The IFRS Journey in Insurance:

A Look Beyond the Accounting Changes

A Deloitte Research Report

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Dear Colleague:

The use of IFRS (International Financial Reporting Standards) is on the rise across the globe and, to a certain extent, in the US. Though convergence of US GAAP (Generally Accepted Accounting Principles) with IFRS concerns all companies, insurance companies must take special notice. IFRS specifically addresses financial reporting for insurance contracts through an insurance project that is split in two phases. The project seeks to address recognition, measurement, presentation and disclosure requirements for insurance contracts.

To help companies prepare for changes fostered by new accounting standards, Deloitte has developed significant knowledge and resources in the area of IFRS conversion. Our research and programs address the challenges of determining a business case and future vision for IFRS adoption, performing a comprehensive conversion to IFRS and enabling continued reporting under IFRS. We approach conversion efforts in a holistic manner, providing insight into changes related to technical accounting, process re-engineering, technology and infrastructure, and organizational change, for example.

Whether you are just embarking on or traveling well down the path of the IFRS journey, or continuing to report under GAAP, we hope that this report will provide you with insight into how the implementation of IFRS may impact business strategy and market structure in the insurance industry. Moreover, we hope this research will present you with a constructive starting point for addressing both the challenges and opportunities that IFRS poses for differentiation and competition in the industry.

Rebecca C. Amoroso
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Executive Summary

International Financial Reporting Standards (IFRS) are gaining momentum and acceptance worldwide. Over 100 countries have adopted, have convergence plans with or allow the use of IFRS. In the US, IFRS is already used by subsidiaries of foreign filers and joint ventures, driven by the ultimate foreign filer requirement under IFRS. Further, it is expected that by 2011, US companies will have the option of using IFRS and almost every country around the world could be using IFRS to some extent.

This report is not intended to discuss the merits of IFRS, but rather to explore the implications of the changes it introduces and of its widespread use. The transition to new accounting policies under IFRS requires a change in mindset, presenting companies with both challenges and opportunities. Insurers embarking on the IFRS journey will have their hands full understanding the new policies and keeping pace with changes required throughout the organization, including in accounting and financial reporting, finance/treasury, investment management, risk and controls, performance and decisions, actuarial and claims management, and tax, among others. Meanwhile, IFRS for insurance contracts will increase volatility in financial reporting statements, and enable consistency and transparency of reporting across insurance entities. These factors, combined with regulatory mandates such as eXtensible Business Reporting Language (XBRL),[1] solvency-related requirements and increasing attention on risk management, will raise the level of transparency around the financial performance of insurers to new heights.

Amid this changing backdrop, insurance companies need to consider how these forces may influence their business strategies and shape the insurance marketplace. Recognizing that there are still unresolved questions and interpretations related to IFRS, this report illustrates the potential role of IFRS in shaping five areas of insurers' business strategy and, as a consequence, insurance market structure. Specifically, in some markets, IFRS will likely contribute to substantial changes in insurance product design, price and offerings; investment strategy; risk management practices; securitization; and merger and acquisition (M&A) activity. Together, these changes will give rise to pressure for both convergence and divergence across insurance lines, thereby adding complexity and dynamism to the market structure of the insurance industry.

Thus, whether or not an insurance company concurs with the merits of IFRS, it behooves its management to consider carefully the potential implications of the widespread implementation of IFRS in the industry. To compete most effectively with a new reporting regime in place, insurance companies should begin to visualize and strategize for the journey upon which IFRS may guide the industry. By taking a proactive approach to understanding how the implementation of IFRS will impact key areas of insurers' business strategies, management can avoid the risks of being blind-sided and seize the new opportunities IFRS presents for differentiation and competition.

Catching up with IFRS

The IFRS revolution is gaining momentum and acceptance worldwide, presenting companies with both challenges and opportunities. The growing acceptance of IFRS as *the* global accounting standard is placing pressure on both US and non-US companies not using IFRS to make the transition. From an accounting perspective, IFRS represents a different way of looking at financial reporting and requires a change in mindset. For insurance companies, the changes are even more dramatic and drawn out in a special accounting project for insurance contracts that strives to enable companies to better understand their risks. Insurers that understand their risks and act to manage their business effectively under the new mindset will establish a clear advantage over those companies that do not.

IFRS around the World

Despite the continued debate regarding the benefits and the challenges of IFRS, in an era of increased globalization, IFRS has emerged as *the* global accounting standard. IFRS is already in use in over 100 countries, and large countries like Brazil, Canada and India have recently announced mandated adoption. Approximately 40 percent of Global Fortune 500 companies use IFRS, and that percentage is increasing.[2] By 2011, almost every country around the world could be using IFRS to some extent. As more companies around the world report using IFRS, "there will likely be increasing pressure" on US insurers "to do the same."[3]

IFRS is gaining acceptance in the US and is already impacting many companies in the US. Since 2002, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have been working together to converge IFRS and US GAAP (Generally Accepted Accounting Principles). In November 2007, the SEC (Securities and Exchange Commission) eliminated the requirement for foreign private issuers using IFRS to reconcile their financial statements to US GAAP. It is expected that US companies will have the option of using IFRS by 2010 or 2011, and that the SEC may issue a "proposing release" to that effect in as early as 2008. In fact, Deloitte & Touche LLP's "2008 IFRS Survey" found that, if given a choice by the SEC, approximately 30 percent of CFOs and senior finance professionals would consider adopting IFRS.[4] Meanwhile, IFRS is already used by US subsidiaries of foreign filers and joint ventures, driven by the ultimate foreign filer requirement under IFRS. Additionally, US companies interested in competing with other major industry players that use IFRS have begun considering and preparing themselves for the prospective use of IFRS.

