CAS Task Force on Fair Value Liabilities
White Paper on Fair Valuing Property/Casualty Insurance Liabilities

Section E - Accounting Presentation Issues

The purpose of this section is to discuss financial reporting presentation issues resulting from a change to fair value accounting. Financial reporting presentation deals with the design of the reporting template, i.e., what financial values should be displayed, and in what format. It assumes that any required value can be determined, such as through the various methods in Section D. While many implementation issues may arise from the choice of a particular reporting template, such issues will not be discussed in this section. All implementation issues will be discussed in the next section (Section F), whether arising from the estimation method chosen (Section D), or arising from the presentation template chosen.

The following actuarial presentation issues will be discussed. This list is meant to stimulate awareness of the various actuarial issues/concerns surrounding presentation and fair value accounting. It is not meant to give definitive guidance on how presentation should be done. The final choice of any presentation template is a judgment call, depending on the goals, priorities and preferences of the template designer(s).

- Historical loss development:
  - risk margins
  - time value of money
- Disclosure of fair value estimation methods.
- Gross versus net (of reinsurance, other recoverables).
- Recognition of premium revenue.
- Income classification:
  - Unwinding of interest discount
  - Interest rate changes
  - Experience adjustments, changes in assumptions.
- Consistent treatment of assets and liabilities
- Different financial statements for insurance vs. noninsurance entities
- Disclosure of credit standing impact
- Consolidated financial statements
- Regulation and tax requirements

1. *Historical Loss Development* - Currently some financial statement exhibits show historical loss development. These exhibits are useful for evaluating management's previous estimates of liabilities, and for evaluating the risk inherent in the estimates. Should these exhibits show historic fair value estimates? Issues associated with doing so on such exhibits include:

   a) Risk margins. The risk margin for a given coverage year runs off over time to a value of zero as the losses are paid. In addition, the perception of risk changes over time. For example, the risk margin of hurricane losses would have been valued less before the recent large hurricane losses in Florida. The perceived risk for mass tort liabilities is also now much greater than believed in the 1970s and prior. Are the purposes of these historical exhibits furthered or distracted by including historic risk margin estimates in

the reported history?

b) Time value of money. The amount of discount runs off to zero as losses are paid out. Interest rates also fluctuate over time. As such, historical exhibits that reflect the time value of money might show development trends impacted strictly by changes in new money investment yields or the unwinding of interest discount. The economic impact of these trends depends on the how the corresponding asset portfolio was impacted. How should the historic loss development exhibits handle this issue?

A possible way of addressing the above two sub-issues might be to require historic loss development exhibits to be on an undiscounted, expected value basis. This would isolate the issues surrounding the expected value estimate (although it would ignore the issues surrounding the amount of the discount or risk margin). An alternative approach for evaluating the amount of the discount would be to require loss development exhibits to show all actual and projected values discounted back to the beginning of the coverage year. This would allow reflection of time value of money issues and expected value estimate issues, without the distortion from interest rate fluctuations. The issue would remain regarding whether to use the historical interest rates at the first valuation of the coverage year or restate at the current interest rates.

2. *Disclosure of fair value estimation methods* - Should the methods used to determine the fair value estimates be disclosed in the financial statements and if disclosed, where, and in what levels of detail? Depending upon the method(s) employed, the fair value components may differ by line of business as well as subline of business, duration of payments, location of the liabilities, and the currency that will pay out the liabilities. In addition, any changes to the method(s) or the values used to determine the fair value of liabilities may need to be disclosed in the financial statement.

3. *Gross versus net (of reinsurance, other recoverables).* – A decision needs to be made with regard to how much of the fair value presentation should be on a gross versus net basis. Should fair value adjustments be included in both gross and recoverable reportings, or would an overall net adjustment suffice? Where various amounts are reported in more detail, should these fair value adjustments be disclosed in the aggregate or by individual reinsurer or excess insurer (for a self-insured's financial statement)?

4. *Recognition of Premium Revenue* – How should premium revenue be recognized, under a fair value accounting system? Currently, premium revenue is recognized for property/casualty companies based on earned premiums, which equal written premiums plus the change in the unearned premium reserve. Since fair value accounting would require estimating the future losses associated with the unexpired portion of the policy, should this estimate of future losses be included in the loss reserves, and premium revenue become written premium? If so, the unearned premium reserves could disappear.

Long duration policies cause additional presentation issues if premium revenue is defined as written premium. Should revenue from long duration policies be reported or disclosed separately in financial reports, so as not to distort analyses of annual exposure growth? These policies may also distort otherwise reported policy year loss development trends. Should a single long duration policy be broken into separate 12-month policies for the purposes of policy year loss development exhibits?

Special policy features such as death, disability, and retirement benefits may also be impacted by a change in premium recognition. Should such benefits be accounted for as loss reserves or as unexpired policy benefits, under a fair value system?

