



**Subprime Crisis: Impact on International  
Accounting for Insurance Contracts**

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Jerry M. de St. Paer, Executive Chairman  
Group of North American Insurance Enterprises



On behalf of GNAIE, it's my pleasure to have the opportunity to appear before you this morning. I am speaking as Chairman of GNAIE.



GNAIE is an association of US, Bermudian and Canadian insurers, as shown on this slide.

## Who is GNAIE?

- GNAIE is an industry organization of US, Bermudian and Canadian based insurers.
- The mission of the GNAIE is to assist North American and global standard setters and regulators in cooperation with the global insurance industry and with insurance and other financial services industry trade associations:
  - To support high quality insurance accounting standards that are useful, understandable, comparable and reliable; that preserve the insurance industry's level-playing field access to global capital markets; and that provide good disclosure to the insurance industry's diverse constituencies;
  - To support high quality insurance solvency standards that provide useful and effective statutory solvency measures to protect the interests of policyholders and other stakeholders while encouraging competitive insurance markets; and
  - To enhance cooperation, education and communication regarding insurance accounting and solvency among the insurance industry's standards setters, regulators, and diverse constituencies.



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As an association we are committed to assisting standard setters and regulators to support high quality insurance accounting and solvency standards. And, we are committed to trying to achieve a single global set of such standards.

## Disclosure

- **Remarks today are my own.**
- **Reflective of positions taken by GNAIE.**
- No reason to believe any GNAIE members would feel differently.
- GNAIE policy is established by its Board through a due process that involves its committees and all of its members.
- **Not a representative today of any of GNAIE's member companies.**



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## Call to Action

- Extremely active process - Going forward full speed
- Fundamentally alter insurance industry accounting standards
- International Financial Reporting Standards (IFRS)
- Solvency regulation (Solvency II)
- Simmering project. Standard setters are proposing solutions, some of which could be operational within a few years.
- It doesn't feel urgent.
- **But...**



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As NAIC and GNAIE representatives reported yesterday to the NCOIL International Insurance Issues Committee, there is an extremely active process going forward that will fundamentally alter insurance industry accounting standards (IFRS) and solvency regulation (Solvency II) in many ways for decades to come. The process has been simmering for a long time. It doesn't feel urgent.

**But it is...**

## Call to Action

- IASB Fair Value Insurance Contracts Discussion Paper principles would cause harm and uncertainty to the global insurance industry and insurance consumers.
- **This new framework could be in place within eighteen months!**



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The points being proposed by the IASB in its Insurance Contracts Discussion Paper include “fair value” principles and untested methodologies that, if adopted, in my view will cause irreparable harm to the global insurance industry and uncertainty for insurance consumers worldwide.

A process is now unfolding where the basic principles of this new framework will be decided by year-end 2009. (only a year and a half away). If the industry does not coalesce now recognizing this danger, the only thing left will be the implementation process.

## Call to Action

- Not just “IFRS Countries”
- Major impact on US regulation
- **Involvement is critical or it will be decided away from us.**



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And, this is not just a challenge for those countries (including Canada) who have resolved to adopt IFRS. This will also directly impact the US industry.

Further, the European approach to insurer solvency, Solvency II, is gaining international momentum, and many of the “fair value” principles at the heart of Solvency II share some of the same challenges as the IASB’s current concepts of IFRS.

**The North American industry, including insurance companies, analysts, investors, regulators, standard setters and legislators, must all be urgently involved in this process or it will be decided away from us**

## History Lesson

- 1997 - IASC Board begins Insurance Contracts Accounting Project
- 1999 - Issues Paper
- 2001 - IASC Converts to IASB
- 2002 - IASB/FASB Agree to Converge
- 2002 - Europe Mandates IAS by 2005
- 2004 - Partial Insurance Standard Adopted
- 2007 - Insurance Contracts Discussion Paper
- 2009 - Exposure Draft (near final)
- 2011 - Implementation



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This process started a long time ago and has moved at the pace of grass growing compared to other developments in our industry, which has made it easy for the North American industry to ignore. Ho! Hum!

As you'll see, the European industry is ahead of the North American in this respect because of their unique situation where the European Parliament mandated the adoption of IFRS.

1997 IASB started its Insurance Contracts Project. Two groups were formed. **The Insurance Steering Committee was formed, with the belief that persists to today that insurance contracts are financial instruments, should be accounted for at fair value, but may have some differences from other financial instruments. All meetings of the Steering Committee and the Joint working Group of standard setters were closed sessions.**

1999 IASB Issued a Paper – The Steering Committee put forward a series of issues that confirmed their previous conclusions regarding fair value of insurance contracts. Most insurance companies were not aware of the activity. Few commented.

