an increase in the cost of capital and the public's interest in long term life insurance products will reduce because of their increased volatility in returns.' US life insurer.
- 'Unless the accounting regime and market education is at an appropriate level, there is a considerable risk of investor suspicion of the results and there will be a tendency of companies to focus on products that are easier to explain.' UK life insurer.
- 'It could be very negative if it results in an "apparent" reduction in the capital base of the insurance industry.' Irish life insurer.
- 'There will be an adverse effect on the capacity of insurers and reinsurers to supply protection, as fair value will reduce the value of balancing a portfolio of risks over time.' German insurer.
- 'Loss of comparability of industry data. In the extreme difficulty in assembling insurance market statistics.' Brazilian insurer.
- 'Reduced role of interest rate guarantees to consumers.' Dutch insurer.
- There is likely to be adverse impact on non-life and reinsurance on security levels. Reduced prudence would lead to increased capacity as well as insufficient level of reserves to meet major catastrophes.' UK non-life insurer.
- 'Fair value will force companies to raise prices in certain products to compensate for the increased spurious volatility.' Swiss insurer.
- 'In theory, if the valuation of our liabilities were to be more transparent, this might lead to a reduced cost of capital resulting in a lower implicit

discount applied by the stock market, this would be beneficial to the capacity of the industry. It is not at all clear that this will happen.' UK life insurer.

- 'There will be an adverse effect on our ability to fulfill our risk absorption role within the economy as there will not be a level playing field with other industries we compete for capital, as they will not be required to report highly volatile results.' European reinsurer.

17. Conclusions

The survey reveals a number of important issues. First, no insurance company in the forty international insurance companies that participated in the survey currently uses a full fair value system as a general accounting model for internal planning and control, nor would any company wish to do so voluntarily.

Secondly, senior management in insurance companies consider that they would be under some pressure to change their internal accounting systems over time to realign them more with a new financial reporting system. This is in part to be consistent with investor and other user perceptions and in part because it would be costly and confusing to have two very different accounting systems running side by side.

Thirdly, the introduction of a full fair value reporting system would significantly change the business strategies, corporate policies and systems over time in a way that most companies consider would reduce their competitiveness.

Fourthly, there is a high degree of agreement that the higher volatility of reported earnings would increase the cost of capital of insurers and that it would be more difficult to provide earnings' forecasts or forward-looking information to the investment community.

Fifthly, most insurers consider that measuring the fair value of insurance liabilities (insurance contracts) would be very subjective and there might be compliance problems under the Sarbannes-Oxley Act.

Sixthly, a majority of companies perceive that the disclosure of fair values of insurance liabilities, if they could be measured credibly, would be unlikely to increase the transparency of financial statements to users, but a significant minority, all outside of the United States, consider that it would increase transparency to some degree over the prevailing national reporting standards. However, nearly all companies consider that this increase in transparency

should be provided in the notes to the accounts rather than distorting the primary financial statements.

Seventhly, there is a broad consensus that a full fair value reporting system would have some adverse impact on the risk transfer role that the insurance industry plays within the wider economic system.

The introduction of a full fair value system for all financial instruments has been a long-term ambition of the IASB, and some national accounting standard setters, including FASB in the United States and ASB in the UK, because of its conceptual coherence. However, experience shows the IASB, and other national standard setters, have shown pragmatism when faced with having to reconcile a theoretical preference with real-world complexity and problems of implementation. This can be seen in the structure of IAS 39, and its subsequent amendments, which permits a mixed system of measurement for investments. A similar mixed measurement system for investments continues to apply in United States under FAS 115.

Phase II of the IASB's Insurance Contracts project has already started, which will seek to define an international reporting standard for the measurement of insurance liabilities. And there are also other prospective international financial reporting standards (IFRS's), including the standard on Performance Reporting, of relevance to insurers and the users of their published accounts. These standards will need to be designed in a way that complement IAS 39 as it emerges as an international standard, not least to ensure consistency in the treatment of financial assets and liabilities. The suggestion advanced in our earlier report that insurance liabilities should be viewed as a held-to-maturity or as available-for-sale (available-for-settlement) financial instrument might be one way forward, since it permits a consistent treatment with the mixed measurement system for investments under IAS 39 and FAS 115 that is likely to remain for the foreseeable future (see Dickinson, February 2003, pp. 40-41). In conclusion, it is hoped that the findings of this survey will help to inform the search for workable international accounting standards for insurance companies that not only increase comparability but are understandable, relevant and reliable.

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