The Accounting Revolution

For US companies and many non-US companies alike, IFRS reflects a departure from GAAP and requires a major change in mindset for management, auditors and users of their financial statements. The new standards are generally more focused on objectives and principles and less reliant on detailed rules and interpretations than US GAAP.[5] They strive to answer one key question: *Do the financial statements represent the economic reality underlying the transactions and events accounted for in the financial statements?* As a result, the standards draw on a fair-value-like[6] or mark-to-market and mark-to-model methodologies, and seek to raise transparency to new heights through increased disclosure.[7]

Nowhere is the change in mindset more pronounced and the implementation of IFRS more complex than in the insurance industry. Insurance contracts are treated separately under IFRS 4 Insurance Contracts, which lays the groundwork with the considerable task of defining an insurance contract and aspires to record both insurance contract assets and liabilities at their current exit value (CEV). The shift to fair-value-like accounting for liabilities has grown into a challenging task, so much so that the IASB has split the insurance project in two parts.

Introduced in March 2004 as an interim standard to help European Union insurers convert to IFRS by 2005, Phase I of IFRS 4 Insurance Contracts establishes a specific definition of insurance and reinsurance contracts,[8] introduces several changes to the accounting for insurance contracts and requires increased disclosure related to future cash flows and risk exposures. The introduction of a specific definition of an insurance contract will result in the reclassification of certain contracts from insurance contracts to financial instruments. Among the key accounting changes introduced in Phase I are the requirement for insurers to account for embedded derivatives (e.g., guarantees, such as return of premium, offered as part of a life insurance product) and record them at "fair value," as well as the elimination of equalization and catastrophe reserves utilized in some countries.

Phase I of the insurance project also requires increased quantitative and qualitative disclosure related to risk exposure. For example, it requires increased disclosure related to the explanation of reported amounts, including information on accounting policies, significant assumptions and material changes to insurance liabilities, reinsurance assets, and deferred acquisition costs (DAC). Additionally, it "will require the disclosure of risk management policies and terms and conditions that have a material impact on the amount, timing and uncertainty of the insurers' cash flows."[9] Through these changes, Phase I endeavors to enable users of financial statements to better understand the nature of insurance and how changes in assumptions and external factors such as credit exposures can affect the valuation of assets and liabilities.

Despite all of these changes, there continues to be a lack of consistency in the accounting for insurance contracts, particularly in the valuation of liabilities. The lack of consistency arises from the fact that, aside from the specific requirements outlined in Phase I of IFRS 4 Insurance Contracts, insurance companies continue to use local GAAP for accounting for insurance contracts. Moreover, local GAAP varies from country to country. Thus, Phase II of the insurance project, whose implementation is pending and not expected before 2012, strives to close this gap by focusing on the implementation of CEVs for liabilities. After soliciting comments on the Discussion Paper for Phase II, the IASB expects to publish an Exposure Draft of its proposals in the third quarter of 2009, with the final standard in place by the end of 2010, and implementation by two years afterward.[10]

The long time line is due, in part, to complications arising from the lack of a liquid market for those liabilities from which to obtain an observable price. Nevertheless, as currently proposed in the IASB Discussion Paper on accounting for insurance and reinsurance contracts, entitled "Preliminary Views on Insurance Contracts," Phase II of the insurance project would require insurance contracts to be reported at their CEV, or the amount that would be received today if the entire obligation were to be sold to a third party. In determining CEV, insurance companies will need to provide current estimates of the future cash flows from the contract, apply an appropriate discount rate for the time value of money, and estimate the margin that market participants would require for bearing the risk (risk margin) and for providing other services, if any (service margin). Further, the cash flows must be explicit; as consistent as possible with observable market prices; incorporate all available information about the timing and uncertainty of cash flows arising from the contractual obligations in an unbiased way; and be current based on conditions at the end of the reporting period.[11]

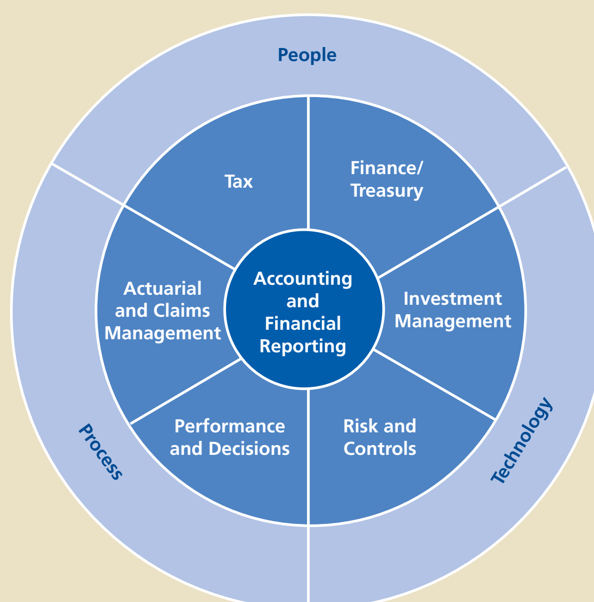
In addition to adhering to IFRS 4 Insurance Contracts (Phase I and Phase II), insurance companies reporting under IFRS must also adhere to IFRS 7 and IAS 32— related to the disclosure and presentation of financial instruments, respectively — and IAS 39, related to the recognition and measurement of financial instruments. Together, these standards aim to improve transparency around pricing, profitability, risk management and investments. If implemented, the new standards will redefine the rules by which insurance companies compete. Among insurers that report under IFRS, those who are able to understand their financial performance and effectively manage their business under the new mindset and in an increasingly transparent world will find themselves at an advantage relative to other companies.

If the momentum toward IFRS continues, companies continuing to report under US GAAP may also need to develop an understanding of IFRS and its implications. For example, these companies may find that analysts will seek to convert their financial statements to IFRS to facilitate comparison across companies. Moreover, for insurance companies in particular, it is possible that that the FASB and the IASB will undertake a joint project in order to develop a common, high-quality standard that addresses recognition, measurement, presentation and disclosure requirements for insurance contracts.[12] Thus, irrespective of the merits of IFRS, it behooves all insurance companies to consider carefully the potential implications of the widespread implementation of IFRS in the industry.

