

**Commentary**

**Canada  
Life Insurance**

# Flawed Accounting for Life Insurers

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This commentary is a new edition of the concluding piece in a series of commentaries on substantive flaws in the current Canadian accounting regime for life insurance companies (life, annuity and health business).

Due to the long-term nature of life insurance, accounting for life insurers is necessarily complex. Third parties have difficulty dissecting life insurance accounting due to both its complexity and the insufficiency of disclosures. Unfortunately, an inside look into the Canadian accounting regime for life insurance reveals a substantively flawed accounting model.

Canadian life insurance accounting is flawed because of flaws in the valuation of the policy liabilities (the estimate of the life insurer's liability for its obligations under insurance policies), which dominates a life insurer's accounts (the policy liabilities are upwards of 80% of the balance sheet). The purpose of accounting is to reveal economic position and activity. Flaws in the valuation of the policy liabilities are of such significance that the accounting fails this purpose. The accounting fails because it allows earnings to be substantially manipulated and because exposures are hidden and volatility smoothed away.

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*"... accounting allows earnings to be substantially manipulated ..."*

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Any of the big Canadian life insurers (Manulife Financial Corporation, Sun Life Financial Inc. and Great-West Lifeco Inc.) could choose to manipulate earnings, up or down, in any given quarter by \$1 billion while remaining in full compliance with accounting standards! (I know a good consultant if they need help.) Earnings can be manipulated through both (i) the assumption driven actuarial valuation of assets that is embedded within the policy

liability valuation and (ii) by adjusting exposures to certain risks (mortality risk and interest rate risk; adding or reducing exposure to these risks at *market prices* will decrease or increase earnings). Consider Manulife:

- In 2002, an adjustment to its actuarial valuation of assets (a change in accounting estimate) released \$380 million of Manulife's policy liabilities into earnings (23% of before tax earnings for 2002) to offset a loss from telecom bond write-downs that general accounting principles necessitated (conversely, the banks and Sun Life took earnings hits for these write-downs).
- At year end 2002 Manulife held a pot for interest rate and other risks that was \$2.2 billion, that might in large part be released into earnings by enacting closer matching of assets to liabilities to remove interest rate exposure.
- Manulife had potentially accelerated hundreds of millions into earnings from reinsurance transactions (lack of disclosure prevents isolating the earnings effect of reinsurance activity but the reduction in policy liabilities due to reinsurance was \$3.3 billion at year end 2002, up \$0.9 billion for the year).

These are big numbers. Manulife had earnings in 2002 of \$1.4 billion and book equity at year-end 2002 of \$8.7 billion. Sun Life and Great-West have their own considerations, which may be more or less significant than those of Manulife.

It is not known to what extent any entity has conducted any earnings manipulation within or without accounting standards. The problem for the life insurers is that even if they act within accounting standards, these standards are so loose that they

allow the opportunity to substantially manipulate earnings. The possibility of substantial earnings manipulation causes earnings of life insurers to be suspect in the absence of sufficient disclosure to dispel these suspicions. Disclosures to date haven't dispelled anything.

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*“... possibility of earnings manipulation causes earnings to be suspect ...”*

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If a life insurer decided to use manipulation to boost its earnings growth rate, such earnings would not be sustainable and would eventually collapse (expansion domestically or in foreign markets only makes the pyramid bigger). The potential of accelerated earnings makes it very dangerous to value life insurer stocks using earnings multiples. Earnings acceleration runs full course once the actuarial valuation of assets is wound as tight as possible and the pot for interest rate risk has been released into earnings (by closer asset-liability matching) along with the fat in the valuation of mortality (through reinsurance). Thereafter, earnings will collapse because the normal flow of earnings has dried up (e.g. little asset profits, no mortality profits) and there is no place left to go for some extra juice. After an earnings collapse, a life insurer's balance sheet could significantly misrepresent financial strength since the sources of conservatism (the pot for interest rate risk and the fat in valuation of mortality) are no longer available to offset the overvaluation of the assets.

