

IFRS – the Demise or the Future Foundation of U.S. Statutory Accounting Principles for Insurers?

The following questions and answers were excerpted from a panel discussion held at the International Accounting and Systems Association's 2009 Annual Conference. Panelists included Ramon Calderon, the Deputy Commissioner for the California Insurance Department and Chair of the NAIC's International Solvency and Accounting Working Group and who has recently accepted the position of Senior Financial Regulation Adviser at the NAIC's Center for Insurance Policy and Research; Bill Boyd, Financial Regulation Manager for the National Association of Mutual Insurance Companies (NAMIC); and Tom Finnell, Managing Director of Invotex Group and leader of the firm's insurance practice. The comments expressed herein are the views of the individual panelists and do not necessarily represent the views of their respective organizations, constituencies or clients.

Q: How is Statutory Accounting Principles (SAP) currently developed and maintained?

Calderon: The National Association of Insurance Commissioners (NAIC) undertook a major effort in the late 1990s to codify SAP, the result of which became effective in 2001. Thereafter, codified SAP has been maintained largely by reference to new statements or interpretations of Generally Accepted Accounting Principles (GAAP) issued by the Financial Accounting Standards Board (FASB). The NAIC's Statutory Accounting Principles Working Group deliberates each such new GAAP item and decides whether to adopt, reject, or modify it for SAP. State insurance regulators may also bring forward other topics that are not currently being considered by GAAP. But the maintenance of SAP to date has primarily relied on FASB statements and interpretations as a comprehensive source of subject matter from which potential changes to SAP are then considered by the NAIC's working group.

Boyd: Codification was a difficult process in which many participated, regulators and industry alike. Efforts were made to gauge the effects of the then-proposed uniform system on the industry as a whole. In the end, a compromise was made to permit the admissibility of deferred tax assets, with some limitations, so as to not disturb the industry-wide levels of statutory surplus. The give and take with regulators was essential to having a uniform and workable system of accounting.

Finnell: The Codification project in the late 1990s may be the only comparable event that has taken place in recent insurance history where we can look back with hindsight and assess what took place to effectuate a significant change in industry accounting guidance, as well as the related implications and costs. Codification was an immense project, one that was nonetheless eased somewhat by the NAIC's decision to link the development and maintenance process for SAP to GAAP. The NAIC did consider alternative approaches at the time. The issues and alternatives presented during Codification are very similar to those that the industry and its regulators face currently as they anticipate the

coming of IFRS. The decisions made will have significant implications as to resource requirements and related costs, both for the industry and the regulators.

Q: Why might the adoption of IFRS have an impact on SAP?

Calderon: There is a domino effect. Adoption of IFRS may lead to elimination of U.S. GAAP and its maintenance framework. It is the GAAP maintenance process that the NAIC's SAP working group leverages to maintain SAP. So if GAAP goes away, the NAIC has to find another way of maintaining SAP. In the meantime, and regardless of whether or not U.S. GAAP is ultimately abolished, the FASB has agreed to converge accounting standards with those of the IASB. For insurers in particular, the process of convergence involves study of two significant areas relating to accounting for insurance contracts and financial instruments. Once adopted under a converged U.S. GAAP/IFRS framework, the NAIC would be faced with a decision to adopt, reject, or modify those positions for SAP. So one way or the other, SAP may change, perhaps significantly.

Q: What is the position of industry about the prospects of changing to IFRS?

Finnell: There are certainly many insurers, particularly the largest ones, who are supportive of the notion of a single, global, principles-based financial reporting regime. But they also have concerns about some of the views expressed in issues papers of the IASB and are working together to have a stronger voice in the final outcomes. Many have joined the Group of North American Insurance Enterprises (GNAIE) for that purpose.

Boyd: NAMIC's members are largely mutual insurers who, to a large degree, manage their business based on SAP measures. They have found the NAIC's process for maintaining SAP to be reasonable. A similar process may occur if IFRS were to usurp GAAP, but there is much to consider before any large scale departure from SAP occurs. The current process at the NAIC's SAP Working Group results in constant debate and deliberation and works well. With the movement to IFRS, something significantly different is coming, and whether to do it, how to do it, those are crucial questions.