Embarking on the IFRS Journey

Companies embarking on the IFRS journey may find that the transition or conversion is a complex process requiring multiple layers of change. At a core level, companies may find that significant changes to and re-engineering of their accounting and financial reporting processes might be necessary. In addition, management will need to understand its financial performance under the new standards. The implementation of IFRS may also have an extended impact on the processes of finance/treasury, investment management, risk and controls, performance and decisions, actuarial and claims management, and tax. Finally, any effort to improve the performance of any of the core or extended impact areas will require consideration of the impact of key enablers such as people, process and technology. The accompanying diagram illustrates how almost every aspect of a company's business could potentially be affected and is followed by a discussion of three key challenges facing insurance companies in particular.

The adoption of IFRS will affect more than your company's accounting and financial reporting function. Consider both core and collateral impact, and enablers that support value creation.



Core Impact
Area of primary impact from IFRS implementation. Changes to this process are significant and re-engineering of the process might be necessary.

Extended Impact
Areas of secondary impact from IFRS implementation. Changes to affected processes may be partial and not have an impact on all three enablers.

Enablers
Enablers support effective execution in core and extended impacted areas. Any effort to improve performance of any of the core or extended areas will require consideration of the impact on each of the key enablers.

Ultimately, almost every aspect of a company's business could potentially be affected.

Source: Deloitte Development LLC, 2008

Accounting and Financial Reporting: Bridging the Technical Gap

As currently proposed in the IASB Discussion Paper, IFRS 4 will likely present most insurers with a major challenge in the area of actuarial modeling. As a point of reference, in Europe, the move toward fair value calculations in European Embedded Value has led life insurance companies to develop stochastic models. These models require additional assumptions regarding how management and policyholders may react in different economic scenarios. These assumptions often have to be made in the absence of much concrete data and involve some subjectivity. Further, where the use of market-consistent embedded value by European insurers has already removed a large part of the subjectivity in economic assumptions, subjectivity remains in insurance risk assumptions.

As Phase II of the insurance project under IFRS will likely require similar fair-value-like calculations, it is likely that insurers will need to become comfortable with providing appropriate assumptions, whether market consistent or portfolio-specific. For example, in estimating market consistent values for

insurance liability cash flows, a lack of observable data for some inputs (e.g., claims frequency and severity for certain insurance lines) may force some insurers to develop more sophisticated actuarial models. "Estimating liability cash flows is already difficult, and such difficulties are compounded when the actuary must consider the possibility of extreme tail events and weaknesses in the availability of observable market data that will appropriately represent the financial values. The challenges will be greatest for long duration life insurance and P&C long tail lines of business that are characterized by long emergence patterns, potentially high payouts and large volatility."[13] Insurers will need to grow comfortable with these techniques and work to continually test models under new conditions and refine them.[14]

Technology: Closing the Systems Gap

The implementation of IFRS will likely necessitate redesigned accounting, reporting, consolidation and reconciliation processes. Additionally, IFRS entails more extensive disclosure requirements, requiring regular reporting and usage of financial data that may not be standardized in insurers' data models. IFRS may also increase the need for documented assumptions and sensitivity analyses, factors that may expand the scope of information managed by insurance financial systems. From an actuarial perspective, the requirement that insurers estimate cash flows and liabilities on a market consistent basis will place a premium on the aggregation and integration of both internal and external data into a consistent format that enables analysis.[15]

People: Filling the Talent Gap

Reporting under IFRS may deepen the talent crisis insurers face. To conform to the new reporting requirements, these insurers will need to have a strong knowledge of IFRS across actuarial, accounting, finance, tax, IT (information technology) and product development functions. The talent challenge will entail hiring qualified individuals, training existing employees and keeping staff abreast of new IFRS-related developments through tools such as internal business school-like programs and e-learning courses, as well as the help of external consultancies. In acquiring this talent, insurance companies will face steep competition from firms in other financial services sectors.

Filling the IFRS talent gap has been and continues to be a major challenge for European insurers that adopted IFRS in 2005, and US insurers seeking to report under IFRS should expect to face a similar challenge. In its August 2007 concept release, the SEC cited the lack of experience in preparing IFRS financial statements in the US market as a potential issue in the implementation of IFRS. It also posed questions related to the education and training of the accounting and auditing profession and other specialists such as actuaries and valuation experts, as well as related to transition and timing. In the document, the SEC noted that: "[p]rofessional associations and industry groups would need to integrate IFRS into their training materials, publications, testing and certification programs. Colleges and universities would need to include IFRS in their curricula. Furthermore, eventually it may be appropriate to include IFRS in the Uniform CPA Examination."[16]

Studies confirm the need for more awareness about IFRS and the existence of a talent gap with respect to IFRS. For example, Deloitte & Touche LLP's "2008 IFRS Survey" found that approximately 10 percent of US companies said they had insufficient knowledge to determine whether they would consider adopting IFRS, if given a choice. Of those that would consider adopting IFRS if given a choice by the SEC, the survey found that approximately two-thirds said they lacked the skilled resources to make and maintain the conversion to IFRS financial statements in their US operations, and one-third said they lacked skilled resources in their non-US operations. Another survey found that the lack of IFRS-related knowledge is prevalent at the C-level as well, with approximately 77 percent of US Chief Financial Officers (CFOs) and senior controllers reporting they have no experience preparing financial statements according to IFRS.[17]

For those companies already reporting under IFRS, Phase II of the insurance project will intensify the talent shortage. The quest for talent will become an even greater challenge for management as IFRS is extended to companies filing local financial statements in addition to the existing consolidated statements. Further, the eventual use of IFRS as a basis for regulatory and solvency purposes will exact a sound knowledge of the new accounting standards. Insurers that move quickly to gain access to new talent or train existing staff will reap big rewards.

