November 16, 2007

Technical Director
Financial Accounting Standards Board
401 Merritt 7
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Via Electronic Mail: director@fasb.org

Re: FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts

File Reference Number 1540-100

Dear Sir/Madame:

Standard & Poor’s Ratings Services (Standard & Poor’s) appreciates the opportunity to provide the Financial Accounting Standards Board (the Board) with our comments on the FASB Invitation to Comment: An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts (the Invitation to Comment). The views expressed in this letter represent those of Standard & Poor’s and do not address, nor are they intended to address, the views of the McGraw-Hill Companies. Further, our comments are intended to address the analytical needs and expectations of credit analysts.

We support the Board undertaking a joint effort together with the International Accounting Standards Board (the IASB) to address insurance contract accounting. Insurance accounting has historically evolved with a focus on the insurance products being marketed by insurers, rather than developed as part of a comprehensive framework addressing the conceptual accounting issues related to these contracts. As a result, the current state is one where the accounting framework for insurance contracts is fragmented and produces results which often are not consistent among products or types of exposure, and may not be consistent with the underlying economics of the transactions. Further, the disclosures are also incomplete and inconsistent and do not provide our analysts with adequate information (e.g., regarding the nature and timing of the actual and potential underlying cash flows; significant assumptions used; the potential volatility of future cash flows and variations in assumptions).

Additionally, the lack of a comprehensive framework has resulted in non-insurance entities becoming parties to arrangements with economically similar attributes and cash flows to insurance contracts, but accounting for these arrangements in meaningfully different ways.

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While we believe the Discussion Paper provides a suitable starting point for developing an overarching framework for insurance accounting, its provisions and views represent a significant change in the methods by which insurance and other similar contractual arrangements (e.g., letters of credit) and related balances will be presented in financial statements. Accordingly, we believe the Board and the IASB should consider field-testing the application of its principles prior to release of a proposed final standard. Given the complexity of many insurance arrangements, we believe it will greatly help determine if the final standard results in meaningful financial statement presentation and disclosure of insurance obligations and cash flows, and highlight areas where further improvement, clarification, or application guidance may be needed.

We recognize the Board is currently working on several projects that will clearly have implications for the insurance contract accounting project (e.g., conceptual framework, revenue recognition and financial statement presentation). However, a global financial reporting standard for insurance contracts is long overdue, and if necessary, should be given priority to jointly address insurance contract accounting with the IASB. Ideally, this will be done concurrently with other projects or in recognition of their likely direction. Otherwise, we are concerned that attempting to address differences in insurance accounting models after the IASB has concluded on a standard would be difficult, and accordingly, better addressed as part of a cooperative effort.

We expect accounting for insurance contracts to be symmetrical between policyholders and insurers for the most part, whether the insurance contract is written as a reinsurance contract or not. If, however, addressing policyholder accounting would result in a significant delay, we recommend dealing with those issues as a separate project.

Further elaboration of our views on the Discussion Paper is included in our comment letter submitted to the IASB (attached).

We thank you for the opportunity to provide our input on the Agenda Proposal. We would be pleased to discuss our views with any member of the Board and its staff. If you have any questions, or require additional information, please contact Neri Bukspan, Managing Director and Chief Accountant at (212) 438-1792 (neri_bukspan@standardandpoors.com) or Ronald Joas, Director of Financial Reporting at (212) 438-3131 (ron_joas@standardandpoors.com).

Very Truly Yours,

Neri Bukspan
Managing Director and Chief Accountant
Standard & Poor’s

Ronald Joas
Director, Financial Reporting
Standard & Poor’s

Enclosure
Dear Peter

Standard & Poor’s has long advocated the need to improve the global insurance financial reporting framework and strongly supports the IASB’s objectives. We also generally support the direction that the IASB has taken in the Discussion Paper (DP) and hope that a final standard can be issued as soon as practicable to allow for appropriate due process by standard setters and for insurers to commence their preparation for its application.

