STATUTORY INSURANCE ACCOUNTING AND THE MOVE TO IFRS

The International Financial Reporting Standards (IFRS) continues gaining acceptance as a universal template for preparing global financial statements. The biggest impact on the insurance industry, should this be adopted in the United States for statutory accounting, could be on the valuation of statutory surplus, i.e., net worth.

In June 2011, in an effort to harmonize global financial reporting and offer greater accounting flexibility, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) jointly proposed the adoption of a single accounting system using International Financial Reporting Standards (IFRS). A single set of robust accounting standards could make it easier for investors to track performance on a global basis and help companies with foreign subsidiaries issue financial summaries using the same accounting language as their global competitors.

Key to this effort is guidance covering U.S. Statutory Accounting Principles (SAP) for insurance companies, including the potential convergence of IFRS with U.S. Generally Accepted Accounting Principles (GAAP).

Accounting regulators believe that IFRS accounting, with its greater flexibility, could form a suitable platform for global accounting alignment. As of late 2011, more than 100 different countries have incorporated IFRS accounting standards, with Canada, Argentina and South Korea among the more recent converts.

While it remains unknown whether or when full convergence of IFRS/U.S. GAAP/Statutory (SAP) will occur, some adoption of IFRS appears likely. This could present significant challenges for insurance companies, which should consider well beforehand reassessing current accounting and reporting practices, gauging possible costs in areas such as underwriting and portfolio-management strategy and implementing changes to conform.
CONVERGENCE COMPLICATIONS
Statutory accounting is designed to provide policyholders with transparency into the solvency of an insurance company through timely, accurate reporting. Insurers typically have used various methods of valuing insurance contracts within a statutory financial report. With a principles-based accounting model such as IFRS in place, regulators hope to improve the flow of data from region to region and achieve global accounting unity.

In its 2011 IFRS “Backgrounder” report, the American Institute of Certified Public Accountants underscored the growing interest in “a single set of robust accounting standards.” Common standards would make it easier for investors to track performance on a global basis, while companies with foreign subsidiaries could issue financial summaries using the same accounting language as their global competitors.

Differences between IFRS and U.S. GAAP, however, point to a markedly changed environment for statutory accounting. Under IFRS, assets and liabilities are shown at fair value as of the balance sheet date and are treated exclusively as trading securities. Convergence of GAAP and IFRS could therefore require that certain financial instruments that are currently reported at amortized cost be recorded at fair value in both the balance sheet and income statement.

A converged GAAP/IFRS also could affect methods used to calculate fixed-income valuation under U.S. statutory accounting. Moving to a principles-based system could alter the way statutory surplus is monitored, subjecting these assets to increased volatility. Premium-writing capacity, analytical ratios and risk-based capital testing may be affected by temporary market fluctuations in fixed income assets and the effect of recording unrealized gains/losses on gross asset values and statutory surplus.

Reporting flexibility offered under IFRS is another aspect to consider. In a 2011 National Association of Insurance Commissioners’ (NAIC) focus report titled “Wanted: One Crystal Ball,” Connie Woodroof, a statutory accountant for insurance-industry service provider StoneRiver, suggested that many of the jurisdictions that have adopted IFRS did so with modifications specific to their needs. “IFRS allows for considerable judgment on the part of the reporting company,” notes Woodroof, “and a significant number of optional choices – two concepts that make U.S. insurance regulators very uncomfortable.”

NEW U.S., GLOBAL REGULATIONS
Additionally, insurance companies could feel the effects of new regulations regarding use of over-the-counter derivatives under the Dodd-Frank Wall Street Reform and Consumer Protection Act as well as the restrictive proprietary trading guidelines of the Volcker Rule the Dodd-Frank Act includes. The new Solvency II regulatory regime in Europe is already influencing emerging U.S. regulations. Portions of the NAIC-proposed Solvency Modernization Initiative (particularly the Own Risk and Solvency Assessment) bear strong similarities to Solvency II. The NAIC hopes the European Union will deem the U.S. regulatory framework “equivalent” under Solvency II rules, thereby enhancing the competitiveness of U.S. insurers doing business in Europe.
As a result, not everyone is convinced that convergence is the answer. While acknowledging the implicit benefits of global accounting alignment, groups like the National Association of Mutual Insurance Companies (NAMIC) have argued against moving away from the historical cost-based method of reporting that has been the hallmark of SAP. Yet with differences in valuation methodologies creating enormous barriers across jurisdictions, the industry needs to have a starting place, said NAIC CEO Terri Vaughan. Speaking at a March 2011 Solvency Modernization Initiative Task Force meeting, Vaughan called IFRS “the logical candidate” and stressed the importance of staying actively involved in the development of international accounting standards. “If we have a common benchmark, we can better understand the strengths and weaknesses of a particular jurisdiction’s system and the ways in which deviations matter,” she said.

Though regional differences may make it difficult to impose a single unified initiative, regulators appear willing to use portions of a successful program like Solvency II as the basis for similar regulation in the United States and elsewhere. That means requirements currently found in Solvency II could serve as a prelude to data-collection and NAIC requirements under Dodd-Frank.

As regulators around the world raise risk management and transparency requirements and global companies seek economies of scale by applying consistent cross-border business practices, we can expect to see a gradual convergence of regulation.

PREPARING FOR IFRS

Because the situation is still in flux, insurance companies may hesitate to make adjustments pre-IFRS. The good news is that there is still ample time to get one’s house in order. For instance, adoption of Dodd-Frank regulations through the Office of Financial Research (OFR), established as part of Dodd-Frank to boost the efficacy of financial data, is only now beginning to take shape. The first OFR congressional report is scheduled for release sometime during the summer of 2012. Insurance companies that start acting now may be able to capitalize on the changing nature of financial reporting under IFRS and be better positioned to gain a competitive advantage.

IFRS issues aside, boosting the efficacy of reporting data remains an ongoing challenge for insurance companies. The use of multiple custodians (and external fund managers), for instance, requires insurers to have advanced data-aggregation technology to obtain accurate information to feed market-risk models. To satisfy OFR requirements, insurers must have high-quality data that is granular and searchable, giving policyholders even greater transparency into the underlying portfolio.

Supporting these needs could require substantial amounts of IT investment capital, say observers. Accordingly, insurance companies should consider partnering with consultants or their service providers with insurance industry expertise. This would allow insurance companies to reduce internal costs and liability while they focus on distribution and product growth. Reduced manual processing of daily business process outsourcing lets companies centralize data flow and, in turn, lower operational expenses.

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Furthermore, insurance companies should look to their service providers with expertise specific to help them prepare for the likely statutory accounting changes. These service providers can offer guidance about possible operational impacts of IFRS and related developments on insurers’ business models and products.

“For example, the requirement to adjust in force future profits through retained earnings at transition will clearly impact an insurer’s subsequent performance under IFRS,” notes advisory firm Ernst & Young in a recent report. “Clear and transparent communications that help stakeholders navigate their way through the changes to regulatory and statutory reporting will create confidence and help manage any potential adverse impacts on share prices and ratings.”