

IAA PAPER
EFFECT OF INSURER'S CREDIT STANDING ON INSURANCE
LIABILITY (IASC Insurance Issues Paper, Sub-Issue 11I)

Sub-issue 11I of the IASC Insurance Issues Paper (the IASC Paper) discusses whether the credit standing of the insurer should affect the measurement of its insurance liabilities. The following summarizes the major arguments (including significant counter-arguments) concerning this issue in a fair value accounting regime. It is being addressed in a number of forums for insurance contracts and other financial instruments. While some of the arguments relate to all financial instruments, others may relate only to instruments such as general purpose debt or insurance (and other regulated) contracts.

Arguments in favor of recognition of credit standing

- 1. The fair value of an obligation that is recorded as a liability should equal the fair value of that obligation held as an asset.** Since the fair value of many financial instruments held as assets reflect the credit risk of the entity at risk, the corresponding credit risk should also be reflected in the measurement of the value of the liability. A counter-argument is that the markets for a number of financial assets and liabilities are different, with credit quality of purchasers not necessarily the same as the original insurer. In addition, although the obligation and therefore the credit risk is not transferred with the sale or exchange of some types of financial instruments, it is not transferred in a sale or exchange of other instruments such as insurance contracts, which results in the credit risk of the current insurer being irrelevant. In fact, the value of the insurance contract held by a contract-owner as an asset does not relate at all to the corresponding liability of that insurance contract as an obligation of an insurer. Lastly, although an asset should be adjusted to reflect credit standing because the probability of receiving payment is affected, a willing buyer will always demand full value to relieve the obligation of any enterprise, potentially impaired or not.
- 2. It is illogical for a general debt instrument to ignore the effect of credit risk** while the fair value of a share directly reflects the financial condition of the issuer. The resulting immediate loss whenever a loan is made, the extent to which would be affected by the degree of credit risk, would not be acceptable. A counter-argument is that insurance should not be viewed in the same way as general debt, due to the lack of a liquid market, to exit price being relatively insensitive to the credit risk of the insurer (because in many cases the obligation is not transferable and because of the public policy nature of the risks involved due to the long-term guarantees involved).
- 3. Reflection of credit standing is the fair value of a liability.** This is evidenced by a lower entry price that an insurer of worse credit standing would have to charge to attract the same amount of business. A counter-argument is that prices for insurance products aren't significantly affected by credit risk, except in extreme cases. In addition, since fair value is exit value the credit standing of the current party obligated is not relevant, since it would be possible to create arbitrage opportunities in the reinsurance market.

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4. **The credit risk adjustment** reflected in the value of liabilities **should absorb part of any material decline in the value of tangible assets or increases in tangible liabilities** that contributes to changes in credit standing to the extent that surplus deteriorates to the point it becomes negative. A counter-argument is that in existence of effective regulation, surplus has to disappear completely before contract-owner benefits are affected.
5. **It is inconsistent not to reflect the effect of insurer credit standing while reflecting it for ceded reinsurance (it is presumed that expected amounts not receivable from ceded reinsurers would not be taken as a credit for such reinsurance)). Both reflect related expected cash flows. The counter-arguments include the fact that the effect on expected cash flows representing a liability is fundamentally different from those representing an asset.**
6. **The credit rating of the party assumed to be the same as that of the party currently obligated to satisfy the liability.** It is assumed that the contract-owners would not permit the exchange (as opposed to reinsurance) if the new insurer had a lower credit quality and that an additional price would be charged if it were transferred to an insurer with a higher credit quality. A counter-argument is that, due to the existence of regulatory constraints or the price sensitivity of the market, no additional price is charged as long as the purchaser has a minimum credit standing, say A. In those cases, credit risk would not be relevant, since no price differential would likely be reflected in the market. Even if the equivalent of a credit-enhancement premium is paid, because of the bundling of options in most insurance contracts, the difference in value of such premium will most likely be indistinguishable from the other risk elements and imperfections in the market. In addition, in most insurance contract sales or exchanges, the contract-owners don't get a chance to approve or disapprove most sales or exchanges of insurance contracts.
7. **Contract-owners bear the credit risk of an insurer.** Since they should expect to pay a lower premium (or be paid a higher crediting rate) for a contract with an insurer with a low credit standing, the value of the liability should be adjusted accordingly. A counter-argument is that contract-owner expectations in a regulated industry are that guaranteed benefits will be paid. Even if a potential contract-owner is credit risk sensitive, this is not relevant since the appropriate measure is exit value rather than entry value. However, since the exit value is the purchaser's entry value, it is the credit risk associated with the regulator (or rather, the guarantee fund if the regulator is expected to allow the original insurer to fail), potential reinsurer or purchaser, who are all likely to be of higher quality at the time of exchange than the original insurer. Any premium for quality would likely be paid out of the original insurer's surplus, rather than as a reduction in benefits payable.