Our comments are mainly included in the attached document – “Toward A Global Financial Reporting Standard For Insurance: Standard & Poor’s Comments On The IASB’S Preliminary Views On Insurance Contracts” - which was published on our website on 15 October 2007. The document lists our principal views and considerations as follows (and are fully developed in the document):

- A global financial reporting standard for insurance contracts is long overdue.
- The development of a standard should become a joint IASB/FASB project.
- Assuming the DP is translated into a standard that is supplemented by robust disclosure, we expect it will meaningfully enhance the quality of our insurer analysis and peer comparisons.
- Discounting of insurance liabilities captures an economic reality that should be reflected in all insurers’ financial statements, both life and non-life.
- The development of a suitable disclosure regime and income statement format is equally crucial.
- Disclosure of discount rates and liability durations will be vital, along with disclosure of loss reserve confidence intervals and more extensive loss development tables (ideally by line of business). Equally important will be disclosure of the effects of service and risk margins, life policyholder participation, and the effects of adjusting of liabilities for the insurer’s own credit characteristics. These disclosures are vital to enabling users to more meaningfully assess the risk-profile of the underlying business, the quality of underwriting, the adequacy of risk margins ascribed, and the susceptibility of the liability to future variations and volatility.
- Future premiums on life contracts should be recognized not only to the extent they are required for guaranteed insurability, but also where future payment/renewals can be reasonably expected from past policyholder...
behavior. It would make the resulting value more consistent with the underlying economics.

- We have no conceptual objections to the possibility of "day one" profits (as well as losses) provided that the effects are disclosed.
- In the absence of a credible global standard for life insurance, market-consistent embedded value (MCEV) may meet the need. Embedded value (EV) measures are highly informative to our analysis.
- Although we have no conceptual objection to unbundling, we acknowledge that insurance contracts may not be priced and managed in such a way that a discrete value may be assigned to the unbundled contractual provisions. Accordingly, we would object to values for unbundled provisions that are not reflective of the value of the contract as a whole.
- Industry and user education must be increased and acceptance levels raised before the standard is finalized.

To the extent that we have additional comments specific to the questions asked in the DP they are addressed below (the questions are repeated below for ease of use).

**Question 2**

*Should an insurer measure all its insurance liabilities using the following three building blocks:*

(a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,
(b) current market discount rates that adjust the estimated future cash flows for the time value of money, and
(c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?

*If not, what approach do you propose, and why?*

We believe that the building block approach could provide the foundation for a more robust valuation of an insurer's liabilities than is currently the case.

The most vociferous objections to this approach come from the US property/casualty insurers, many of whom argue that different models should be applied to non-life and life insurance contracts. We sympathize with this position, but only to the extent that it relates to the most unpredictable classes of business' liabilities such as Environmental Liability, Product Liability, Directors' & Officers' Liability and Errors & Omissions Liability. We believe that many non-life classes of business are amenable to the building block approach, especially Workers' Compensation, Motor and Property insurance. Establishing probability weightings, cash flow profiles and risk margins for the former classes of business will be particularly challenging for preparers and will require very clear guidance.

We recommend that further guidance is provided on the objectives and application of the service margin concept since most market participants we have met with question the need for such a margin and how it should be determined.
Question 7

A list follows of possible criteria to determine which cash flows an insurer should recognize relating to beneficial policyholder behavior. Which criterion should the Board adopt, and why?

(a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favors this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder’s risk profile and at a price that is contractually constrained.

(b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favor this criterion, how would you distinguish existing contracts from new contracts?

(c) All cash flows that arise from those terms of existing contracts that have commercial substance (i.e., have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).

(d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.

(e) No cash flows that result from beneficial policyholder behavior.

(f) Other (please specify).

We favor criterion (b), which we believe encompasses the pricing and underlying economics of life insurance business. For this purpose, cash flows should only be included for the period of cover in force at the balance sheet date. This would preclude policies which require a formal renewal, typical of most non-life insurance contracts.

Question 15

Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

To the greatest extent possible inconsistencies between the treatment of insurance and financial liabilities should be eliminated such that insurance and financial contracts which are economically similar are represented in a similar way regardless of the legal form of the contract or the type of institution involved. As well as enabling better analysis, this would also serve to afford a level playing field between different types of institutions and minimize arbitrage opportunities. However, we recognize this would be a longer term objective rather than one that was readily achievable at the implementation of the standard. Having set a standard for insurance contracts, we would expect it to inform the treatment of financial liabilities in the long term.
Question 17

Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?

(a) Permit or require insurers to recognize treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework’s definition of an asset).

(b) Permit or require insurers to recognize internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).

(c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).

(d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).

We believe that separate disclosure of the unitized portion of unit-linked assets and liabilities is merited and that balances should not be co-mingled with other assets and liabilities backing insurance contracts. The carrying value of such unit-linked assets should be dictated by the contractual valuation basis for the matched liabilities. To allow accounting mismatches of unit-linked assets and liabilities would be folly.