5. *Income classification.* - Under a fair value accounting system, recorded balances (such as loss reserves) will reflect the time value of money, estimated future cash flows, and risk adjustments. Any of these components are subject to change over time, as the balance runs off. How should the changes in this components be reflected in income? The following discussion contains a discussion of the components.

a) Unwinding of interest discount – The principal question here is whether the unwinding of interest discount should be separately reported in income, and if so, where? Currently when companies discount property/casualty loss reserves for anticipated investment income, the unwinding of this discount over time flows through underwriting income, as a change in incurred losses, and is not separately identified. Discount unwinding for life insurance reserves also flows through as a change in incurred losses, but is separately identified in U.S. statutory accounting statements. Alternatively, the unwinding could be reported as interest expense, not in underwriting income.

Reflection of this unwinding in incurred losses maintains consistent treatment of any item affecting paid or outstanding losses, at the cost of distorting comparisons of losses to charged premiums. This distortion is caused by premiums being fixed in time, with no reflection of future investment income potential. If loss reserve discount is all unwound in incurred losses, then reported histories of incurred losses to premiums will tend to show excessive loss ratios for any long-tail line, distorting the true profitability picture. Reflection in interest expense allows more direct comparisons of losses to charged premiums.

b) Interest rate changes. How should changes in market interest rates used in discounting existing liabilities be reflected? Should the effect of these changes flow through underwriting? Should the effect flow through investment earnings? Should it be reflected in the same manner as unrealized capital gains, as a change in interest rates should affect both liabilities and assets similarly in a matched portfolio? Or should changes in loss reserves for any purpose other than unwinding of discount (e.g., change in expected ultimate payout, change in expected payment pattern, change in interest rates, etc.) all be reported in the aggregate, with no differentiation as to the cause?

Section E - Accounting Presentation Issues

c) Experience adjustments, Changes in assumptions. Another issue is how should an insurer present the effect of experience adjustments and changes in assumptions? Should changes due to actual cash flows being different from expected be reported separately from changes in assumptions about the future? The first are "realized" and the second are currently "unrealized". Should there be an effort to keep consistency with how similar issues for invested assets are treated? Should changes in risk margins be isolated, or combined with changes in any other assumptions?

6. Consistent Treatment of Assets and Liabilities - This issue arises whenever recoveries are available (beyond the initial premium) to offset changes in the estimated liabilities. Examples include retrospectively rated insurance policies, deductible policies, policyholder dividends, (re)insurance policies for which reinsurance (or retrocession) protection exists, and contingent commission plans (on reinsurance contracts). In these examples the change in a claim (or similar) liability should lead to an offsetting change (either in full or partial) in either an asset or another liability.

   For example, a direct retrospectively rated insurance policy may be subject to reinsurance. This could result in at least three balance sheet entries after losses have started to occur:
   - a liability for direct claims
   - an asset (liability) for additional (return) premiums on the retrospectively rated policy
   - an asset or contra-liability for the portion of the claim liability that is recoverable from reinsurers.

   The presentation issue regards the manner of reporting these amounts and their fair value adjustments in a consistent manner, and in such a way that their individual adjustments will not easily be taken out of context.

   (Note that to the extent the retrospective rating plan and the reinsurance coverage transfer risk, the overall net risk adjustment for all three items should be less than the risk adjustment on direct claim liabilities. This implies that the risk adjustment for some of the individual components may be a help to surplus.)

7. Different Financial Statements for Insurance Versus Non-Insurance Entities - Should financial statement requirements differ for insurance versus non-insurance entities? This issue arises when comparisons are attempted between insurers and self-insurers, traditional insurers and captive insurers, or insurers and other financial services companies selling similar products. The issue also arises with consolidated financial statements when the reporting entity includes both insurance and non-insurance operations.

8. Disclosure of Credit Standing Impact – If the fair value of liabilities is to include the impact of credit standing, these impacts should probably be disclosed separately in the financial statements. (The credit standing issue is discussed in more detail in Section H.)

Section E - Accounting Presentation Issues

9. Consolidated Financial Statements – Fair valuation generally requires that transactions be measured as if they were at arms-length. A key question regarding consolidated versus legal entity reporting is the difficulty in measuring fair value for legal entities of the same quota share group, especially when applied to a fresh start valuation of old claim liabilities. Thus, it may be necessary to estimate fair value for each pool member's direct book of business separately, rather than determining the fair value of the total quota share pool and then allocating the total pool result to the pool members.

   A related issue is how to report values containing risk margins if the component reporting entities have risk margins that do not add to the total risk margin of the consolidated entity. Should the component risk margins be scaled back to show value additivity?

10. Regulation and Tax Requirements – The change to fair value will impact both the absolute value of many of the statement items as well as the format of the financial statements. This may impact existing regulatory and tax use of financial information that may have come to depend on the existing financial statements. The final "fair value" statements may have to include accommodations for these needs. Alternatively, the regulatory and tax processes could be changed to adapt to the new financial statements. A third alternative would be to create additional supplemental reporting, based on the old accounting standards, as if nothing had changed. Examples of areas potentially impacted include federal income taxes, solvency testing, and market conduct exams.