

CAS Task Force on Fair Value Liabilities

White Paper on Fair Valuing Property/Casualty Insurance Liabilities

Section B - Fair Value in the Insurance Context

1) General statement

In general, the fair value projects of both the FASB and IASC propose that any asset or liability that ultimately settles in cash should ideally be valued at its "fair value." This would include (but not be exclusively limited to):

- Loss reserves (i.e., claim liabilities)
- Loss adjustment expense liabilities
- Policy reserves, including unearned premium or unexpired policy liabilities
- Accrued retrospective premium assets
- Return retrospective premium liabilities
- Contingent commissions
- Reinsurance recoverable amounts
- Deductible recoverable amounts
- Salvage and subrogation recoverable amounts.

In addition, a fair value accounting approach (at least according to the FASB) would not recognize prepaid acquisition costs as an asset. Hence, these assets would disappear under fair value accounting.

Premium deficiency reserves would also disappear under fair value accounting, as any expected price inadequacy on in-force policies would be directly reflected in the unearned premium reserve valuation.

Given the absence of an active market for most (maybe all) of these items, their fair value would have to be based on an estimate. The estimate would involve discounted cash flows.

For now, the focus from the FASB and the IASC is on contractual cash flows. Non-contractual cash flows, such as future renewals, would be precluded from the cash flows used to estimate fair value, even when the renewals are largely unavoidable due to existing legal or regulatory rules. The only renewal business flows to be included in these cash flows are those that are contractually guaranteed.¹⁴

¹⁴ The treatment of renewal business is still an open issue. The quandary these accounting organizations face is that renewal business IS considered currently by those valuing the overall net worth of insurance enterprises. Therefore, a "market value" of the enterprise would include these intangibles. If a market price would include them, then why should a cash flow estimation procedure, generally meant to estimate a hypothetical market value, exclude them? So far, they have leaned against including them, despite a risk of being inconsistent with real-life market valuations, due to problems with reliably estimating the renewal flows. While both the FASB and IASC proposals include contractually guaranteed renewals in these projected cash flows, the IASC definition further requires that the insurer's pricing flexibility for these renewals be restricted in some fashion.

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These discounted cash flows may need to be adjusted for:

- Risk or uncertainty in the flows (with the size of the adjustment based on market compensation for such risk)
- Credit standing of the obligor
- "Market imperfections," including possibly illiquidity.

2) Risk or uncertainty adjustments.

A summary of the October 27, 1999 FASB Board meeting¹⁵ included the following statement, regarding the board's conclusion concerning present value-based measurements.

"A risk premium is necessary if the risk is identifiable, measurable, and significant. In cases where the risk does not meet those characteristics, risk should not be incorporated into a measurement."

We expect little disagreement that the risk in insurance liabilities is "identifiable" and "significant." We expect the principal discussion to be on the measurability of this risk, in an accounting context.

3) Credit standing of the obligor

As mentioned above, the FASB views the credit standing of the obligor as an integral part of a liability's fair value. After numerous discussions on this topic, they clarified their original statements to say that such credit standing reflection "includes the effect of associated deposit insurance, state guaranty funds, purchased credit insurance, or similar enhancements."¹⁶

4) Market imperfections, including illiquidity

It is generally recognized that there is no active market for most or all p/c insurance liabilities. Hence, such liabilities will be illiquid to some degree in a fair value context. It is less obvious how a fair value estimate should adjust for such liquidity problems.

5) Alternatives to fair value

Both the FASB and IASC documents recognize outstanding issues regarding the implementation of fair value accounting for insurance liabilities. It is possible they may not be resolved or resolvable in the foreseeable future. Therefore, it is possible that the accounting standards bodies would propose an alternative to fair value accounting, reflecting some of the economics but possible not all that might impact a "fair value."

6) Potential advantages and disadvantages of fair value accounting in the insurance context

Below are some of the advantages and disadvantages to fair value accounting, as it might be applied to insurance liabilities, that have been discussed in prior literature. This partial list is intended to aid in comparing fair value accounting to the various alternatives, discussed in the next section. More detailed discussion of these and other advantages/disadvantages can be found

¹⁵ From the FASB Action Alert No 99-35, dated November 3, 1999.

¹⁶ FASB Action Alert, No 99-34, Dated October 27, 1999.

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throughout the later sections of this paper.

Potential advantages - Fair Value

- Consistency with assets. If insurance company investments are to be reported at fair value, then its insurance liabilities should be too. This consistent treatment across the entire balance sheet would prevent false volatility in reported earnings and equity.
- Eliminate accounting arbitrage. Valuation of insurance liabilities at other than what they are worth in the market creates incentives to manage earnings through sales of these liabilities, even when done at non-economic prices.
- Consistency with other financial instruments. To the extent that non-insurance financial liabilities are similar to insurance liabilities, they should be accounted for similarly. Otherwise, the inconsistent accounting rules could create competitive advantages based strictly on the accounting, not the economics.
- Relevance. As the value at which such liabilities could be extinguished or traded, fair value should be the most relevant measure for investors.

Potential disadvantages - Fair Value

- Difficulty in measuring. The calculation of reliable fair value adjustments may be a difficult task, and may not always be possible.
- Greater estimation reliance. Fair value accounting systems increase the number of estimates underlying the reported financials. This raises questions as to potential estimation error, and even manipulation of estimates.
- Volatility in earnings. Liabilities held at fair value may show much greater volatility, due to changing yield curves and risk adjustments, versus undiscounted or conservatively discounted liabilities.¹⁷ This additional volatility may provide more noise than information to capital providers and other users of financial statements.
- Cost. Implementation and maintenance of a fair value accounting system will cost time and resources. There may be other alternatives that cost less, and do not have all the disadvantages mentioned above, while still maintaining many of the advantages of fair value accounting.
- Uncertainty. Fair value accounting has never been implemented for insurance liabilities, or other liabilities for which there are no active markets. There will inevitably be some unintended or unexpected consequences from its implementation.

¹⁷ Assuming that the conservative discount rate is not readjusted each reporting period.