Generally, the American industry view is that it can't happen here



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In the Spring of 1999, the International Accounting Standards Committee (IASC) opened its first Board meeting. Over four days in Washington DC, only one insurance lobbyist appeared. Generally, the American industry view is that it won't happen here.

## Learning from Subprime

- Classic “market disruption”: cash flow and economic value disconnected from market value.
  - Creditworthiness
  - Liquidity
  - Efficiency/pricing



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The subprime crisis should give us a heads up about fair value accounting as it relates to the key issues facing the US insurance industry, importantly including our legislators, with regard to insurance accounting and solvency.

I'll address the issues regarding the “fair value” of financial assets as well as what the fair value methodology can mean for the valuation of insurance liabilities.

The market crisis driven by subprime mortgage market difficulties is a classic market disruption where a series of events in deep and liquid markets led the prices and volumes of market transactions to be significantly lower and in some cases to almost disappear entirely. This created a significant disconnect with the cash flow the securities are expected to deliver over time.

## The Issues

- Cash flow matters.
- There are times when the market price doesn't represent the best understanding of the impact of the instrument on the wealth of the entity.
- Capital requirements for regulated industries (banking and insurance) are increasingly tied to "fair value".



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- For most going-concern entities the cash flow is an important part of a security's value. For insurers, many plan the payout pattern of the securities they purchase to match their long-term payout promises to policyholders – asset liability matching. This is part of the insurance industry's value proposition to the economy and society.
- When the market becomes "short-sighted" in its valuation of an asset based on short-term liquidity and pricing issues, the market price can become unrelated to the value the instrument has for entities who are relying on future cash flow as opposed to the market.
- When regulated entities are required to mark their invested asset portfolios to market – and there is a significant dislocation in the market – the regulated capital position of an entity can be seriously distorted. If the market disruption is based on short term market effects then this capital distortion will be unrelated to the true long term health of the entity.

## Implications?

- What's the value when there is no market?
  - Market disruptions
  - Liabilities
  - Insurance contracts
- Short view v. long view
- Mark to myth accounting



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The “fair value” of assets is problematic in times of market disruption. These disruptions are usually short-term, but as we’ve just seen with the subprime crisis they can cause serious threats to economic stability. And that threat is for assets where markets exist in stable times.

Very few liabilities have active markets. Insurance liabilities in particular are almost never traded. Yet the FAS 157 Fair Value Measurement Standard, when it applies, asks issuers to value their liabilities in accordance with a non-existent market.

There are, broadly, two issues when there is no market to base the “market value” of a liability on:

First is that, as the subprime crisis demonstrates, the market price is myopic and relies on the ability to trade out of the position. Because the holder of a liability generally cannot trade out of the position, the holder usually takes the long view with regard to its value - they base their valuation on their understanding of the ultimate economic impact of the obligation, rather than a guess as to what the market might think of the trading value today.

Second is that the control afforded issuers to model values in accordance with a mythical market will open the door to a level of manipulation that we’ve seen before in the “fair valuing” of assets and liabilities – recently in the case of Enron.

## 2002 - The Norwalk Agreement

- The current movement started in the Fall of 2002 with the Norwalk Agreement: between the FASB and the IASB.
- Among other things, it established that FASB/IASB would coordinate their agendas



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Where are the IASB and the FASB headed with all of this.

It began in 2002.

## 2002 - The Norwalk Agreement

- Both pledged to use their best efforts to:
  - Make their existing financial reporting standards fully compatible as soon as practicable (by removing differences between IFRSs and US GAAP that will remain at January 1, 2005); and
  - Coordinate their future work programs to ensure that once achieved, compatibility is maintained



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The pledge to make IFRS and GAAP fully compatible is laudable and important. GNAIE supports that objective.

## Memorandum of Understanding February 2007

- US Securities and Exchange Commission (SEC)
- Financial Accounting Standards Board (FASB)
- Committee of European Securities Regulators (CESR)
- International Accounting Standards Board (IASB)



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This is reinforced by the Memorandum of Understanding.

## Memorandum of Understanding February 2007

- All Agreed to move forward with Joint Projects and Due Process Documents
- Reconciliation between US GAAP and IFRS would be eliminated by 1/1/2009
- SEC Eliminated Reconciliation for YE 2007 for IFRS foreign filers; now considering for domestic filers



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Which played a role in the elimination of reconciliation to GAAP by IFRS filers, a decision GNAIE supported in its comment letter to the SEC.