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*“... potential of accelerated earnings makes it very dangerous to value life insurer stocks using earnings multiples ...”*

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This actuarial valuation of assets that is embedded in the policy liabilities overrides the asset values presented on the balance sheet and causes the assets to be overvalued through a front-ending of a portion of the risk premium on securities that is yet to be earned (the risk premium is the amount that the market yield of a security is in excess of the equivalent treasury bond). This front-ending of risk premium yet to be earned improves the current position to the detriment and risk of future earnings. Assets that support policy liabilities are valued in excess of market consensus, perhaps in the order of

5%. At year-end 2002, 5% of assets supporting policy liabilities was 36% of book equity for Manulife and 32% for Sun Life. Insurers bizarrely present this practice as *conservative* since they haven't front-ended 100% of the risk premium! However, life insurance accounting should not be characterized as being overly aggressive since this overvaluation of the assets (along with other sources of front-ended profits) needs to be weighed against sources of inappropriate conservatism (the pot for interest rate risk and the fat in the valuation of mortality). However, if earnings acceleration reduces the inappropriate conservatism over time then the weighting tips to the side of overly aggressive. Regardless of the appropriateness of the balance sheet, an acceleration of earnings creates a dangerous deception.

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*“... built-in smoothing of earnings is another cause of accounting failure ...”*

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Another cause of the accounting failure is built-in smoothing of earnings (this is in addition to possible manipulative smoothing). Earnings smoothing misrepresents inherent volatility in the business of life insurers. The same culprits that make earnings manipulation possible provide the built-in smoothing of earnings:

- The actuarial valuation of assets is assumption driven rather than market driven (a change in the market value of assets held does not transfer to earnings since the actuarial valuation is assumption driven and these assumptions are typically unresponsive to market movements).
- The pot held for interest rate risk absorbs the effects of adverse interest rate movements (the exposure to interest rate and other risks was capitalized in prior periods and now provides earnings stability and a source of extra profits).
- The fat in the valuation of mortality keeps moderate adverse mortality experience from damaging earnings (the exposure to adverse mortality was also capitalized in prior periods and also now provides earnings stability and source of extra profits; this provision has recently been accelerated into earnings by increased use of reinsurance and is becoming a smaller consideration but is important in assessing the sustainability of prior earnings).

The bulk of the accounting problems could be fixed by eliminating: (i) actuaries valuing assets, (ii) having a pot held for interest rate risk and (iii) putting fat in the

valuation of mortality. These fixes would be achieved by having the accounting reflect market consensus for (i) asset values, (ii) interest rate and other risks and (iii) mortality rates. By eliminating these pliable aspects of the policy liability valuation, the ability to manipulate earnings (within accounting standards) would no longer exist and the mechanisms that smooth earnings would be no more. The result would provide relief from suspicion of earnings manipulation and would accurately convey the volatilities that are inherent in the business of life insurers. If the accounting isn't fixed then as a poor second, improved disclosure would allow non-recurring earnings to be identified thus making earnings manipulation more transparent, but nothing would be done for the smoothing. Satisfactory disclosure requires detailed information on the actuarial valuation of assets, the size of the pot held for interest rate risk (Manulife disclosed its pot as being \$2.2 billion for year-end 2002) and details and valuation of all reinsurance transactions.

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*“... eliminate pliable aspects of policy valuation to remove ability to manipulate earnings and built in smoothing ...”*

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The accounting profession is responsible for the current state of affairs as it sets accounting standards. The accounting profession has through complacency and ignorance made itself remote to life insurance accounting matters by deferring the details and the underlying principles for the valuation of the policy liabilities to the actuarial profession. There is little

dissent from the status quo within this beholden actuarial profession. If the actuarial profession continues to be dominant in life insurance accounting, the status quo will perpetuate. Reform will not occur without outside pressure (the accounting profession doesn't have the subject on its radar screen; the life insurance industry will obviously leave well enough alone). As for the gate-keepers, the federal regulator has its own actuaries who tow the professional line (keeping it all within the actuarial black-box) and this is hardly a hot-button item for security regulators; these bureaucracies aren't the proactive kind, it might take a major crisis or blow-up for them to move.