Question 18

Should an insurer present premiums as revenue or as deposits? Why?

Our comments on the related question of unbundling are included in the attachment. To the extent that contracts are unbundled, we believe that the financial cash flows should not be included as revenues, but the flows should be disclosed in footnotes.

The answer to the question varies depending on the underlying type of business. Non-life insurance is sometimes characterized as a “revenue-type business” while life insurance is sometimes characterized as an “asset accumulation-type business.” Clearly this is an over-simplification. However, it does affect the way that users analyze financial statements. The key performance ratios for revenue-type business (which include most types of non-life business and some life business) use revenue denominators (e.g. return on revenue, loss ratios, combined ratios, expense ratios). The absence of such ratios would be unwelcome in the new ‘regime’. If a new presentation is envisaged, a transition period should be considered. Asset accumulation-type business is typically analysed using asset denominators (e.g. return on assets) or margin analysis (e.g. embedded values) which is a more logical fit for the new ‘regime’.
Question 20

Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

We believe that it should, so that the income statement presents the value created for shareholders. However, a columnar analysis of valuation changes would allow users to evaluate and distinguish meaningful differences their nature, and include or exclude various changes in their own analysis.

Question 21

Do you have any other comments on this paper?

The DP does not express preliminary views on performance reporting and the disclosure regime. Clearly both are fundamental to the success of the final standard.

Given the number of IASB projects in progress, and expected to be started in the foreseeable future, that could materially affect the insurance contracts standard, we believe that those projects should be sufficiently advanced such that future material revisions to the insurance standard are kept to a minimum.

Many market participants are concerned with the use of theoretical market assumptions rather than entity-specific assumptions in relation to expenses. We share these concerns. The determination of market-level expenses would be a highly subjective exercise and could fail to recognize the reality of insurers’ competitive positions. In some respects, given the uniqueness of most insurer’s business mix, market level expenses would arguably be entity-specific.

We would be very happy to discuss the contents of this letter and attachment directly with you or at the next Insurance Working Group meeting.

Yours sincerely

Rob Jones
Managing Director

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The Opportunities For Change Are Real

Related Research

Global financial reporting of insurers is broken. Consistency is lacking, not just between countries, but also within countries, and in some cases even within consolidated groups. Furthermore, many insurers' financial statements are opaque and provide inadequate disclosures, causing many investors to mistrust the insurance sector and some to avoid it. The International Accounting Standards Board (IASB) has embarked on a two-phase project to produce a global financial reporting standard that addresses these concerns. Standard & Poor's Ratings Services has long advocated the need to improve the global insurance financial reporting framework and strongly supports the IASB's efforts, as stated in our commentary referred to under "related commentary," below.

We here comment on a recently issued discussion paper that outlines the IASB's tentative conclusions regarding the future direction of insurance accounting--"Discussion Paper: Preliminary Views On Insurance Contracts" (DP).

Given the global convergence of accounting standards and a reciprocal invitation for comments by the U.S. Financial Accounting Standards Board (FASB), the DP's framework may well set the tone for a new global foundation for insurance accounting.

While the objectives of the DP are appropriate and long overdue, the preliminary views it expresses are radical and would, if implemented, meaningfully change how financial statements of insurers are presented and how liabilities and profits are calculated. The leading insurers in Europe are the more supportive of the DP, but have their reservations. Although there has been limited U.S. industry engagement in the debate so far, there is strong opposition from those that have voiced an opinion, especially in the non-life sector (or property/casualty as it is known in the U.S.). As users of financial statements, while we have some specific concerns, we expect to be able to adapt our analysis to the DP's views and believe that overall, its application will enhance our ability to analyze insurers' financial statements. Few users have been educated on the impact of the DP and unfortunately have generally not been highly engaged in the debate. We believe that prospective users need to be engaged more actively and provide their perspectives, which will serve to enhance the end product, predominantly as it relates to the contents of disclosure and income statement format and presentation of insurance revenues and costs. These areas are vital from a user perspective, yet only discussed in a perfunctory fashion in the DP and will require further development, ideally with extensive user input before the issuance of a final standard. We further believe that, while a proposed global solution is unlikely to achieve unqualified acceptance by all market participants, it is crucial that acceptance levels are raised, especially in the U.S., if the views expressed in the DP are to be translated into a global standard.
For The Uninitiated, What Is All The Fuss About Insurance IFRS?