Q: But if IFRS replaces GAAP, why couldn't the NAIC follow the same SAP maintenance process and just start with IFRS instead of GAAP?

Calderon: It is not so easy to simply say that the NAIC can just look at IFRS rather than GAAP as a future starting point for determining SAP. A number of key actionable thresholds are based on current SAP measures, including RBC, IRIS ratios, investment limitations, and more. Moreover, IFRS is largely a principles-based framework for accounting, as opposed to the plethora of rules that underlie FASB statements. How the industry might transition from one to the other presents some real and potentially significant implementation issues.

Finnell: There also is a matter of what I will refer to as “calibration.” With Codification in the late 1990s, many of the same issues were presented. There were concerns about changing the accounting rules and measurement basis midstream but without the ability to change the regulatory triggers that were embedded in individual states’ statutes and regulations. At the end of that lengthy project, there was a true-up of sorts through negotiations between the industry and the regulators that resulted in a compromise; as Bill has stated earlier, that involved the admissibility of deferred tax assets, albeit with some limitations. With that change, there was more assurance that industry-wide surplus pre- and post-Codification would be relatively level.

With regard to the current notion of changing the SAP maintenance foundation from U.S. GAAP to IFRS, the calibration process will be much more difficult. The U.S. insurance industry overall is less knowledgeable about the potential impacts of transitioning to IFRS now than they were about changing to the then-proposed and primarily GAAP-based Codification in the late 1990s. Their concern with regard to changing to IFRS now is made much more challenging because of the major IFRS issue papers that are still being debated.

Q: What might it cost to transition the SAP maintenance framework from being based on U.S. GAAP to IFRS?

Boyd: One estimate from the transition to IFRS in Europe is that one half to one percent of revenue was spent in the year of conversion. Attention needs to be made to these cost issues. It is a situation of high anxiety on the subject of IFRS for mutuals; all in all, we’re not ready for IFRS, and if or when it comes, and in whatever form, there needs to be a package, a set of instructions, and an easy-to-operate set of machinery. There has been much turmoil recently in the financial sector; despite that, the regulatory system for U.S. insurers has proven to work pretty well.

Finnell: Those transition costs based as a relative measure, for example as a percentage of revenue, will likely increase as the size of insurers decrease. Smaller companies may be less complex, but they are also of smaller scale and therefore can’t spread their costs as far as their larger competitors. Such costs will not be insignificant, and include training costs for industry, regulators, and professionals alike. Even companies that are currently filing IFRS statements in the U.S. will have additional costs as the outstanding issue papers on insurance contracts and financial instruments are finalized.

Q: How does IFRS differ from U.S. SAP or GAAP?

Boyd: The Discussion Paper on insurance contracts was issued by the IASB in 2007 with some content that initially was very alarming. No distinction was made in the principles-based approach suggested between property and casualty and life contracts; all were to be treated as financial instruments, packaged and valued on the same basis. But that’s not practical. Reserving was remarkably complex based on the concept of exit value. The

current view is that fulfillment value is a better way to go, an approach that is a little more company- or industry-centric and which represents some progress. But that change occurred only because U.S. companies jumped in to introduce reality into what previously was only a theoretical approach.

Calderon: The exit value concept makes an attempt to value how much reserves would be sold for in the market notwithstanding that there is no such market for reserves, so it is a concept of concern to U.S. regulators as well.

There are some other concepts in the discussion paper that are being rejected by U.S. regulators. For example, the concept of “own credit standing” provides that if an insurance company is downgraded or if there is a likelihood that the company would be unable to fulfill its obligations in the future, then the company would reduce its reserves, an outcome that makes no sense to U.S. regulators.

And there are other items, for example, with regard to the IFRS proposal for discounting of property and casualty loss reserves, a legitimate concept, but one that is contrary to traditional regulatory views in the U.S. that for purposes of conservatism reserves should not be discounted. In fact, IFRS has no concept such as conservatism, but that’s clearly something that is sacrosanct in the SAP framework. So that’s why it is so critical how we respond to IFRS and how SAP will be maintained.