Looking Beyond the Accounting Changes

As insurance companies embark on the IFRS journey and confront many of the challenges illustrated above, they will also find that the marketplace in which they compete is evolving rapidly. While the impact of IFRS on a given country's insurance market will vary based on the accounting and regulatory standards in place prior to IFRS, one thing is for certain: change. In fact, a 2004 Geneva Association survey found that 91 percent of life insurers and 87 percent of non-life insurers felt that a full fair value system would have a "significant or major influence" on management thinking, and the corporate strategies and business models used to run companies.[18] Recognizing that there are still unresolved questions and interpretations related to IFRS, this report illustrates the potential role of IFRS in shaping five areas of major change: insurance product design, price and offerings; investment strategy; risk management practices; securitization; and M&A activity.

Product Design, Pricing and Offerings

As noted earlier, IFRS seeks to help companies develop a more economic representation or what can be considered a more "realistic" view of their business. By accounting for features such as embedded derivatives, calculating risk and service margins, improving the sophistication of their modeling techniques and conducting sensitivity analyses around the performance of their insurance assets and liabilities, it is likely that companies will be able to make better strategic decisions about whether or how to continue offering specific product lines. The additional information that will become available to management from adopting IFRS will provide insight into the profitability of new business when it is written, and will likely help life and non-life insurance companies attain a better understanding of the risks and uncertainties associated with individual business lines or portfolios. As a result, the cross-subsidization of underperforming lines of business may become more transparent and therefore less likely.[19]

Life Insurance

Few things in life are for free. The implementation of IFRS 4 in some markets has required insurers to develop a deeper understanding of their products by examining their entire books of business to enable the classification of products as insurance contracts or financial instruments. It has also brought to light the fact that, in many markets, insurance companies have historically not properly or explicitly charged for certain product features, such as options and guarantees on life insurance products, because they thought the features would always be out of the money. As insurance companies increasingly become aware of these factors, the additional information flowing from the adoption of IFRS will lead them to properly price these embedded derivatives and to do so at "fair value." As a result, it is likely that certain life insurance products and annuities may be discontinued, redesigned or priced higher.

A look at European multi-national companies that have been valuing embedded derivatives in accordance with European Embedded Value principles, which result in market consistent calculations similar in spirit to those proposed by IFRS, supports the likelihood of this trend. In Europe, several insurers have scaled down the product features they offer and moved toward offering products that pass on greater insurance and investment risk to policyholders, such as unit-linked products,[20] while making sure to maintain enough risk to retain their classification as insurance products under IFRS 4. In fact, in a 2004 Geneva Association survey of leading international insurance executives, life insurers noted that in switching to fair value reporting, "they would be more inclined to pass on insurance and investment risks to policyholders by offering contracts with fewer guarantees and less flexibility on surrender options and other embedded options." Generally, 86 percent of the life insurance executives felt that the change in reporting would have a "significant or major impact" on their existing product range.[21]

Other European insurers have modified their product design to offer less valuable or risky guarantees by instead offering smaller fixed guarantees, then ensuring the ability to stay competitive through the use of a discretionary additional return. On the other hand, other insurers have moved toward offering customers even more choices. For example, some insurers have moved to offering products such as variable annuities with customized guarantees or options that are mapped more explicitly to prices, but that in return require them to make substantial upgrades to their standard modeling, risk management and pricing processes.

With the sub-prime credit crisis, it is likely that customers will continue to demand products with guarantees, the effective underwriting of which should be a core competency of life insurance companies. To maintain their competitive advantage vis-à-vis investment alternatives such as those offered by asset management firms, life insurance companies need to continue to match customer demand with product design. Simultaneously, they must also ensure the products are profitable as reported under IFRS, even during periods with low interest rates. In the new reporting environment, insurers that are best able to price these features and communicate their value will likely be most successful in charging the appropriate prices for these products. Viewing this challenge as an opportunity, transparency may provide insurers the opportunity to show customers the value they are providing and demand the corresponding price.

Non-Life Insurance

Under IFRS, the modeling of liabilities, especially for non-life insurers, will become more complicated with the advent of discounting and the use of stochastic techniques. Companies offering long term insurance products such as general liability, commercial automobile, workers' compensation and specialty lines of insurance, such as directors and officers (D&O) and errors and omissions (E&O), that seek to cover the long tail lines of business will find the estimation and modeling of liability cash flows the most challenging, as these lines have weak observable market data, high volatility and potentially large payouts. Further, as insurance companies provide more detail in their financial statements regarding how risk is priced, for example through increased disclosure related to the calculation of risk and service margins, assumptions and sensitivities based on actuarial modeling, the concentration and mitigation of risks, and claims development, the pricing of risk will likely become more transparent.

Transparency in the pricing of risk may make the insurance market more competitive, as it may expose both those who price risk too aggressively to gain market share (or lack sufficient actuarial and underwriting expertise) and those who charge an unusually high premium for risk. This trend may be strengthened with the elimination of equalization and catastrophe reserves (utilized in some countries) that will no longer obscure the true performance of insurance companies and increase volatility in the equity line of insurance companies. Further, the true volatility in the performance of all insurance lines will likely be more transparent to the market, especially the volatility of low frequency, high severity insurance lines such as catastrophe and terrorism. As a result, insurers may be able to command higher prices and reap the associated benefits. However, as profits become transparent, prices may again decline. Thus, profit and loss cycles may become more severe.

Faced with increasing transparency in the pricing of risk and more competitive markets, insurers—regardless of whether they report under IFRS or GAAP—will need to streamline their operations and enhance their pricing capabilities in order to improve their cost structure and their ability to compete effectively.

Reinsurance

With several unresolved questions and interpretations, it may be too premature to foresee the impact that the implementation of IFRS will have on reinsurance. It is possible that, as IFRS places an increased focus on risk, insurance companies may review their demand for reinsurance products as part of their overall management of risk and capital. Further, as insurance companies continue to seek ways to mitigate their risks and potentially focus on reducing volatility in financial reporting, it is possible that demand for reinsurance products may increase.