Financial reporting for insurance businesses is in chaos globally. Dozens of different methods are in use around the world, with varying degrees of relevance and reliability. Existing IFRS promulgated by the IASB (whose standards are being adopted in the EU, Australia, Canada, and much of Asia) has improved matters somewhat, particularly for non-life business with the introduction in 2005 of IFRS 4 (the Phase I standard). But inconsistencies remain even among insurers reporting using IFRS since guidance on measurement of insurance liabilities was largely untouched by IFRS 4 and, as a consequence, divergent policies were permitted. The Phase II standard, which is much more radical and may be implemented as soon as 2011, is currently the subject of an IASB discussion paper. Under a global convergence agenda, the FASB is also considering overhauling U.S. GAAP for insurers, possibly as a joint project with the IASB.

Under the Phase II standard, insurance assets and liabilities are expected to be measured at fair value. Ultimately, "fair value" is expected to mean that market values will apply where they exist, otherwise, they are expected to be based (controversially) on a proxy of expected value of future cash flows plus risk margins. Australian financial reporting has some similarities, but the approach is radically different from most other approaches around the world.

As a consequence, familiar features of an insurer’s balance sheet will disappear and be replaced by a fair value basis for policyholder liabilities (measures and methodologies yet to be fully developed and refined). Unearned premiums and deferred acquisition costs would go. In life insurance, various common forms of accounting currently seen in financial statements around the world (such as statutory accounting, modified statutory accounting, embedded values, achieved profits, and margin on services) will disappear. In establishing the single figure for life and non-life claim provisions, companies will be required to determine probability-weighted current estimates of future cash flows and discount rates on those cash flows, and will need to add to this explicit provisions for the nskiness around the current estimates.


Standard & Poor's Views

We strongly support the development of comprehensive and consistently applied global accounting standards. We also generally support the direction that the IASB has taken in the DP and hope that a final standard can be issued as soon as practicable to allow for appropriate “due process” by the accounting standard setters and for insurers to commence their preparation for its application. Our principal views and considerations include the following:

- A global financial reporting standard for insurance contracts is long overdue.
- The development of a standard should become a joint IASB/FASB project.
- Assuming the DP is translated into a standard that is supplemented by robust disclosure, we expect it will meaningfully enhance the quality of our insurer analysis and peer comparisons.
- Discounting of insurance liabilities captures an economic reality that should be reflected in all insurers’ financial statements, both life and non-life.
- The development of a suitable disclosure regime and income statement format is equally crucial.
- Disclosure of discount rates and liability durations will be vital, along with disclosure of loss reserve confidence intervals and more extensive loss development tables (ideally by line of business). Equally important will be disclosure of the effects of service and risk margins, life policyholder participation, and the effects of adjusting of liabilities for the insurer’s own credit characteristics. These disclosures are vital to enabling users to more meaningfully assess the risk-profile of the underlying business, the quality of underwriting, the adequacy of risk margins ascribed, and the susceptibility of the liability to future variations and volatility.
- Future premiums on life contracts should be recognized not only to the extent they are required for guaranteed
insurability, but also where future payment/renewals can be reasonably expected from past policyholder behavior. It would make the resulting value more consistent with the underlying economics.

- We have no conceptual objections to the possibility of "day one" profits (as well as losses) provided that the effects are disclosed.
- In the absence of a credible global standard for life insurance, market-consistent embedded value (MCEV) may meet the need. Embedded value (EV) measures are highly informative to our analysis.
- Although we have no conceptual objection to unbundling, we acknowledge that insurance contracts may not be priced and managed in such a way that a discrete value may be assigned to the unbundled contractual provisions. Accordingly, we would object to values for unbundled provisions that are not reflective of the value of the contract as a whole.
- Industry and user education must be increased and acceptance levels raised before the standard is finalized.

These views are further developed in the sections that follow. Our detailed response will be formalized and presented to the IASB and the FASB as part of their comment process, by Nov. 16, 2007.