Finnell: The problem in isolating differences is that there are three separate moving targets – IFRS, GAAP, and SAP. IFRS and U.S. GAAP differ markedly now, but they are expected to significantly converge in the near future, especially with respect to the major elements of financial reporting for insurers which includes financial instruments and reserves. The real issue is how a converged IFRS/GAAP basis of accounting will vary from SAP; we expect those variances to be significant, primarily because the underlying concepts are also quite different.

In theory, if U.S. GAAP and IFRS converge, the role of the FASB could be eliminated. If that were to occur, there no longer would be U.S. GAAP as the foundation for the maintenance of SAP by the NAIC. But in the meantime, there is no process to link existing SAP guidance to IFRS. The NAIC would have to do so, which would result in something akin to another Codification effort. If that were to occur, SAP could stay much the same as it currently stands, but there are the matters of cost, due process, documentation, training, and more. Those are the issues that confront us now.

In addition to the fundamental changes to the basis of accounting itself, there also is the concern about how reports prepared on that new basis of accounting will be perceived and used by analysts, regulators, shareholders, and others. The impetus behind the support for IFRS appears to derive largely from the financial markets and the analyst community. Conceptually speaking, under IFRS a public company’s financial profile will be more transparent and the market value of its shares, or the trends in that value, might then better reflect the underlying economic reality of the company. But the same could not be said about non-public companies such as mutual insurance companies which could

also become subject to IFRS directly or indirectly depending on the future of the SAP maintenance framework. For mutuals, there are no shares, and there is no market or market value. So analysts would not have the ability to perform a reality check of a mutual's financial profile against some market value or trends. That suggests to me that one of the main purported benefits of going to IFRS in the first place simply does not exist for non-public companies.

Q: Is there more inherent risk in a principles-based accounting regime than a rule-based framework because there is more room for interpretation and less consistency between companies?

Finnell: That is perhaps true, but proponents of IFRS would say that it is mitigated by the fact that users of IFRS-basis statements would have more and better disclosures about how a company addressed an underlying accounting principle. In other words, there would be less boilerplate and more substance. So instead of saying, "this is the rule, trust us we did that," reporting entities would have to state the respective principle and what they did to comply. So there will be more information for analysts that crave that kind of detail. For regulatory analysts, it may be a more severe change to transition from standardized disclosures that can be ranked or benchmarked to increased disclosures about more qualitative aspects that require a different kind of experience for adequate interpretation and analysis.

Calderon: For reserves of life insurers, the NAIC is undergoing the most significant change over the past 50 years by transitioning to a principles-based framework. For example, if all that is said is that you have to drive safely through a residential neighborhood but without any specification as to what speed is deemed to be safe, then we leave that at the discretion of each driver. Some drivers may be comfortable at a maximum speed of 25 miles per hour, but there are others who might feel perfectly comfortable at 80 mph. Thus, in a principles-based world there is a question as to comparability because there is the latitude to interpret principles-based statements to serve one's advantage. This issue is still open, because the IASB stated that it did not have the time to develop the volume of guidance akin to that underlying the current U.S. GAAP framework. Over time, IFRS may avail itself of reference to some other authority, like the Academy of Actuaries, to help with supplemental guidance.

Boyd: I'm skeptical about how a principles-based framework, such as that for IFRS, might work in the context of current U.S. accounting. Principles-based accounting will ultimately lead to the process of interpretation that we now have for U.S. GAAP, which in turn will ultimately lead to more rules. So this principles-based framework may ultimately turn out to be only the foundation of IFRS, not the end result.

There also is another matter relating to accounting and economics involving large companies which is of course quite complex. When we go to principles-based reserving and accounting, does that give more opportunity to those who want to defalcate or in some way enrich themselves through their leadership of a company? Or, can a board see

through false arguments presented through faulty assumptions in principles-based reserving and act appropriately? These are issues that will need to be addressed.

Q: Regardless of the impact of a conversion to IFRS by insurers, is it reasonable to expect that U.S. regulators could make the transition?