The one likely exception to this trend, however, is financial reinsurance. Since reserves will be calculated on a discounted cash flow basis under Phase II of the insurance project (as currently proposed in the IASB Discussion Paper), IFRS will likely reduce the role of financial reinsurance products that effectively discount reserves or exploit accounting arbitrage opportunities. Further reinforcing this trend, in some markets, IFRS represents a change in the classification of financial reinsurance products, from insurance products to financial instruments. This reclassification may have a negative impact on reinsurers' willingness to offer these products from an accounting perspective, as the contracts will no longer show premium income and instead be accounted for similarly to a loan on the balance sheet.

Investment Strategy

As currently proposed in the IASB Discussion Paper, the valuation of liabilities at their CEV under Phase II of the insurance project will likely encourage companies to focus on improving another major part of their business: investment management. As IFRS potentially introduces greater volatility into financial reporting statements, insurance companies will need to pay closer attention to their investment strategies. On the asset side, IAS 39 has introduced what for some markets (not the US) is a new classification system for investments held (e.g., held-to-maturity, available-for-sale, and trading). On the liability side, the measurement of liabilities at CEV as proposed in Phase II of the insurance project, will force insurers to better understand and quantify the risks and uncertainties associated with their liabilities and how those will be reported in their financial statements. Thus, a more careful consideration of investment strategies in light of changes in the valuation methodology of liabilities could lead to substantial improvements in asset-liability management (ALM).

IAS 39 introduces what, in some markets, is a new classification system for recognizing and measuring financial assets. It has led many European insurers to focus more on how they designate their portfolio securities and led to more volatility in the asset side of their balance sheet. For example, as IFRS entails steep penalties for misuse or abuse of the held-to-maturity classification that allows securities to be held at amortized cost, insurers have increasingly held securities in the available-for-sale (AFS) classification. The AFS classification has introduced greater volatility in the equity of companies, which companies must learn to handle.

Generally, a fair-value-like approach to measuring liabilities will encourage insurers to reduce asset-liability mismatches, which have a high cost in terms of risk and may invoke punishment under accounting and solvency calculations. Further, as IFRS requires embedded derivatives to be estimated at "fair value," it will force insurance companies to effectively manage the risk associated with these features. In some European countries, better asset-liability management has generally led companies to review the balance between equities and fixed interest products, resulting in a shift away from equities and toward fixed income products, as well as an increase in the use of derivative hedging strategies.[22] In the US these shifts have already occurred. Nevertheless, IFRS may lead to improvements in cash flow hedging strategies, as it is intended to help insurance companies establish a better understanding of the timing, risks and uncertainties underlying their cash flows.

Further, while IFRS does not explicitly entail solvency calculations, by providing a more market consistent or economically informed net assets figure, it may help insurers identify areas where potential excess capital may lie. Naturally, it is hoped that IFRS will contribute to the process of determining solvency calculations, though the resolution of many details is still pending. Finally, as described below, IFRS may facilitate growth in the securitization of insurance liabilities, which may also free up capital. As excess capital is identified, insurance companies will need to make informed decisions regarding how the released capital may be invested.

Risk Management

The transition to IFRS will likely help insurance companies improve the sophistication of their risk management practices. First, as described earlier, IFRS intends to help companies arrive at a better economic view of their business portfolio, which will likely lead to improved management of the business. Second, IFRS provides an opportunity for firms to substantially improve internal controls. Finally, above all, greater transparency may lead to greater levels of accountability for risk management practices.

IFRS strives to enable better management of the business. As noted earlier, better information available following the implementation of IFRS will enable insurers to review the profitability of their business portfolios, and help them attain a better understanding of the risks and uncertainties associated with individual business lines. By arriving at what might be considered a more "realistic" view of their business, insurers will be able to make better strategic decisions about whether or how to continue offering certain product lines. The adoption of IFRS may also help companies improve their cash flow management, due to consistent standards across countries and policy changes regarding dividends paid from subsidiaries. As noted earlier, from a balance sheet perspective, IFRS will likely help insurance companies improve their asset-liability management practices. Further, the increased transparency around the performance and capital position of a company and its business lines may expose management to scrutiny from investors, competitors and others.

Regulatory mandates such as XBRL will reinforce the trend toward improved management of the business. By bringing a consistent taxonomy for data items across the reporting supply chain and across software products, "XBRL will facilitate information sharing instantly and directly, within organizations and between companies and all of their different stakeholders."[23] For example, the eventual implementation of XBRL is intended to lead to better data management, enabling management to make more timely and informed decisions. XBRL will also provide greater transparency to Boards, potentially enabling them to provide better oversight. Additionally, creditors may receive more timely, frequent and consistent credit and covenant compliance analyses, which may substantially improve credit risk management.[24]

IFRS will also create an opportunity for improvements in internal controls. It will present companies with the prospect of centralizing and standardizing all reporting processes from local subsidiaries to the consolidated entity, potentially reducing inconsistencies and errors related to data and metrics. Additionally, where statutory statements can be prepared in accordance with IFRS, thereby avoiding manual conversion of statements from GAAP or other local standards, insurers may experience a reduction in compliance-related errors.

Meanwhile, solvency-related trends will also reinforce the trend toward improved risk management in insurance companies. For example, in Europe, the parallel evolution of IFRS and the Solvency II framework, with expected implementation in 2012, will bring about increased disclosure of risk management practices and risk margins, therefore driving consistency and rigor to risk management practices from a capital adequacy perspective. In fact, one of the advantages of IFRS in Europe is the likely compatibility of accounting standards with solvency calculations. In the US, the National Association of Insurance Commissioners (NAIC) is reviewing its risk-based capital approach to solvency requirements and IFRS remains a few years away from optional adoption. The two trends may benefit from each other if they are developed in concert with each other. Otherwise, multiple valuation systems and frameworks alongside solvency calculations could become onerous.