A Long And Winding Road Toward A Global Standard

The DP is the first step toward a comprehensive international financial reporting standard (IFRS) for insurance contracts. The current standard, IFRS 4, is only a temporary and highly abbreviated standard (Phase I) put in place to satisfy an immediate need for insurance financial reporting standard since all EU-listed companies were required to report on an IFRS basis from 2005. This temporary standard allows insurers to continue to use their various pre-2005 practices for much of the liability side of their balance sheets. On the asset side, insurers must now value their investments according to IAS 39, which has meant that most investments are carried at fair (market) value. Fair values are elusive on the liability side, especially when many related assets are not reported at fair value, leaving the IASB the challenge to find suitable proxies under the Phase II standard and thereby eliminate the mismatch that currently exists.

The basic model to value insurance liabilities described in the DP is referred to as "current exit value." It has three building blocks:

- Market-consistent, probability-weighted current estimates of future cash flows;
- Discount at current market rates; and
- Margins (mainly for risk).

This compares to a variety of current approaches that are intended to be best estimates of liabilities (although only insurance liabilities with more predictable payout patterns are typically discounted) supplemented by the loose concept of prudence instead of explicit risk margins. The elements of the new model represent a sea change to the insurance industry; as a result, the IASB is not expecting to be able to finalize them for implementation before 2011 at the earliest.

Furthermore, although the DP addresses many aspects of insurance accounting, certain critical facets, including disclosures and income statement presentation alternatives, remain to be formulated and discussed. The credibility of current exit value is supported by the European Commission’s (EC) requirement to use the current exit value methodology (albeit with some variations) in the measurement of liabilities for the purpose of European insurance supervision under the proposed Solvency II regime. The International Association of Insurance Supervisors (IAIS)
has taken a similar stance for global supervisory standards.

IFRS is also being adopted in Canada and across much of Asia-Pacific. Furthermore, the U.S. the Securities and Exchange Commission (SEC) is considering eliminating the requirement to reconcile financial statements from IFRS to U.S. GAAP for its non-U.S. registrants, and even permitting its U.S. registrants to file under IFRS. Hence, there is much momentum behind IFRS as a global standard. The FASB has pledged to converge standards with the IASB, and has issued its own invitation to comment to ask market participants whether it should also embark on an insurance project and, if so, whether to do it jointly with the IASB. We believe that it should, although a joint project would likely delay implementation well beyond 2011.

Industry Reactions To The DP Are Polarized

The DP is very well researched and written, and explores many alternatives in coming to its conclusions. In attempting to design a principles-based approach to global insurance accounting, it has come up with views that have a sound theoretical basis anchored to "fair value" principles, to which the IASB, other accounting standards setters, and, increasingly, insurance supervisors around the world, are wedded. The potential impact of the proposals is huge, however, and the IASB undoubtedly will have to sacrifice some theoretical purity and deviate from the DP to achieve a satisfactory and globally accepted standard.

In our opinion, both insurers and financial statement users must be persuaded of the benefits of change. If the solution bears no relation to the way insurers run, or wish to run, their business and would not enhance the informational value of their financial statements, these changes would be unwelcome. The reactions of insurers and users of their financial statements are highly dependent on their geographic location and whether they are focused on life or non-life business. With broader global industry acceptance, we expect to be able to adapt and enhance its analysis for a fair value environment, although we have some specific concerns.

Global Life Insurance Financial Reporting Is Broken

Financial reporting of life insurers is in a poor state globally and is in dire need of fixing. We encounter dozens of different approaches around the world. Although IFRS 4 provided welcome new disclosure, it added asset-liability mismatches and did little to minimize the multitude of available approaches being used by allowing companies to retain the accounting conventions previously in use, particularly with regards insurance liabilities. Since many listed insurers, particularly in Europe, are composite groups (writing life and non-life business), the whole listed sector is "tainted".

In the absence of a satisfactory, globally consistent financial reporting standard, a market solution has emerged in the form of embedded value (EV) measures. In Europe and increasingly in Asia, we look to EV disclosures where available, either publicly or confidentially, to give us greater consistency in making global peer comparisons. Although many U.S. insurers also use EV measures extensively as a management tool for such practices as valuation, pricing, performance management, and management incentive compensation, very few use EV in their external financial communications. We believe that EV is a useful tool and would be valued by U.S. investors and analysts. In particular, we value the more meaningful information provided by EV-based measures because they more faithfully represent the underlying economics of the insurance portfolio, and enable us to dissect financial performance by new business contribution, experience deviations for all principal assumptions, and assumption changes.
While EV has some shortcomings in terms of assumptions and disclosures, many of these have been addressed under the CFO Forum's European Embedded Value (EEV) approach since 2005 (the CFO Forum is an industry body comprising the CFOs of 19 leading European insurance groups). Furthermore, the recent development of EEV convergence around market-consistent EV (MCEV) has been positive. Additionally, IFRS 7 will enhance disclosure and bring EV reporting within the scope of the external audit from 2007 onward.

