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

## Section G – Accounting Concepts

### ***Introduction***

This section discusses the proposed fair value adjustments in terms of the attributes demanded for sound accounting bases. We set out below the criteria (termed accounting precepts) that accountants and accounting standard setters judge accounting bases by, and consider who the users of financial statements are. We then consider each of the major fair value adjustments in terms of the accounting precepts. The fair value adjustment for the entity's own credit standing is discussed in section H.

Fair value accounting could be applied to any financial reporting; GAAP financial statements, statutory (regulatory) financial statements or even tax returns or internal management reports. While, in the U.S., GAAP financial reporting is determined by the FASB and the SEC, statutory financial statements will remain the responsibility of the NAIC. Even if fair value accounting were adopted for GAAP financial statements, a different non-GAAP basis might well be maintained for statutory financial statements.

### ***Generally accepted requirements for 'good' accounting***

The two relevant accounting pronouncements that discuss how to select the most appropriate accounting treatment from a range of alternatives are:

- FASB – Statement of Financial Accounting Concepts no. 2: Qualitative Characteristics of Accounting Information.
- IASC – Framework for the presentation of Financial Statements.

Fortunately, to a large extent the two documents agree as to what is desirable. The FASB document is longer and more discursive.

The IASC framework document defines the object of financial statements as:

> *"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."*

The desired traits of an accounting system are:
- Relevance
- Reliability
- Comparability and Consistency
- Neutrality
- Cost Benefit

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***Relevance.*** To be relevant information must be capable of making a difference to users' decisions. This is achieved either because the information can directly feed into a prediction of the future position of the enterprise, or because the information can be used to refine previous expectations. Untimely information generally has little relevance. The IASC framework details a separate characteristic of "understandability," stating it is an essential characteristic of financial statements that the information is readily understood by diligent users. This is implicit in the FASB concept of relevance, information which cannot be readily understood lacks the characteristic of being able to inform users' decision making. Also implicit in the two concept statements is the concept of transparency, i.e. that items in financial statements should be clearly disclosed so as to maximize their utility to financial statement users. (Neither the IASC nor FASB documents listed above mention transparency explicitly, although the IASC notes "substance over form," that is, following the economic substance rather than legal form as a basic requirement).

***Reliability.*** Reliability depends on the representational faithfulness with which a reported item reflects the underlying economic resource, obligation or transactions. Reliability does not imply a need for certainty, and reporting the degree of uncertainty in an item may provide a better representation of the underlying economic reality than a single point estimate. In certain cases the measurements of the financial effects of items could be so uncertain that enterprises would not be allowed to recognize them in their financial statements (for instance, nonpurchased goodwill). Financial statements should be free from bias in their measurements. FASB, but not the IASC, notes verifiability as a characteristic that helps constrain bias in financial statements.

***Comparability and Consistency.*** Financial statements should be comparable over time and between different enterprises in order to be able to ascertain trends and the relative position of different companies. Conformity to a uniform set of accounting standards helps achieve comparability and consistency.

***Neutrality.*** Financial statements should be free from bias. However, the IASC framework notes that where an element of a financial statement is subject to uncertainty a degree of caution is needed in the exercise of judgment in making the required estimates.

***Cost Benefit.*** The balance between cost and benefit is a constraint on "good" accounting paradigms rather than one of their qualities. If accounting information can only be generated at substantial cost, the relevance and utility of that information to users needs to be established before it is sensible to adopt accounting standards that demand such information.

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## ***Fundamental Assumptions***

The IASC framework notes two fundamental assumptions for the preparation of financial statements. These are:

- ***The Accruals basis***: Transaction are recognized when they occur, not when cash changes hands, and reported in the financial period to which they relate.

- ***The Going Concern basis***: Financial statements are prepared on the basis that the enterprise will continue in business for the foreseeable future. If there is the likelihood or intention to substantially curtail business or to cease to trade, financial statements may need to reflect this in their choice of accounting policies, and the circumstances are to be disclosed.

## ***Accounting paradigms***

There are two types of modern accounting paradigm.