Calderon: In my opinion, the train has left the station and conversion of IFRS and U.S. GAAP will occur. The question now is, what impact will such conversion have on the NAIC? The NAIC has dedicated resources to follow the IASB, has representation on the IAIS, and participates with other country regulators as part of the Insurance Contracts Subcommittee, the Solvency and Reinsurance Subcommittees and the Group Supervision Subcommittee. It is a matter of time, and there will be a transition period, and transition costs. But in all honesty, we are entering some uncharted waters.

Finnell: The question a year ago was what will become of SAP if IFRS is adopted and U.S. GAAP disappears? But what is apparent now is that, regardless of whether or not IFRS is adopted in the U.S., we're going to be at roughly the same place – either using IFRS, or a version of U.S. GAAP that is substantially similar to IFRS. In getting to that point, U.S. GAAP will have to change to meet the convergence objectives and to react to changes resulting from new guidance on insurance contracts and financial instruments.

So the real question then becomes, under the current SAP maintenance framework, what is the likelihood that SAP will also converge with those new GAAP statements? Or will SAP as we now know it remain largely unchanged? If the latter, the implication is that SAP and GAAP will continue to diverge, notwithstanding that the way SAP is determined as a derivation of GAAP.

Calderon: The overriding concept for SAP financial statements is solvency and the protection of policyholders. I don't believe the NAIC will ever change that. There is a lot of pressure to keep the state-based framework of SAP intact once IFRS and GAAP converge on most insurance accounting issues. But it is unclear what will happen when the smoke clears.

For example, we could look at IFRS statements as a replacement for a SAP statement then change the RBC formula to immunize the IFRS effect and maintain the status quo, at least based on the measure of RBC. So there are ways to go about preserving the framework, but the end result may not be the conventional method that we're used to seeing. But the notion of recalibrating RBC to work with other bases of accounting was rejected during Codification, and it may not fly now with regard to the current issue involving IFRS.

Boyd: A principle here lies in maintenance of regulatory power. Regulators need some powers for their purposes to measure where companies are and to compare across companies and over time.

Finnell: As an example of how that power was used recently, we need to go back no further than to December 2008 when the NAIC's Capital and Surplus Relief Working Group was debating the wish list that had been brought forward by the life segment of the industry. The NAIC used their power and refused to adopt the ACLI's requests. But certain individual states, in turn, nonetheless kept their own power and granted relief to certain of their respective domestic insurers. This issue of power through control of SAP is a major part of insurance regulation in the U.S. as we now know it. It is also something quite unique to the U.S. in that most other countries do not have a separate SAP basis of accounting, rather just a general framework for public reporting that also serves regulatory purposes.

Q: Would other countries be more amenable to making IFRS more rules-based like U.S. GAAP?

Calderon: While the media expresses the view that with IFRS we finally will have a standard that allows for consistency in reporting, we are hearing that other countries that have adopted IFRS are having difficulties in application. That suggests to me that it is possible that IFRS will indeed wind up with more rules to solve those concerns, just as rules have served us well here in the U.S. under GAAP and SAP.

Q: Other countries have the same responsibility as do U.S. regulators to protect the interests of policyholders. Are they comfortable doing that with general purpose financial statements?

Calderon: That's one of their objectives, but they have a different legal framework within which they regulate solvency. For example, regulators in other countries can more easily restructure policies than can be done in the U.S.

Boyd: Solvency regulation in the U.S. has a different emphasis than that which underlies general purpose financial statements.

Finnell: Most other countries don't have a separate regulatory basis of accounting. They've apparently developed some thresholds based on general purpose statements that have served them over the years.

Q: For small companies, such as many mutuals, is it possible that they might be exempted from IFRS-based SAP?

Boyd: There is no particularly convenient dividing line that exists, which implies a need to provide a way for comprehensive application to all insurers across the board.

Calderon: I agree. There is a tendency to avoid creation of multiple separate accounting frameworks, and a real effort underway to homogenize accounting.

Q: How does the International Association of Insurance Supervisors (IAIS) fit in as it promotes uniform accounting around the globe?