Our expectation is that MCEV will have wide acceptance among the users of financial statements by the time that the Phase II standard is capable of being implemented. The risk for the IASB's project is that without broader acceptance of the proposed model, the primary financial statements may continue to be marginalized. We think the measure of the Phase II standard's ultimate success would be if the supplementary EV statements were rendered redundant in the eyes of users. Practically, if this is to be achieved, the Phase II outcome would need to produce levels and measures of profitability and financial position not significantly different from those of MCEV.

Although the IASB indicated in the DP that it believes EV-based measures are less relevant than exit values, we think that insurers increasingly run their business using EV, and we would rather have a dialogue with management using the management view (with appropriate levels of consistency and disclosure) than one imposed on them and that often bears little connection to the way business is run and managed.

Global Non-Life Financial Reporting Is Not Broken, But Not Perfect Either

For insurers exclusively writing non-life business, we do not have the same concerns about the current state of financial reporting. IFRS 4 was successful both in substantially converging IFRS with U.S. GAAP and in improving disclosure. In particular, it:

- Banished fund accounting;
- Eliminated catastrophe and equalization reserves;
- Codified unexpired risk provisions (known as "premium deficiency" under U.S. GAAP);
- Narrowed investment valuation options;
- Enhanced risk disclosures; and
- Provided loss development tables.

While non-life financial reporting is not broken, it is not perfect. It is fair to say that users are not lobbying for change, although liability adequacy is a big concern and is likely to remain so regardless of the accounting framework. Discount on non-life reserves is applied sporadically around the world, but not extensively or consistently. The absence of discount from the valuation of liabilities ignores economic reality and has allowed accounting arbitrage abuses in the past (e.g. finite contracts with predominant finance characteristics disguised as insurance contracts). The inclusion of discounting in liability valuations would introduce less discretion in this regard and close the door to many of these abuses. Nonetheless, it may open new ones in the absence of a requirement for robust disclosure (including discount rates and liability duration). Furthermore, we believe that enhancements in the form of disclosure of loss reserve confidence intervals and more extensive loss development tables by line of business would be an essential component.

Determining current exit values will be challenging for the non-life industry, particularly for smaller, less sophisticated insurers who have less resources and access to valuation models and expertise. Valuations of liabilities, already inherently subjective, may become more prone to error or manipulation. Accordingly, to earn users'
The IASB has made considerable progress in winning the hearts and minds of preparers and users. Whereas members of the CFO Forum initially responded with uncoordinated objections, its coordinated response (See "Elaborated Principles For An IFRS Phase II Insurance Accounting Model", published in June 2006) was supportive.

Similarly, short-term contract pricing disruptions could distort exit value calculations and cause significant financial statement volatility which may not be reflective of the longer-term fundamental economics of the insurance contracts. For example, post-KRW prices for U.S. hurricane exposure were materially lower in the January 2006 renewals as compared to the June 1 renewals for policies on risk for the June 1 to November 30 hurricane season. In applying the exit value model, insurers with the January 1 pricing may have had to book a loss in the March 31st financials due to the increase in premium rates. Non-life insurers may be hard pressed to explain this volatility to users of their financial statements. Where we determine this volatility is not reflective of the underlying economics of the contract (e.g., the loss or gain will not ultimately be realized), we may analytically adjust the published financial statement figures to better represent our view of earnings and capital.

Only a few non-life insurers currently determine their loss reserves using an explicit probability weighting. Most insurers rely on management judgment based on extensive input provided by their actuaries. In practice, such judgment is influenced by implicit (externally at least) margins that tend to vary according to the position in the insurance cycle. While there are tools that enable probability weighting, they are not widely recognized or accepted by the actuarial profession at this stage. Furthermore, the longer the tail on the line of business, the less reliable these tools become in determining the ultimate losses and by extension, the appropriate risk margin. Countering these questions however, is the simple fact that insurers must evaluate these uncertainties when determining premiums. This being the case, should they not be capable of valuing the liability on their balance sheets in a more comprehensive way?