The increased transparency and greater disclosure related to risk, as introduced by IFRS, combined with capital adequacy frameworks, will lead to insurance companies being held to greater levels of accountability for their risk management practices. Moreover, changes in reporting due to IFRS and XBRL will empower investors and analysts, who will make easier comparisons across companies and hold management to heightened levels of accountability. With the transition to new standards and increased transparency, come both an opportunity and a challenge to develop an effective communication strategy for explaining assumptions, risk and volatility to policyholders and other stakeholders.

Securitization

As currently proposed, the implementation of Phase II of IFRS 4 may be a key catalyst in fostering growth in the market for insurance-linked securitization (ILS), including for example the securitization of closed books of business such as life insurance policies. IFRS may facilitate the execution of securitization transactions, as well as help insurance companies uncover a number of reasons to engage in these transactions.

ILS in Context

ILS volume has traditionally been low relative to banking industry securitization, reinsurance or the global bond market. Current securitization revolves around high severity, low probability risks in both life (e.g., bird flu) and non-life (e.g., hurricanes or earthquakes). And attempts to develop an ILS market on trading platforms have had little success, as insufficient data and modeling capacity have traditionally made it hard to repackage insurance risk.[25]

Drivers of Growth in ILS

Increased transparency under IFRS will likely provide reassurance to investors contemplating investment in an ILS. Because a fair-value-like exit model, with the assumptions and methodology disclosed, is more transparent, insurance liabilities can be more fairly valued by buyers, thereby making it easier to offload liabilities and increasing the potential to securitize them.[26] Moreover, IFRS will provide a stronger framework for evaluating companies across countries and lines of business, giving investors more comfort with the underlying finances of transactions.

As described earlier, IFRS will also likely require improvements in modeling capacity, which will likely facilitate the repackaging of insurance risk. For example, as IFRS requires insurers to calculate the CEV of contracts, insurers will need to devote more resources to modeling and developing accurate, market-consistent prices. In turn, more accurate pricing evidencing itself, for example, through risk and service margins, may contribute to an increase in the desire of management to unlock the value of closed blocks of business or value in force in both life and non-life lines, as well as across personal and commercial lines.

For an insurance company's management, the implementation of IFRS, and in particular the increased levels of disclosure, might encourage greater consideration of the attractiveness of engaging in securitization transactions. For example, in the drive for better ALM strategies, difficulty in matching discounted liabilities with effective strategies on the asset side may lead some insurers to consider offloading certain liabilities. From a general risk management perspective, insurers may engage in securitization transactions to manage the increased balance sheet volatility associated with reporting under IFRS. For example, as companies become more sophisticated in their modeling capacities, they may increasingly seek to transfer both market and non-market (e.g., longevity and mortality) risk off the balance sheet in order to manage their capital more effectively.

As the ILS market grows, its role may overlap at times with the traditional role of reinsurance. Time will tell if reinsurers will compete against, complement (e.g., divide up types of risk transfer) or facilitate (e.g., play the broker's role in) securitization in the insurance market.

In addition to potentially increasing the use of securitization as a risk management tool, IFRS may also lead companies to use securitization as a financing vehicle for new business activities or mergers and acquisitions. For example, as discussed earlier, the additional information flowing from IFRS will help companies understand the underlying profitability or un-profitability of business lines and how much profit relies on "risky" activities such as investments in non-risk-free assets. As a result, companies may seek to either build out their core competencies further (for example, through mergers and acquisitions) or diversify their business model as a hedge against volatility. In either case, the securitization of liabilities will free up capital to be deployed in these activities.

Toward Discipline in ILS

Securitization has transformed the banking industry through the development of various forms of asset-backed securities, which have contributed to improved balance sheet management and a reduction in earnings volatility. However, the sub-prime credit crisis has raised questions about what types of commitments companies are engaged in and principal-agent problems that resulted in lower due diligence or underwriting standards.[27] At this juncture, it makes sense to question how the ILS market may grow in such a way that these risks are mitigated.

IFRS may not solve but does address these two risks. First, IFRS requires substantial disclosure about risk management practices, which may entail securitization. And greater transparency around risk management alongside pricing and profitability, in general, should provide further reassurance to investors. Second, the principal-agent problem between insurance providers and reinsurance companies as originators of risk, as opposed to warehousers of risk,[28] is mitigated by stricter requirements under IFRS. For example, attaining an off-balance sheet treatment of securitized assets or liabilities is much more difficult under IFRS. In fact, under IFRS, there is no concept of a qualified special purpose entity (QSPE), and most securitization SPEs must be consolidated and then evaluated for derecognition.[29] IFRS allows proportional layoff of the risk of insurance cash flows and insurers may be able to derecognize a portion of their liabilities. However, insurers will continue to keep their proportional share in the risk of the liabilities on their balance sheet, and as a result, continue to focus on the quality of underwriting of the underlying risks.

As a general note, financial innovation such as insurance-linked securitization must be approached with some caution. Before engaging in securitization transactions, insurance companies should seek to learn from the sub-prime credit crisis. For example, one key lesson learned from the sub-prime crisis is the difficulty that financial innovation poses for practitioners to understand, price, model and rate risks effectively. Another important question raised by the recent crisis is the role that Boards should play in the management of risk related to financial innovation. Insurance companies that internalize and act upon the lessons learned from the sub-prime credit crisis will likely fare the best in the market for insurance-linked securitization.

Mergers & Acquisitions

While IFRS will not likely be a major driver in rationalizing an M&A deal, it may indeed encourage M&A activity. More importantly, when an M&A deal fits the overall strategy of a firm, IFRS can play an important role in improving the quality of the M&A process, by adding value at each stage of the process.