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Arguments against recognition of credit standing

1. **Changes in credit standing will result in confusing and misleading results** in that a company whose credit standing improves will have its liabilities increase in reported value, with resulting losses (correspondingly, if credit standing deteriorates income will improve). A counter-argument is that most likely there is a corresponding offsetting change in the value of its assets or other liabilities. However, to the extent that the change in credit standing is due to changes in intangibles, the misleading result will occur in any case; trying to solve this problem by splitting such a change into its tangible and intangible components would be subjective and arbitrary in the best of cases. In addition, the timing of the different changes may occur in different periods, particularly because of lags in credit standing reporting, and this too will generate misleading results.
2. **Insurance obligations are not like general debt.** The price of debt is related directly to an enterprise's credit standing, while insurance prices (except in the extreme situation, in which case regulators will be involved) are not. Since it is not the debt of the original insurer that is being transferred, a willing buyer will not reflect its own likelihood of fulfilling its obligation. A counter-argument is that even though insurance is a regulated industry, price is often a factor, as evidenced to periodic "flights to quality" or the need for lower rated insurers to offer lower prices in order to increase their sales.
3. **In most cases, settlement cost does not vary with credit standing.** This is partly due to contract-owner expectations of an enterprise within a regulated industry. In other cases, this is true as long as a minimum level of credit standing exists for the buyer, i.e., satisfies certain regulatory criteria.
4. In those cases in which actual assets do not affect the measurement of insurance liabilities, **it is inconsistent to permit those assets to affect the discount rate of liabilities through their impact on credit standing.** Since any change in the value of tangible assets would already have affected the fair value of those assets, any further impact would represent double counting. Reflection of the enterprise's credit risk might be viewed as converting the discount rate to a company-specific rate and be inconsistent with the objective of not having actual assets affect the value of liabilities. To do so would be an indirect approach to have the financial condition of the company affect its liabilities.
5. Although conceptually the measurement of credit standing for a particular liability could be reflected as the value of a credit put, there is a question as to **whether or how to reflect such a put in financial statements.** It would not qualify under the IASC's definition of an asset, since it would not be expected to result in an increase in the resources of the company. Since, as a result of the regulated nature of insurance, the contract-owner claim is generally superior to that of the shareholder, it may be more appropriate to reflect this as an offset to surplus, rather than an offset to

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the insurance liability, at least as long as the entity is a going concern and the value of surplus is positive.