We acknowledge that discounting is an economic reality that should be reflected in financial statements, although the U.S. industry is particularly concerned about establishing credible distributions of payout patterns. The industry is also concerned that capital represented by discounts may be illusory and that irrational competition may follow the "windfall" at implementation date. We would argue, however, that different methods of financial reporting cannot be held accountable for uneconomic pricing. Consistent with our aforementioned views, appropriate requirements for disclosures of discounting and risk margins will largely serve to mitigate these concerns.

While we understand and support the role of risk margins in determining a fair value proxy, the need for and meaning of risk margins in insurance company financial statements is lost on many users, and represents a major educational challenge for insurers. Furthermore, a framework for calculating risk margins needs to be developed and must be incorporated in insurers' core systems. This framework should be risk-based, reflecting the volatility of expected liability payouts, and as a consequence, that of the underlying account value.

Preparers And Users Must Be Won Over

The IASB has made considerable progress in winning the hearts and minds of preparers and users. Whereas members of the CFO Forum initially responded with uncoordinated objections, its coordinated response (See "Elaborated Principles For An IFRS Phase II Insurance Accounting Model", published in June 2006) was supportive.
in many respects of the approach taken by the IASB to value liabilities. The CFO Forum partly deals with the non-life concerns by supporting the retention of the unearned premium reserve as the best available proxy for the item the IASB refers to as the "pre-claim liability." Generally, we remain supportive of the CFO Forum's proposals (see "IFRS For Insurance: Opportunity Revived As The CFO Forum Steps Up Its Involvement," published Nov. 23, 2006, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis). However, we have taken a broader perspective which conceptually allows for profit or loss recognition at inception, provided there is a robust disclosure of the underlying assumptions and methodologies resulting in these as well as the impact on the financial statements. In most cases, day one profit implies an inherent loss in other current or future contractual or economic relationship—ignoring these will likely amplify the effects of accounting mismatch. Further, we would expect insurers' disclosures to provide support for the assertions of gains taken at inception, as this represents a greater risk to our (and other users' and regulators') analysis of capital.

In this respect, we believe the use of "current exit value" terminology by the IASB has been a distraction. Instead, we prefer the term "current market-consistent value" because it would more readily allow for a hierarchy of measurements to be used in the absence of a reliable exit price (which is the case in the pre-claim period). Furthermore, market participants would argue that the systems needed to support the measurement of liabilities in strict current exit value terms could be burdensome.

Many U.S. insurers, via their representation in the Group of North American Insurance Enterprises (GNAIE), appear to be sympathetic to the CFO Forum's proposals, although they object to the use of current exit values at all for non-life insurance liabilities because of the subjectivity involved. While their voice is not being heard, we suspect smaller European companies agree with the GNAIE, even though these arguments are unlikely to sway the IASB. Nevertheless, the draft Solvency II Directive specifically requires current exit values for liability valuation purposes, such that European insurers (small as well as large) will be driven down this path.

Life companies are generally more comfortable with the DP principles because probability weighting and discounting of liabilities are more natural to them. Explicit risk margins are less comfortable, but they are likely to be much less material than in non-life business. The IASB struggles with the recognition of the rights and obligations associated with the prospects for future premiums on recurring contracts (for example, when the pricing contemplates renewal beyond the specific contractual rights and obligations associated with a particular policy). The DP only envisages recognizing these future premiums if payment is required to retain the right to guaranteed insurability. Failure to recognize future premiums would ignore the economics of some types of contracts and well-substantiated and observed policyholder behavior in our opinion.

Life insurers also are concerned about the prospect of reporting "day one" profits. This is certainly at odds with the heritage of accrual accounting and prudence. However, the DP sees suitably calibrated risk margins as providing a "release from risk." Here too, we do not object to the possibility of "day one" gains in principle, provided there is good disclosure of this circumstance. Neither does the EC or the IAIS.

Many insurers contend that Phase II will produce more volatile results, with a consequent increase in their cost of capital. Using the existing accounting frameworks, insurers often artificially shield their headline results by smoothing the volatility effects (using various tools available to them). While we believe that underlying volatility should be fully and faithfully represented in financial statements, its effects should be explained through high-quality disclosure informing users of the inherent risks in particular lines of business and causes of a variations in a particular period (even if within accepted and expected boundaries). Indeed, disclosure and transparency will be key
to the ultimate effectiveness of this new accounting regime.