## Adoption of Fair Value Standard

- FAS 157 defines “fair value” as the exit price quoted on an active market, when available.
- The balance of the guidance tells you to calculate an “exit value” based on models when you do not have a market.
- At Level 3 - Insurance Contracts - it is a hypothetical calculation of a non-existent market.



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Now let's focus on “fair value”.

FAS 157 sets the standard.

## IASB Proposal for Insurance

- Same as FAS 157 using the same concepts of “fair value”
- Universally opposed by the overwhelming majority of the insurance industry.



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IASB uses the same concepts.

The insurance industry was overwhelmingly opposed – not just the North American industry.

## Yet, Where are We Going with Insurance Contracts?

- IASB *Insurance Contracts Discussion Paper* proposes a fair value method insurance contract accounting
  - Elimination of Reliability as a Criteria
  - Elimination of Verifiability as a Criteria
  - Elimination of Likely to Occur as a Criteria, but...

**But...**



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- The recently released IASB Insurance Contracts Discussion Paper proposed measuring insurance contracts at “current exit value” the same measurement attribute as for fair value under FAS 157.
- We are concerned, as an industry that this proposal will leave us vulnerable to market disruptions that have no real impact on our solvency or credibility.

We all agree there is no deep liquid market for insurance liabilities – the lack of market leaves the “mark to myth” valuation modeling open to manipulation.

## Yet, Where are We Going with Insurance Contracts? Two Examples

**Would Allow  
Gain at Issuance  
of an  
Insurance Contract**

**ENRON  
Style Accounting**



**GNAIE**

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- Two issues that flow from this are gain at issue and own credit risk. GNAIE opposes both of these notions – they would weaken global insurance reserves.

The IASB proposal would permit insurers to book a profit on an insurance policy at its inception – before the insurance coverage even begins. The proposal also requires the insurer to take into account changes in its own credit risk – potentially requiring an insurer who is suffering losses to book a gain in revenue on insurance policies based on the fact they are now less likely to fulfill the obligation.

## Yet, Where are We Going with Insurance Contracts? Two Examples

**Reduce Reserves and  
Capital as the  
Company gets  
Weaker**

**Own Credit Risk**



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- In spite of GNAIE's and industry comments before the discussion paper was released warning the IASB that fair valuing insurance liabilities would not work, the IASB persisted in proposing exit value for insurance liabilities, even though the vote was almost a dead tie – 7-6-1 in favor. Why?
- There is an overarching goal at the IASB and other standard setters to reduce the use of measurements tailored to the economics of specific industries in favor of so-called comparability – the idea that a single or very small set of measurement bases can describe all economic activity. The idea that trading widgets is the same as trading insurance contracts.

## Difficulties and Problems

- Apples, oranges and widgets.
  - Insurance *is* different (e.g. NCOIL)
  - Not all insurance is the same, either
  - Life, Health, Auto, Workers' Compensation, Title, among others
- Quantitative Impact Assessment (Field Testing)
- Justification of decisions as they are made



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• The drive to account for all transactions “equally” and the perception that the insurance industry has its own special accounting seems to have prevented some on the IASB from seeing the fact that *economically*, insurance contracts are different. Not only different from widgets, but different from investment contracts, derivatives, options and other financial instruments.

And not all insurance is the same, either. Property casualty insurance is currently accounted for differently from life insurance. There are good reasons for this based on how the certainty of the estimates and the length of the contracts affect the economics of the products.

• As international accounting principles have moved from the product of a global think-tank to requirements that actual companies must use to prepare their books, the IASB’s concept regarding the process for developing standards has hardly changed.

The IASB is proposing a wholesale transition to a largely theoretical model of “comparable” accounting, and at the same time resists every request for in depth and robust quantitative impact testing to prove that the models proposed work – models intended to impact trillions of dollars of valuations and transactions. To prove they reflect the economics of the transactions in question. Whether the models can be implemented efficiently and whether users can interpret the results are open questions as well.

We get accused of only wanting to retain the accounting we’ve always used. Yet the GNAIE Life and P&C principles are a considered effort to evolve insurance accounting in line with what we perceive to be the rational direction of international accounting. GNAIE at least is seeking to move the standard setters from the theoretical constructs to the economic realities. We ask the standard setters to look past the history to the realities – rather than ask how the contract is the same as every other – ask how it is different.

