



On August 9, 2011, SCOR SE, a global reinsurer with offices in more than 31 countries, acquired substantially all of the life reinsurance business, operations and staff of Transamerica Reinsurance, the life reinsurance division of the AEGON companies. The business of Transamerica Reinsurance will now be conducted through the SCOR Global Life companies, and Transamerica Reinsurance is no longer affiliated with the AEGON companies.

While articles, treaties and some historic materials may continue to bear the name Transamerica, AEGON is no longer producing new reinsurance business

The Forecaster

Accounting Standards: All Fair for Assets and Liabilities?



By Darin Zimmerman,
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Financial reporting is in a state of fundamental change for insurers, as reflected in major efforts underway on both the regulatory (e.g., principles-based regulation) and accounting (e.g., fair value) fronts. Recent write-downs associated with the credit markets have focused intense scrutiny on market-consistent valuation of assets and added new concerns around the move to market-consistent valuation of liabilities, a critical issue for life insurers.

Darin Zimmerman, Transamerica Reinsurance's Vice President and Chief Actuary, recently spoke about this topic with William Hines, Principal and Consulting Actuary for Milliman, Inc. William points out that the benefit of moving to fair value of assets and liabilities is that it reveals the underlying economic performance of the company's operations better than the standard book value. However, he cautions that the transition will not be easy – for insurers, actuaries or regulators. Specifically, determining the fair value of non-traded liabilities such as life insurance contracts will test the capabilities of all parties involved and likely will take some time to develop.

William's roles with Milliman include serving as appointed actuary for life insurers in the US and Bermuda, and extensive consulting on International Financial Reporting Standards (IFRS) as well as US GAAP and Statutory accounting. Before joining Milliman, he worked at John Hancock on accounting and valuation issues. He is a Fellow of the Society of Actuaries, a Member of the American Academy of Actuaries, a Member of the International Actuarial Association, and a graduate of the University of Massachusetts, Amherst.

Darin Zimmerman: How does fair value apply to life insurance liabilities?

William Hines: In terms of an insurance contract, it would be how much you would have to pay someone to assume the liabilities in an arms-length transaction under normal market conditions. This is in contrast to today's methodology, where we estimate the static expected value of the liability, add a margin and enter it on the books.

DZ: What is the benefit of moving to fair value?

WH: The key benefit is to better align your financial reporting so that market value passes through both the asset and liability side of the balance sheet. If you have your assets valued at market but your liabilities valued at book, you've got a disconnect running through your income statement and your balance sheet that doesn't reflect the economics and the management of your business.

In times of high volatility fair value consistency will be a benefit because the income statement will better reflect what's going on in the market and how you are managing the business. However, if a company uses fair value for assets and book value for liabilities, an accounting loss or gain can emerge where there is no real economic loss or gain. This may cause investors and analysts to be concerned about a company's capital position or ability to make good on its return promises.

By William Hines,
FSA, MAAA, IAA
Principal
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DZ: What is the key challenge to moving to fair value?

WH: Both the traditional and fair value approach start with a best estimate of the expected value of the liability. Determining mortality and lapse assumptions, policyholder behavior, etc., will not be any different under fair value.

What will be different – and challenging – is how we derive the margin. Under current US GAAP the margin is the actuary's estimate or the industry's accepted norm. Under fair value the margin is based on the market's view of the risk involved in the product. This margin (over the expected value of the business) accounts for the risk of fluctuations in underlying experience and the risk appetite of the market.

The difficulty in determining a market-based risk margin is there's no deep liquid market to guide this valuation. The assessment often depends on the acquirer's view of the implicit risk of that product. It may be highly individualistic, depending on how much experience they have with that business, how much capital they need to put up, what synergies they have and so forth. This risk margin is difficult to calibrate and it hasn't gotten any easier, especially with today's market dynamics.

DZ: Banking has more experience with fair value accounting than the insurance industry has. How do banks treat fair value for liabilities?

WH: First, bank products involve financial risk, which can be sold, repackaged or hedged fairly easily. In contrast, insurance products combine financial and insurance risk. Plus, many contracts share aspects of the financial and insurance risk with the policyholder, adding another layer of complexity.

The long-term nature of the contracts is also unique to insurance, especially life insurance. You don't see banks offering financial guarantees for up to 80 years, yet that happens with a life insurance contract.

So, how do you determine the fair value of long-term guarantees when you have no reference market beyond the 30-year yield curve? How do you determine

the fair value of products that combine insurance and financial risk when there's no corresponding market to help guide the process? Obviously, there are still more questions than answers!

Illiquidity, the Credit Markets and Insurance Liabilities

DZ: Turmoil in the credit markets has led to some push-back on the fair value of illiquid assets. How have recent asset write-downs affected the views of fair value for insurance liabilities?

WH: Determining fair value is inherently difficult for illiquid or infrequently traded assets because you need a deep and liquid market to provide a credible benchmark. The International Accounting Standards Board (IASB) is now looking into the liquidity issue as a separate project, which I think indicates the market stability concerns that have been raised with regard to illiquidity in a fair value environment.