6. Particularly with an increased use of risk-based capital around the world, **it is quite likely that the insurance regulator will step in prior to the insolvency of the insurer to assure that benefits will be paid and protect the public.** This should, in most instances, significantly reduce or even eliminate this risk from the contract-owner's perspective. This could be viewed as a reduction in credit risk as a result of effective regulation, rather than its elimination.
8. **The ethical argument.** Recognition of credit risk can be viewed as being the same as admitting that the insurance benefits may not be paid. In the absence of an efficient market, management would estimate the probability that it will default, putting itself into an exceptionally difficult situation, as well as being difficult to validate. To the extent that credit standing for a particular liability is based on the insurer's judgment, potential moral and ethical dilemmas may arise as management is forced to state the probability that it won't fulfil its obligations, at the same time it advertises and markets its financial strength and the value of its guarantees. One can imagine the scenario at every quarterly measurement that management has to decide how much to reduce their liabilities, somehow based on someone else's assessment, and then communicate to shareholders the assessment of the probability of the future default on its obligations while at the same time justifying to its auditor the level of their credit standing. A counter-argument is that the current zero-one recognition of this risk is not realistic. In addition, ethical arguments are not relevant to accounting measurement, especially in a fair value accounting.
9. **It doesn't make sense to reflect credit standing in the value of the liabilities without also reflecting the impact of credit standing on intangibles,** which isn't possible as long as intangibles aren't valued.
10. **Many users will want to assess the value of the company with her/his own assessment of credit risk** rather than rely on that of the market or a credit rating organization if that were used instead. Thus, the market's adjustment would decrease transparency, rather than increase it, unless disclosure regarding the financial effect of the credit rating on all of the insurer's liabilities (value of the put option) is explicitly disclosed.
11. The IASC Framework has among its assumptions that the enterprise being examined remains a **going concern.** To reflect the possibility that default might occur would be equivalent to recognizing that the enterprise may not remain a going concern. A counter-argument is that the Framework relates to the current condition of the enterprise rather than a probability-weighted scenario that should be reflected in the estimation of the expected value of future cash flows.
12. **Practical difficulties** include:

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- a. It will be **difficult to estimate** (since these liabilities aren't actively traded) since the entity **may have different credit ratings assigned by different rating organizations**, particularly because for the same enterprise credit risk can vary **among obligations** (for reasons such as the duration of expected cash flows and types of obligation). A counter-argument is once the principle is accepted suitable estimates will be developed.
- b. Since the liabilities of an insurer are usually a combination of cash inflows including premiums and cash outflows, **an insurer's credit risk is not applicable to the entire liability**. It could be a significant complexity to apply an assigned credit risk just to the expected outflows, particularly related to the size of any discount involved.
- c. Assuming that the existence of guarantee funds (or regulator forcing a merger with another insurer) will serve as a credit enhancement for an insurance contract at its issuance, this **requires an estimate of the expected effectiveness of applicable guarantee fund's credit enhancement**. This may prove quite difficult to estimate in some jurisdictions. In addition, if a company is exposed to risk in multiple jurisdictions, it may even be difficult to determine which guarantee fund will apply. A counter-argument is that this credit enhancement should be treated as an intangible.
- d. **Market credit rating is not available for all countries around the world.** Whose rating should be relied on? What if rating organizations' ratings are inconsistent? In fact, credit rating may not always be a reliable measure of a company's strength, as it may be influenced by subjective factors used by the particular rating organization. In fact, rating organizations have in the past requested that their ratings not be used for such purposes. In addition, rating organizations' assessments of insurers have in the past generally related to the overall financial condition of the company rather than to a particular liability, which may not be the same.
- e. **If reinsurance is involved** and the reinsurer has a different credit rating than the direct writer, **anomalous values may occur**, particularly because the risk is really shared between these two parties. Depending on the ceded reinsurance contract(s), the effect of the credit standing of any reinsurer might also have to be reflected, depending on the reinsurance contract provisions.
- f. If credit risk as determined by a rating organization, **the lag in recognizing changes in credit risk by rating organizations may result in unavoidably volatile results** due the cause of the change not appearing in the same period as the change. This may result in more confusion than it would eliminate.

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- g. One can speculate **how a shortsighted manager might act, if he or she knew that there would be an immediate boost to the measured value of the enterprise**, to precipitate a ratings downgrade.

Conclusion

With respect to this issue, both practical problems associated with such a provision and conceptual arguments involved are important to consider. Although there are good arguments on both sides of this issue, on balance the IAA believes that it is not appropriate to reflect credit standing in the measurement of the liabilities of insurance contracts. Because it is desirable that similar financial instruments be treated in a consistent manner, the IAA recognizes that this issue should be given careful consideration for all financial instruments.

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