There is the ***deferral-matching*** approach, such as in traditional property casualty accounting. This approach can be characterized as income statement focused. They aim to match revenue and expenses of a period in the income statement of that period, and "park" surplus contractual income flows (future income) and surplus costs (such as deferred acquisition costs) in the balance sheet so they can be reflected in a subsequent periods' income flows.

The alternative is the ***asset-liability*** approach. These models are balance sheet focused. Their aim is to accurately reflect the assets and obligations of a company at periodic intervals. The changes in the values of assets and obligations become the profit (or loss) for that period. A fair value accounting approach for the assets and liabilities of insurance enterprises is one potentially available asset-liability paradigm.

The IASC paper essentially analyses three alternative methods of accounting for insurance: the current deferral-matching model, full fair value accounting, and an alternative asset-liability model.

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## ***Who uses financial accounting, what are their needs, and on what do they focus***

### ***Shareholders, analysts and potential capital providers***

Shareholders and potential capital providers fall into two classes, the professional, often institutional, investor and the individual investor. Both may be interested in the long-term earnings potential of the stock, or the potential for short-term capital gains from holding the stock. Both groups will be interested in earnings trends, the adequacy of reserves for future payments and the value and quality of assets held. Sophisticated users should be able to unravel almost any accounting treatment given sufficient disclosure, (although whether they will in practice be attracted to doing this is questionable). For unsophisticated users it is highly desirable that trends in current earnings can be distinguished from fluctuations arising from volatile shifts in fair value measurements. In addition, they may find it useful to have clear indications of balance sheet risk. Sophisticated users are also likely to welcome user-friendly presentation, particularly in the income statement, and clear indications of balance sheet risk.

### ***Policyholders, potential policyholders, brokers and rating agencies***

Personal and some small commercial policyholders are unlikely to resort to examining insurers financial statements before purchasing insurance. If they use an independent broker for their purchase, the broker is more likely to rely on rating agencies' assessments than to carry out their own assessment of insurers.

Most prospective commercial insureds and reinsureds and their brokers are interested in the solidity of (re)insurers with whom they place business. Essentially they need to evaluate the risk of the (re)insurer being unable to pay claims in full once they become due. While income statement information is not irrelevant, their basic focus is on the balance sheet strengths and weaknesses of the company.

Existing commercial policyholders and in particular policyholders with outstanding claims against insurers/reinsurers of doubtful solvency, require that financial statements provide them with sufficient information to evaluate the credit risk they face from their existing policies' receivables, so that they may plan and act accordingly.

Rating agencies have similar aims as commercial insureds and reinsurers. Their basic focus is on balance sheet solidity. They, like insurance sector analysts are sophisticated users of financial information, and have access to more detailed financial information than that presented in the financial statements.

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***Bankers and Other Creditors***

Bond issues and bank loans are most likely to be the obligation of the holding company of insurance groups, not the individual insurance entities underneath the holding company. The bond holders and bankers behind this debt will be interested in the ability of insurance groups to service borrowings and repay loans, this is a function of both balance sheet strength and the future profitability of the company. In addition both these creditor groups may be interested in ascertaining that covenants are satisfied.

***Regulators***

Regulators have, at least in the US, two perspectives on insurance companies. First, they are interested in the solidity of insurance companies and in minimizing any call on guarantee funds. Second, they may wish to use the financial statements as a resource in the regulation of prices. Regulatory analysis in both these areas might be made more difficult if reported profit measures are volatile. Well understood and accepted measures of shareholder equity would also be advantageous. Regulators have access to other financial information. Indeed, in the US, statutory financial reports will be their primary source for the financial review of an insurance company's operation.

Outside the US, regulators make more use of a company's general purpose financial statements, and generally desire a single accounting paradigm for general purpose and regulatory financial reports.

***Employees***

Employees will be concerned primarily with two questions: how secure is the company? and how well is it doing? Most employees will be unsophisticated users of financial statements.

