



Swiss Re *sigma* study takes a fresh look at the progress in the long-running debate to make insurance accounting practices more economically relevant and internationally comparable

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- **Significant progress has been made on new insurance accounting standards, but key details still need to be settled.**
- **Timetable for implementation likely to be further delayed.**
- **Near-term prospects are not bright for a converged global insurance accounting standard.**
- **Shift in accounting towards an economic view is a key improvement, but more transparency is needed.**

**Zurich, 21 November 2012 – Swiss Re's latest *sigma* research publication "Insurance accounting reform: a glass half empty or half full?" takes a fresh look at the long-running debate over upgrading and harmonising insurance accounting practices. A key conclusion is that the proposed accounting reforms can contribute to more meaningful financial reporting in insurance. But they probably need to be complemented with additional metrics that clearly and concisely communicate insurers' underlying economic value to their stakeholders.**

#### **Insurance accounting reform progressing slowly**

For over a decade, accounting standard-setters have been wrestling with how best to improve insurance accounting practices. In particular, the International Accounting Standards Board (IASB), in collaboration with the US-based Financial Accounting Standards Board (FASB), has been developing a new valuation framework for insurance contracts and has sought to upgrade existing accounting standards for other financial instruments.

At its September 2012 meeting, the IASB decided to seek additional industry feedback on its proposals. According to Kurt Karl, Chief Economist of Swiss Re, "The IASB's decision to reconsult highlights the continued willingness to move these reforms forward, but realistically, it means that new international accounting standards for insurance are now unlikely before 2016." Furthermore, the near-term prospect of a single global accounting standard for insurance has dimmed somewhat. While the FASB are due to expose their proposals for external review in the first half of next year, they announced in June 2012 that a converged international standard for insurance contracts is unlikely to emerge any time soon.

**Insurance presents significant challenges for accounting**

In order to prepare their financial statements, companies need methods to value their assets and liabilities and to recognise associated revenue and expenses. At face value, this would seem straightforward. But in fact it raises significant questions concerning valuation and measurement. Although these issues are not unique to insurance, they are arguably more acute than in many other industries.

A key challenge is that future cash flows stemming from insurance contracts are difficult to estimate in advance and hence it is hard to place a value on them. Some insurance risks, such as motor cover, are reasonably easy to assess. But other insurance products are very complex and their associated liabilities can extend over very long time periods, making valuation – and thus accounting – difficult. For example, to give long-term life insurance guarantees a value, an insurer must consider not only the timing and size of the possible benefits, but also the policyholder's continued willingness to pay premiums.

**Existing accounting can lead to measurement mismatches**

In light of these measurement challenges, a "mixed attribute" model of accounting has developed. Insurers value their assets at historic costs or at current market values depending on their intended use and establish actuarial-based loss reserves to cover future insurance obligations. This not only creates the potential for various accounting mismatches but can also mask important economic mismatches if the intrinsic value of assets and liabilities respond differently to changes in economic conditions.

For example, long-tail liabilities on some insurance covers will be more sensitive to changes in interest rates than their supporting assets which may not show up in insurers' accounts if the actuarial assumptions are locked-in at inception. Moreover, there are significant differences in accounting practice across countries making problematic international comparisons of insurers' financial statements.

**Key reform details still under debate**

In a bid to reflect better the economic substance of an insurer's business in its financial statements as well as improve comparability across countries, accounting standard setters have progressively sought to introduce more market-consistent measurement methods. However, while there is broad acceptance in the insurance industry about the overall thrust of the proposed reforms, considerable debate persists about key details of the proposals.



## **Insurers need to anticipate the ramifications of the final accounting standards**

"Shifting towards a more economic valuation of asset and liabilities should, in principle, help to illuminate the full costs of producing insurance, including the cost of capital required to support the business," says Külli Tamm, co-author of the *sigma* study. At the same time, it may make insurers' reported financial statements more volatile, which could unduly drive up insurers' cost of capital and put them at a disadvantage compared with other industries.

Such cost of capital fears may be exaggerated. Further, the changes in financial reporting could bring potential benefits for insurers. Darren Pain, co-author of the *sigma* study says: "The new accounting standards should encourage insurers to be more open about the source of uncertainty surrounding their estimated assets and liabilities as well as the rewards for bearing risk, but to foster improved transparency, additional reporting metrics will probably be needed."

### **Notes to editors:**

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#### **How to order this *sigma* study:**

The English, German, French, and Spanish versions of the *sigma* study No 6/2012, "Insurance accounting reform: a glass half empty or half full?", are available electronically on Swiss Re's website: [www.swissre.com/sigma](http://www.swissre.com/sigma). The versions in Chinese and Japanese will appear in the near future.

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