Boyd: The IAIS is conscious of the content of Solvency II and that's a recipe for change itself; it includes something similar to the IASB's Discussion Paper on insurance contracts, for example, with respect to an economic value for reserves.

Calderon: The IAIS is similar to the NAIC except that it exists on an international level with the U.S. being just one of many member countries. The IAIS is looking at various IASB pronouncements from the standpoint of using general purpose financial statements for regulatory purposes, which is a very different from our use in the U.S. of a regulatory-specific SAP basis of reporting. But if the U.S. commissioners say that they no longer need SAP financials and are willing and able to utilize general purpose financial statements, then we can use them and make adjustments to meet our objectives.

Q: Where is the NAIC on this? How far along are they in their deliberations?

Calderon: The NAIC has no position on this yet. It participates in IAIS meetings and in its numerous working groups. The NAIC is evaluating the differences between SAP and IFRS, and it faces three options: it can keep SAP and maintain it on its own going forward, but that requires resources, is expensive, and is out of sync with the prevailing global trend toward a single, uniform basis of accounting. Or it could adopt IFRS. More likely there will be a hybrid approach, where the NAIC would support SAP to meet the purpose of U.S. commissioners for protection of policyholders, but evaluate IFRS for SAP and accept, reject or modify individual provisions.

Q: Might the best position have been that there is not to much wrong with our system, and that the NAIC should stick to SAP for regulating solvency?

Calderon: We could have said, we're the U.S., we're the best, the strongest, and we're not going to change. But we're also willing to learn from others as to what we can adopt to make us even better. The fact that we participate in other venues doesn't mean we agree with what is happening. We could have done a better job from a media perspective. For example, there has been much in the news on the international side about IFRS and Solvency II, notwithstanding that what we have in the U.S. is a system that has worked well for many years. When faced with challenges, we have responded and made adjustments where appropriate.

Q: What are your personal perspectives as to what will happen to SAP with the advent of IFRS?

Finnell: GAAP and IFRS will converge over some time frame. The first issue then is whether the SEC will adopt IFRS in the U.S. for general purpose reporting by public companies. The SEC under its new leadership is proceeding more cautiously with respect to the IFRS “Road Map.” The SEC also has concerns that the IASB lacks sufficient independence, governance and finances to proceed without undue influence of local country politics. On top of that, there are many unresolved questions as to what impact accounting, and accounting standard setters, had on the recent global economic crisis. So now may not be the right time for the SEC to cede control over accounting here in the U.S.

If U.S. GAAP continued to serve as the basis of general purpose reporting in the U.S., through convergence it would nonetheless be substantially equivalent to IFRS. So the real question is what becomes of U.S. SAP? I don’t believe state insurance regulators in the U.S. will easily cede the authority they have over regulatory accounting standards in the U.S. Therefore, I expect a continuation of the same SAP maintenance process. There will be a series of new GAAP pronouncements on insurance contracts, financial instruments and other areas. Just like in the past, the NAIC will decide if they want to adopt, reject, or modify such pronouncements for SAP. In other words, the process will stay pretty much the same. And whereas IFRS and U.S. GAAP have converged, SAP will continue to diverge from those general reporting standards.

Boyd: Absent federal preemption of state insurance regulation, state regulators will maintain their power, part of which is a system of specialized accounting to assess what companies are doing on behalf of themselves and their policyholders. Therefore, SAP has a future, altered due to convergence, but still there.

Calderon: There will be changes with convergence, and how that will impact the maintenance of SAP, a process that currently relies extensively on GAAP pronouncements, is uncertain. If we go to IFRS for general purpose reporting, questions arise. There is some friction between the desires of regulators in any jurisdiction to retain its sovereignty and powers and the need to become more global. Some compromises to both will have to be made. The underlying purpose of SAP will remain to protect policyholders. How you get there is up for grabs. Make adjustments, adopt IFRS, use IFRS with exceptions, these are all feasible ideas. There is a real legitimate issue of state sovereignty; short of significant political pressure to do away with SAP, it will continue to exist, at least in my lifetime.