## Principles Require Governance

- Level, principle-based standards based on economic reality
- Considered, practical implementation
- Effective enforcement



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What we are seeking in terms of governance is pretty straight forward.

## What We Need

- Talk to us, listen to us, slow down
  - Regular Advisory Committee Meetings
  - Develop Technical Advisory Groups
  - Roundtables in Different Parts of the World (for those who can't come to London)
  - US Decision Maker involvement



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The ICDP attracted 159 comment letters - many more than 20 pages long. While respondents differed as to the problems and the solutions, the vast majority had significant problems with the IASB's proposal.

This SHOULD compel the IASB towards dialogue – with industry, users and others - to determine the problems and the solutions.

Just this month the IASB staff recommended an eight meeting schedule of questions FOR DECISION by the board as input to the Exposure Draft. And this WITHOUT consulting the IWG, its supposed resource group for the project. It is to the credit of several members of the Board that they noted the extreme optimism of this schedule. We view the schedule as a threat to appropriate and complete due process.

While we welcome the scheduled meeting of the Insurance Working group on 1 April and the 8 meeting schedule, more meetings are needed. More than the proposed limited quantitative impact testing is needed. We also question the lack of roundtables and regional outreach, which the IASB has so far rejected.

This is also apparently intended to proceed without the full involvement of the FASB, the US standard-setter. The FASB will decide whether to add the IASB's work to its agenda and make this a joint project in the third quarter of this year. The IASB has plenty of work to do considering alternatives and proving its proposals. It does not need to take decisions regarding the exposure draft to the board before the FASB even decides to join or not. We welcome discussion with and by the board of the important issues, and we urge that no firm decisions be made until FASB has had the time to weigh in on them.

The desire to complete the Solvency II directive by the end of this year, or to stick to the schedule set for the project may be driving this haste. But this project has been going on for 10 years. Let due process take its appropriate course.

## FASB

- Invited Industry Comments
- May 6 Open Educational Session for the FASB
- Third Quarter Decision
- Put on Agenda of the Joint FASB/IASB meeting on April 22-23
- Adopt as a Joint Project



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This is the FASB process.

## What We Need

- Talk to us, listen to us, slow down
  - More IWG meetings
  - Roundtables, including regional outreach
  - We need the FASB to be involved
- There needs to be testing



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We are very concerned with the IASB's lukewarm attitude regarding testing.

We have had several discussions with staff and Board members concerning the willingness of the worldwide industry to conduct such testing. Just recently, the Society of Actuaries released a report on the results of such testing that showed some of the problems we see with the Discussion Paper's proposals. More such testing, in all parts of the world, is needed to validate whatever proposals emerge from the IASB/ FASB discussions.

## What We Need

- Talk to us, listen to us, slow down
  - More IWG meetings
  - Roundtables, including regional outreach
  - We need the FASB to be involved
- There needs to be testing
- We need our people in the game:
  - Standard-setters
  - Regulators
  - Legislators



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The opinions and realities of the US and North American insurance market are not just the opinions of “one region” or “one country”, as has been characterized by the IASB staff, but the considered experience and economic realities of by far the largest, most developed and best regulated insurance market in the world. Ours is not just “one way of doing things” but the best practices of the largest market developed through strong interaction with our public regulators and private rating agencies.

We need YOU to be involved in this standard setting process. Looking out for not only for the industry, but concerned for the effect on US policyholders, markets and capital.

The EU Parliament is very concerned with the governance at the IASB – our regulators, the SEC and NAIC should be as well – does the “process” at the IASB capture the necessary input? Is it a “due process” sufficient for a direct regulation of US companies? Are US companies to be afforded equal representation? Why, precisely, should quantitative cost benefit analysis, from the perspective of the investor, NOT be a requirement for new standards?

We need our legislators, again YOU – to hold the standard setters’ accountable. Ultimately you and congress have decided the process of US regulation and our relationship to other markets. You are owed answers as to its effectiveness and fairness.

## Contact Us

- For more information please turn to [www.gnaie.net](http://www.gnaie.net) or [www.insuranceaccounting.org](http://www.insuranceaccounting.org)
- *Headquarters:*  
Douglas Wm. Barnert, Executive Director  
40 Exchange Place, New York, NY 10005 USA  
Telephone: +1-212-480-0808  
Email: [doug.barnert@gnaie.net](mailto:doug.barnert@gnaie.net)



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We have extensive information available on our website and in our office.

I encourage you to contact us.