The resources required to implement Phase II will be considerable: It will require huge actuarial resources, which are already scarce, and investment in and migration to, new systems. Accountants and auditors will need to be trained and investors educated on the change. Administrative costs will increase in an industry where margins are already under acute pressure. In this environment, scale will become ever more important. In addition, insurers are nervous about the reaction of tax authorities, and fear that if Phase II results in an acceleration of profitability, authorities will seek ways to tax it, or incremental taxation will result in jurisdictions where taxation is predominantly based on book earnings and profits.

The uncertainty in the standard-setting process is also a concern. The IASB determined by the narrowest of majorities to support an exit-value, rather than an entry-value, approach to liability valuation. It has yet to decide whether current exit value represents fair value since its conceptual framework is being refined. Furthermore, key projects such as the joint IASB/FASB project on presentation of financial statements and the IASB project on revenue recognition and contingencies are also in process and could have a major bearing on the outcome of Phase II. The prospects for a joint project with the FASB magnify these concerns. We believe that the adoption of a common global standard for insurance contracts is highly desirable, but this likely would delay implementation beyond 2011.

Opposition From The U.S. Is Greater

IFRS for insurance has been in gestation for a decade and there is a now great momentum behind the DP. Ten years ago, the notion that IFRS might be implemented in the U.S. was fanciful. However, global accounting convergence developments and the recent SEC announcements make this a real possibility. The U.S. has had representatives on the Insurance Working Group of the IASB since its first meeting in 2004, but the context of their participation has now changed, given that IFRS is looming as a medium-term global solution.

In Europe, IFRS is moving in tandem with the modernization of insurance supervision (Solvency II). To a large extent, the reported balance of an insurer’s equity under IFRS is expected to provide the numerator in the Solvency II capital adequacy ratio. The supervisory pressures are not replicated to the same degree in the U.S., but in the long term we expect they will be, since the IAIS will likely use Solvency II to inform and provide incentives for conforming global regulatory change.

U.S. preparers and users can be forgiven for feeling alarmed at the prospect of IFRS and the pace at which it has crept up on them. Indeed, many wonder what all the fuss is about and would happily have global insurance accounting converge to U.S. GAAP. FAS 60, a comprehensive U.S. GAAP accounting model for insurance, has been around for 25 years and preparers and users are generally comfortable with it despite the periodic patches it has required to respond to market and product developments and the piecemeal approach toward the use of fair values. Moving to a new standard would be taxing and require a major educational effort.

The most controversial aspect of the DP from the U.S. perspective is the probability weighting and inclusion of discount and risk margins in non-life insurance liabilities. The rest of the world partly shares these concerns since U.S. GAAP is reasonably closely aligned with IFRS. Nevertheless, the strength of U.S. opinion is exacerbated by the characteristics of casualty business written in the U.S.

On the life side, U.S. GAAP is tailored for U.S. products and regularly updated for U.S. product developments. Since
products can differ greatly around the world, U.S. GAAP does not offer a global or a flexible solution. Neither does it offer principles that can be applied for the accounting of non-U.S. products.

We have commented extensively on IFRS for insurance as it has developed over the past four years. Given the deficiencies that existed outside the U.S. and the initial improbability of a joint standard, our focus was on necessary improvements outside the U.S., albeit informed by what U.S. GAAP had to offer.

The Opportunities For Change Are Real

So what of the opportunities? There would be inevitable upheaval at implementation of a standard based on the DP, but practices are likely to converge after two or three years. In the expectation that a comprehensive disclosure regime would be developed, analysts would welcome the greater consistency and transparency of financial information. Specifically, better communication of the risks to which a business is exposed could result in lower volatility in stock prices, higher price multiples, and lower cost of capital. Insurers' managements and boards would be better informed than they currently are if IFRS-imposed disciplines were introduced, and there could be a better alignment of product pricing and financial reporting. In the long run, external financial reporting could also be more transparent and better aligned with regulatory filings and requirements. Insurance would be a better managed and thriving industry, and better understood by a broader investor group.

Related Research

The following articles are available on RatingsDirect: Road to Convergence: U.S. GAAP At The Crossroads, July 16, 2007

IFRS For Insurance: Opportunity Revived As The CFO Forum Steps Up Its Involvement, Nov. 23, 2006

International Financial Reporting Standards For Insurance 4: Threat Overstated, But Phase II Looms, June 7, 2005


International Accounting Standards: Threat Or Opportunity?, Sept 8, 2003

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