### <u>***Discussion of fair-value valuation bases in the context of accounting precepts.***</u>

***Fair value adjustment – marking investments to market.***

The principal actuarial issue associated with marking of investments to market is balance sheet consistency. If investments are marked to market, then their value will fluctuate with various financial variables, such as interest rates. If the same variables also impact the economic value of the liabilities, but not the stated value per accounting rules, then reported income and equity will be distorted. These reported income and equity values, and especially the reported changes in those values, will not be relevant and will not be representationally faithful.

If insurance company investments are recorded at fair value, then reporting insurance liabilities at fair value will create consistent balance sheet accounting, and will improve relevance and

representational faithfulness of reported income and equity.

There are alternatives to fair value accounting for liabilities that react to some, if not all, of the same variables impacting the investment market value. These alternatives may produce more relevant financial reports than the current status quo for U.S. GAAP (where most liabilities are undiscounted but many assets are at market). They may also be easier to implement that full reflection of fair value for liabilities. The risk is that they may cause an unacceptable level of inconsistency relative to the assets, for those financial variables that would impact market values but not the alternative standard liability values.

***Fair value adjustment – discounting***
*(as applied to loss and expenses reserves, reinsurers' share of loss reserves, unearned premium reserves and possibly debtor balances and deferred taxation.)*

Currently, most p/c reserves are carried at an ***undiscounted*** value. This current use of undiscounted reserves for loss reserves has the following advantages and disadvantages.

*Advantages*

- It is easy to understand
- It locks in a margin that cannot be distributed to shareholders. (A plus in the eyes of regulators and policyholders)

*Disadvantages*

- It is typically an unreliable measure of the economic value of liabilities. Further, the degree of distortion varies between different enterprises depending on their mix of business and growth history. As a result, return on equity comparisons are distorted both within the insurance sector and with other industries. In particular, insurance company equity is understated in most cases compared to values for other industries. This understatement of insurance company equity leads to an overstatement in returns on equity.
- It results in different valuation bases for assets and liabilities, which can result in spurious earnings volatility when interest rates change even when the underlying cash flows are broadly matched.
- It distorts profit recognition.
- Booking undiscounted reserves may provide grounds for accounting arbitrage.

Fair value proponents, and others in favor of moving to a ***discounted*** basis for insurance liabilities, would argue that moving to a discounted basis for loss reserves, etc., removes or at least substantially reduces:

- The inconsistency between the valuation basis of assets and liabilities, to the extent assets are either at market or at some version of cost (which is effectively an historic market value).

- The inconsistency between enterprises writing different classes of business where the economic value of two reserves shown at the same amount may be substantially different.
- The conservative bias that may be implicit in undiscounted liability values.

They would argue that the profits reported on a discounted basis would be a better (more relevant) reflection of an enterprise's earnings for a period. The use of a fair value liability valuation (in conjunction with holding assets as market) will put assets and liabilities on a consistent footing, so that changes in the values of assets and changes in the discounted value of liabilities broadly mirror each other when interest rates change, so long as liabilities and assets are matched. This will eliminate that part of the interest rate volatility that does not reflect economic change for the insurance enterprise. Further, fair value proponents would maintain that the balance sheet values calculated on a discounted basis better discern between different enterprises; that is they are more relevant, and do not contain conservative biases; that is they are neutral.

Fair value proponents would also argue that well thought out presentation in the income statement matching of investment return and the unwinding of the discount could do much to mitigate the potential confusion that may be suffered by some users as a result of moving to a discounted basis for loss reserves.

Others who oppose the introduction of discounted amounts would argue that liability values currently reported by insurers reflect two offsetting biases, i.e., lack of provision for future investment income and optimistic evaluation of ultimate settlement values (resulting in insurance liabilities that they believe are already implicitly discounted). The introduction of explicit discounting would remove one of the two biases. However, valuing loss reserves at discounted values without addressing the second bias would probably be a disservice to all users as it would overstate available capital and overstate profitability.

Further such observers might argue that if fair values are assessed by direct comparison to exit prices available in the reinsurance market, there is a danger that values substantially different from the net present value of the cost to the enterprise of running off liabilities may be recorded. Substantial overvaluations are possible when there is a hard reinsurance market. Substantial undervaluations are possible when there is a soft reinsurance market, precisely the time at which such valuations cause regulators most concern.