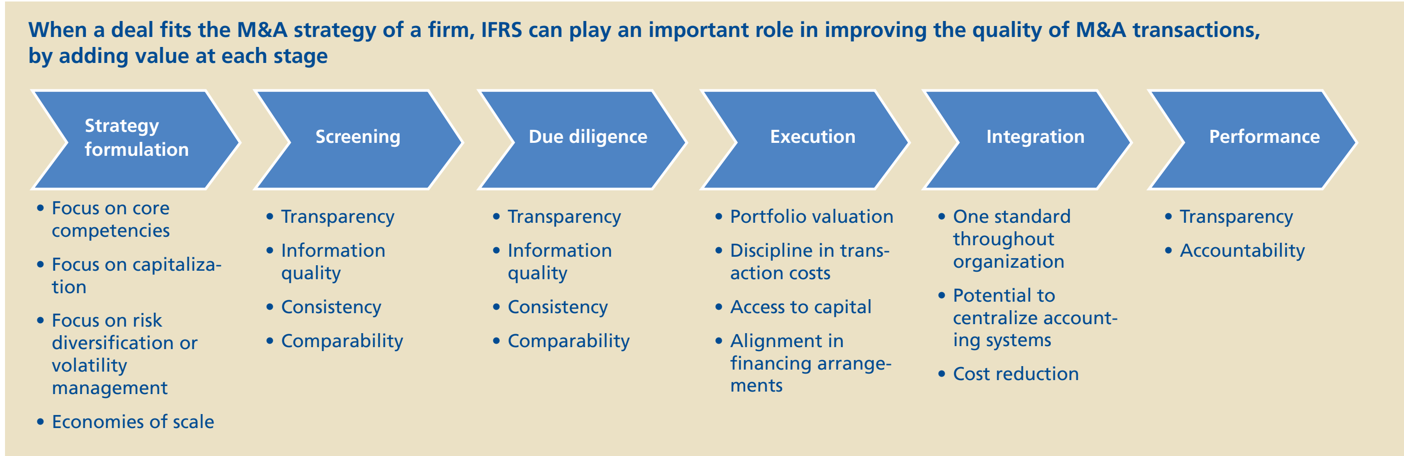
As noted earlier, IFRS may induce some companies to concentrate on their profitable business lines or core competencies. Engaging in M&A is one way in which these insurers may potentially fill the gaps in their core competencies. On the other hand, some firms may choose to diversify their business portfolio as a hedge to balance sheet or earnings volatility under IFRS financial statements, or may seek protection from better capitalized firms. As a result, there will likely be an increase in divestitures of non-performing or capital consuming businesses. Together, these forces may lead to increased trading of closed blocks of business. Separately, high costs associated with transitioning to IFRS and other growing compliance costs may also drive insurance companies to pursue M&A engagements as a way to realize economies of scale.

IFRS will also lead to substantial improvements in the quality of the M&A process. Increased transparency, information quality and consistency in the definition and accounting treatment of insurance contracts will enable better screening and due diligence into target companies using IFRS. The use of XBRL will further enhance transparency, information quality and comparability across companies and across countries.

In executing an M&A deal, in general, IFRS shareholder equity will represent a better starting point for valuing a company than book value under US GAAP has traditionally been, and will potentially be closer to purchase prices going forward. In markets where the expensing of transaction costs represents a change (e.g., under IFRS or under US GAAP as of 2009), the new standard may introduce more discipline into the execution of deals. Firms seeking capital for M&A deals may find that reporting under IFRS will provide greater access to foreign capital markets (e.g., European or some Asian markets), and potentially open up securitizations as a source of financing. Creditors and investors may have a more accurate picture of an insurance company's risks and cash flows, and may be able to structure more appropriate financing arrangements.

From an integration perspective, the use of one financial reporting standard instead of multiple standards will reduce the costs of operating globally, and enable the centralization of accounting systems. In some cases, the ability of insurers to use IFRS for both financial and statutory reporting will further reduce costs.

Finally, IFRS introduces to some markets what are new measures of accountability for the performance of acquired assets. For example, IFRS requires the separation of intangible assets and goodwill, the carrying of goodwill on the balance sheet with no amortization and annual testing for impairment, along with substantial disclosure related to the performance of acquired assets. Though US GAAP also requires goodwill to be tested annually for impairment, IFRS requires more intangible assets to be measured at fair value.[30] These changes will likely enable markets to hold companies more accountable for the performance of M&A deals.[31]



Succeeding in an IFRS World

So where will the IFRS journey for insurers end up? Will it lead to more consolidation or less consolidation in the industry? The answer may not be clear, as the IFRS journey is open ended with many long and winding roads, and potentially many blind corners. As companies embark on this journey, increasing transparency and consistency in the valuation of assets and liabilities will enable observers and competitors to view how they are faring, exposing those companies that are ill prepared and redefining the traditional rules of competition. As a result, insurance company executives will need to learn to survive in a more dynamic world, whether they report under IFRS or not. They should first begin by taking a proactive approach to understanding the changes IFRS may introduce to business models and market structure, so that they are armed to compete effectively in the new business environment. By doing so, companies contemplating reporting under IFRS can avoid the risks of being blind-sided and be first-movers in taking advantage of many of the new opportunities IFRS presents for differentiation and competition.

The potential changes in products, investment strategy, risk management practices, securitization and M&A illustrated in this report will likely give rise to pressure for both convergence and divergence across insurance lines, thereby adding complexity and dynamism to the market structure of the insurance industry. Seeking better capital and risk management overall under IFRS and solvency-related requirements, some insurance companies may seek the benefits of diversification, which may lead to convergence across insurance lines as a natural business hedge against earnings and equity volatility. Additionally, some firms may seek protection from well-capitalized firms that may or may not offer insurance lines distinct from their own. Despite the unique characteristics of distinct insurance lines, a consistent framework for accounting for insurance contracts under IFRS may provide some synergies, making it easier for companies to diversify across lines of insurance. For companies that already have multi-line offerings, the ever elusive cross selling imperative may become even more crucial.