Much of the recent asset write-downs are unrealized at the moment. Some companies that have taken write-downs say they don't think they'll be realized. Many believe the values eventually will be written back up, or the values will recover somewhat and produce a gain. Some people aren't sure that these values are appropriately written down on a fair value basis.

Volatility could affect insurance liabilities too. To the extent that financial markets go up and down, insurance liabilities can go up and down ... the market's risk appetite changes so your market-based margin changes. How much of that actually will be realized?

That's in part why people in the industry are pushing the idea of settlement or run-out value, because most insurance contracts are not traded. You pay a claim or a surrender value, or the contract matures. And if that's really what takes place, it seems like that's what should be focused on for the accounting.

The Transition

DZ: What's the biggest challenge for US actuaries in their transition to fair value?

WH: The fair value of an insurance liability is just that – the liability. It does not take into account what you've done on the asset side, how you've invested, how you're matching your liability cash flows with your asset cash flows.

We've been trained, from a regulatory point of view, to perform asset adequacy testing to ensure the assets we actually have are sufficient to cover our liabilities. Fair value says, 'Ignore all the assets you have and come up with a market-consistent valuation for this block of liabilities in a transfer-type situation.' I think that's the fundamental conceptual challenge that actuaries face. It's not going to be natural.

DZ: Is the expected US transition to International Financial Reporting Standards (IFRS) enough motivation for US actuaries to care what is happening at the IASB?

WH: First off, actuaries will be the ones called upon to calculate the fair value of insurance products because there's not a deep and liquid secondary market from which you can get prices. So there will still be a need for some model-based valuation of liabilities to come up with fair value, and actuaries are best positioned to do that.

Practically, a number of actuaries already are required to prepare reports under IFRS standards because they work for US subsidiaries of European companies, which already report on an IFRS consolidated basis, although IFRS has not yet moved to fair value.

DZ: What is a realistic timeframe for the implementation of fair value accounting or Solvency II?

WH: Solvency II is the measure most certain to be implemented first. They've been working on this for years and issued the necessary directives at the EU level.

I think you're going to see that coming in fairly quickly – 'fairly quickly' being estimated as around 2012.

Fair value for insurance accounting has actually been mentioned as a potential candidate for deferral because of the fallout from the credit markets. The questions of applying fair value to illiquid securities appear to be a higher priority than rapid implementation of an insurance standard. So it may actually be pushed out a couple of more years beyond 2012.

DZ: What competitive advantages exist for adopting fair value in the early stages?

WH: I'm not sure there are any advantages to adopting IFRS early in the near term, unless you want to raise capital outside of the US in foreign markets. If you want to sell a block of business or do a transaction with a company that currently reports under IFRS, that company will want to know what the business looks like on an IFRS basis themselves. You certainly could make it easier on them and the transaction process smoother if you already had that information. So M&A activity or block reinsurance transactions would be helpful on that basis.

Transparency and Managing Volatility

DZ: A stated goal of fair value for liabilities is increased transparency. Given the complexity of the life insurance market, will this goal be met?

WH: Insurers' cost of capital is generally viewed as being higher than it is for other financial services industries. One of the main reasons for this is the lack of accounting transparency in insurance. So the industry and all of the constituents would prefer to move to an accounting standard that provides more transparency.

Whether fair value is the right measurement basis for increased transparency is debatable. The IASB is working on that right now in light of the current financial market crisis. But I think the jury's still out.

DZ: What tools can the CEO or the CFO use to effectively manage the expected increase in volatility?

WH: The volatility already exists today on an economic basis. You're just not seeing it well under the current accounting rules.

Many companies already engage in risk management activities to measure the risk that they're assuming and how they manage those risks. I think ERM and economic capital measures that are coming into play today will be used increasingly to manage risks. But that will emerge whether we move to a fair value basis or not because that's the right way to manage the risk.

So with fair value accounting there is potential increased volatility to be shown, but that's real. And making it transparent is what this is all about. We want managements' actions to show through the accounting results. I think developing a framework to measure that appropriately is very important, and that's where you're going to see the focus on ERM.

DZ: What role can you foresee for reinsurance?

WH: The fair valuing of liabilities will force management to take a hard look at the lines of business they really want to be in. They will want to leverage their strengths. If there are lines of business where success requires them to take a certain risk and they're not comfortable doing that for some reason, I think they will look for reinsurers to help them either manage those risks or to cede the risks to reinsurers.

Reinsurers have traditionally been a key source of education and support for managing risks. I think this will continue going forward. It'll be more in the context of volatility, of how well the assets and liabilities match up and whether a reinsurer can do a better job of that. I think there are similar education opportunities and similar capabilities to provide backstops and move blocks of business around that make a better fit for everyone.

Many questions remain in the transition to fair value accounting standards, and today's market dynamics seem to add to the list. As a US subsidiary of one of Europe's largest insurance groups, Transamerica Reinsurance has experienced part of the transition to an economic, IFRS-based reporting approach. We look forward in sharing our experiences with our clients as the transition unfolds.



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