The use of discounted liabilities will not necessarily result in more or less reliable estimates than the undiscounted ones. Discounting techniques are well understood and generally introduce little additional subjectivity into the liability valuation process. When the uncertainties are concentrated in the tail, discounting of the reserves may even reduce the uncertainty in the estimated liability value. In this task force's opinion, fair value accounting in practice may not

significantly alter the inconsistency between different company's accounts due to variations in reserve strength.

Essentially similar arguments apply to the introduction of discounting for the estimates of other insurers' liabilities or assets

***Fair value adjustment – risk margins***
*(as applied to loss and expenses reserves, reinsurers' share of loss reserves and unearned premium reserves.)*

Fair value proponents would argue that discounting in conjunction with adding risk margins to liabilities provides the best basis for profit recognition. The profit on the book of business will emerge as the associated risk expires.

This approach has the drawback that it is a difficult concept to grasp and may confuse amateur (and some professional) users of accounts. Clear disclosure of the risk adjustment may help such users.

The lack of market depth in the exchange of insurance liabilities between enterprises makes a direct market assessment of the price for the risk margin impossible in most instances. Risk adjustments derived from methods that use industry-wide data to derive industry level risk adjustments may not succeed in producing financial information that can be used to distinguish between one insurance enterprise and its peers. In addition market-based information will be impossible to obtain in countries that do not have significant stock markets, or that have integrated financial service industries where the major insurance carriers also have banking and securities interests within one quoted vehicle.

Other enterprise-specific risk measures can to a greater or lesser extent be criticized as requiring significant subjective input. Proponents of such methods would argue such judgment calls are inherent in arriving at other accounting measures such as the bad debt adjustment to trade receivables in manufacturers' balance sheets.

This is an area where standard setters may well be faced with determining a trade off between reliable (less subjective) and relevant measures.

If there is a wide range of acceptable methods for calculating fair value adjustment this may well lead to a greater spread of the range of acceptable "values" for the various elements of financial statements. Accounting/actuarial guidance is likely in practice to increase the consistency of the calculation of the risk margin.

The introduction of subjective elements into fair value assessments also means that there is additional scope for managing (or manipulating) financial results. Methods that reduce the scope for subjectivity in the assessment, such as an IRR model using regulatory capital, curtail the scope for inconsistency between different insurance enterprises (but, possibly, at the expenses of relevance, see above). More company specific methods may result in greater scope for inconsistency (the scope might well in practice be reduced by accounting or actuarial guidance).

The task force suspects however that the increase in inconsistency due to differences in the basis on which fair values are calculated are likely to be of second order compared to differences in the strength of company's loss reserves.

Opponents of risk margins would argue that a risk margin for insurance liabilities cannot be reliably determined, so that (per FASBs Concepts Statement No. 7, paragraph 62) discounted values with no risk adjustment should be used. Others would argue that undiscounted values would be preferable to discounted values without risk adjustments, which they would contend, could grossly understate a company's liabilities.

***Fair value adjustment – To reserves and creditors to reflect a company's own credit standing.***

This is the most contentious of the fair value adjustments, and is separately discussed in section H.

***Taxation***

The extent of the link between taxes and the financial statements of enterprises varies between different countries. Where the calculation of taxable profits is substantially based on the profit disclosed in the enterprise's general purpose (i.e., GAAP) financial statements, it is certainly possible that at least some companies may suffer a greater burden of taxation. It is possible this may be mitigated to some extent by the recognition for tax purposes of some allowance (i.e., risk margin) for the uncertainty in estimated claim liabilities. In the U.S., the explicit recognition of risk margins may cause them to be removed from allowed claim liability deduction, thereby increasing federal income taxes unless the margins are allowed by the IRS as a part of the liabilities' economic value. If the reserves are currently reported at expected value, the risk margins would have no impact on taxes (if the margins are accounted for as an asset) but would restrict the disposable income.