Yet other players in the insurance industry may instead experience divergence across insurance lines, as IFRS may help them make an informed strategic choice to pursue more concentrated or mono-line offering strategies. For example, the additional management information flowing from the implementation of IFRS will highlight unprofitable lines of business that companies may choose to divest. Accordingly, IFRS may encourage insurers to focus on profitable lines and build out their core competencies through acquisitions. As a result, there may be a substantial increase in the sale and purchase activity of closed books of business. IFRS may also lead to increased securitization of closed books of business, leaving the active portion of the business increasingly concentrated in certain insurance lines.

Those companies pursuing strategies of convergence will need to adapt to managing larger, more complex multi-line business portfolios and maintaining the very transparent profitability of these lines under IFRS. Those that pursue strategies of divergence will need to learn effective ways to manage the dangers of mono-line business offerings, many of which have risen to the forefront in the sub-prime credit crisis, for example.

Though the answers may not be clear regarding how the industry will evolve, companies reporting under IFRS will be required, in effect, to make a choice about how they wish to compete in this changed, more dynamic environment. Regardless of the strategy insurance companies pursue, they must first begin with a systematic evaluation of their business portfolio under IFRS. Next, they must conduct a careful analysis of their product, investment, risk management, securitization and M&A strategies. Finally, in order to compete most effectively in the changing marketplace, they must make a purposeful decision about whether they will pursue strategies of convergence or divergence. Customers, investors and other market participants will be following the journey closely, with transparency enabling them to see which companies are managing the business well and which are not. Companies that develop an effective communication strategy for explaining performance, assumptions, risk and volatility to policyholders, investors and other stakeholders will lead the pack.

Endnotes

[1] XBRL is a standard for the electronic exchange of data between businesses and on the Internet, through the use of unique identifying tags to be applied to items of financial data. XBRL Web site accessed March 24, 2008. http://www.xbrl.org

[2] "TWENTY PERCENT OF U.S. COMPANIES WOULD CONSIDER ADOPTING IFRS – BUT MORE TRAINING IS NEEDED: DELOITTE SURVEY" Deloitte News Release, October 2007 (http://www.iasplus.com)

[3] Ibid.

[4] "2008 IFRS Survey: Where Are We today?" May 2008. Based on 200 US companies.

[5] "International Financial Reporting Standards for U.S. Companies: Implications of an accelerating global trend" Deloitte Development LLC, 2007

[6] In this report, "fair-value-like," "fair value" and current exit value (CEV) are used interchangeably. Though the IASB has not yet determined whether the notions of CEV and fair value are the same, it has not yet identified any significant differences. Fair value refers to the "amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." Appendix A of IFRS 4 Insurance Contracts

[7] While IFRS strives to improve transparency and consistency at a broad level, it may not achieve this goal in all respects. For example, some observers have noted that the increased volume of and variation in the presentation of disclosures may make it difficult for some users of financial statements to find the information they seek and make comparisons. In addition, while fair value strives to present a more "economic" view of the business, the complexity of modeling techniques can also be a challenge for users of financial statements to understand.

[8] An insurance contract is defined as a "contract under which one party (the **insurer**) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder if a specified future uncertain event (the **insured event**) adversely affects the policyholder." Appendix A of IFRS 4 Insurance Contracts

[9] "Mind the GAAP: Fitch's View on Insurance IFRS" Fitch Ratings, 2004.

[10] The IASB has noted that the timeline may be drawn out even further.

[11] For a summary and analysis of measurement issues raised by the IASB Discussion Paper, refer to "Phase II of IFRS for Insurance Contracts – IASB Discussion Paper" Deloitte Development LLC, August 2007.

[12] The likelihood of the FASB's participation in a joint project is uncertain and will be determined at a future date.

[13] "2008 Global Insurance Industry Outlook: Issues on the horizon" Deloitte Development LLC, publication pending, 2008.

[14] Ibid.

[15] Ibid.

[16] "CONCEPT RELEASE ON ALLOWING U.S. ISSUERS TO PREPARE FINANCIAL STATEMENTS IN ACCORDANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS" Securities and Exchange Commission, August 2007. http://www.sec.gov/rules/concept/2007/33-8831.pdf

[17] "CFOs, controllers and IFRS" Strategic Finance, December 2007.

[18] "Impact of a Fair Value Financial Reporting System on Insurance Companies – A Survey" The GENEVA PAPERS on Risk and Insurance ISSUES AND PRACTICE, Special Issue, 2004.

[19] Post, T. et al. (2007). "Implications of IFRS for the European Insurance Industry – Insights from Capital Market Theory", Working Paper.

[20] This observation is in line with the expectations of trade literature written in anticipation of Phase I of IFRS 4.

[21] "Impact of a Fair Value Financial Reporting System on Insurance Companies – A Survey" The GENEVA PAPERS on Risk and Insurance ISSUES AND PRACTICE, Special Issue, 2004.

[22] Concurrent falling stock prices and increased volatility may have reinforced this trend.

[23] "XBRL: Streamlining credit risk management" *Credit and Financial Management Review,* Second Quarter 2003.

[24] Ibid.

[25] Wemmer, Dieter (2008), "The Securitization of Insurance Liabilities: The View from Zurich", *The Geneva Papers*, 33: 1-6.

[26] "Breathing Lessons: International Financial Reporting Standards" Deloitte LLP

[27] Wemmer, Dieter (2008), "The Securitization of Insurance Liabilities: The View from Zurich", *The Geneva Papers*, 33: 1-6.

[28] "A.M. Best States Position on Insurance-Linked Securitizations/Monetizations" *Business Wire,* April 24, 2006.

[29] Adhikari, A. and Betancourt, L. (2008). "Accounting for Securitizations: A Comparison of SFAS 140 and IASB 39", *Journal of International Financial Management and Accounting,* 19:1.

[30] With the convergence of US GAAP and IFRS standards for business combinations. US GAAP will also move toward requiring the fair valuation of more intangible assets as of 2009.

[31] "IFRS: Barriers to M&A?" Acquisitions Monthly, March 2005.

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