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*“... reform will not occur without outside pressure ...”*

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This leaves the proactive role to investors and their proxies. Investors have yet to show distain for life insurers. Life insurer stocks trade at earnings multiples in the same neighbourhood as those of the banks. This premium valuation is undeserved as banks have simpler and more transparent accounting (though by no means flawless). Change in accounting or sufficient disclosure is unlikely until investors refuse to accept flawed, opaque accounting by valuing life insurers at a significant discount to banks.

Of course, if you believe that it is low and petty to think that insurance executives would use flaws in accounting for advantage, the suggestion of accounting reform must appear contemptible. If so, the markets are open, BUY! □

## Hidden Leverage

Canadian life insurance accounting also suffers from a disclosure flaw since it hides exposures by forcing material assets to be netted within the policy liabilities. This accounting treatment is unusual. This flaw causes the balance sheets of life insurers to be artificially reduced, giving an under representation of leverage and risk. The biggest two assets that are netted within the policy liabilities are the behavioural inefficiency asset and reinsurance treaties. These items have little in common, each is described in turn.

The behavioural inefficiency asset (the “BIA”) is a soft asset. The BIA represents the reliance by the insurer on inefficient policyholder behaviour in the exercise of cash value options. The cash value option is a right of the policyholder to terminate its policy for a set amount of cash. The BIA arises from policyholders being assumed to terminate their policies when it is to their disadvantage to do so, or else continuing them when it is to their disadvantage to do so. Life insurers do not disclose the size of their BIA (likely don't even calculate it), however, they are required to calculate and report reserve deficiencies for regulatory filings; reserve deficiencies can be used to estimate the portion of the BIA that is attributable to inefficient continuation and as such are a floor for the BIA. The reserve deficiency of a particular policy is the amount that the liability held by the insurer for that policy is less than the cash value of that policy. For example, where a policy has a cash value of \$10,000 but the insurer only holds a liability of \$2,000 there is a reserve deficiency of \$8,000. The insurer justifies holding only \$2,000 because it anticipates earning future margins on this policy should it be

continued. The BIA is substantially larger than the reserve deficiency due to assumed inefficient termination, i.e. there are also assumed to be terminations when the cash value is less than the liability held (a.k.a. lapse support).

The existence of the BIA may appear unseemly (how can the liability only be \$2,000 when cash of \$10,000 could be demanded?), yet it does have accounting legitimacy when used to avoid earnings distortions. For example, if \$8,000 of commissions or other costs were incurred to acquire the policy then up to \$8,000 of BIA would be legitimate while these costs remain to be recovered. The problem with life insurance accounting is that a liability of \$2,000 is reported rather than the full \$10,000 obligation offset by a soft BIA of \$8,000 on the asset side of the balance sheet. This netting of the BIA within the policy liabilities hides the true liability (e.g. \$10,000) and hides the soft asset (e.g. \$8,000).

Another problem with the accounting is that the BIA is not limited to the acquisition costs that remain to be recovered. This allows profits to be front-ended, which is contrary to general accounting principles (e.g. acquisition cost of \$5,000 with \$8,000 BIA would create \$3,000 of front-end profit even though the entire \$8,000 BIA remains at risk).

The other big asset netting is from reinsurance treaties. Reinsurance treaties allow transfer of insurance risk from an insurer to its reinsurer while the insurer remains liable to its policyholders. Rather than showing the full liability of the insurer with the promise of the reinsurer as an asset of the insurer on the other side of the balance sheet, accounting practice nets the reinsurance asset against the policy liabilities. For example, \$10 billion of policy liabilities with a reinsurance treaty ceding \$1 billion results in \$9 billion of policy liabilities rather than keeping the \$10 billion as the liability and showing a \$1 billion reinsurance asset. This practice hides the credit risk that arises from reinsurance (e.g. the \$1 billion I.O.U. from the reinsurer). Disclosure practices net all reinsurance treaties (those that are assets against those that are liabilities) and thus only provide a floor for the amount of reinsurance leverage in place. Netting reinsurance treaties amongst themselves, with the result then netted against the policy liabilities doubly cloaks real on-balance sheet exposures. This practice of netting reinsurance should be discontinued in order that the balance sheet full can be made full.

Reinsurance also provides regulatory capital relief to insurers. There is no disclosure by insurers of the amount of capital relief that has been provided by reinsurers. If a reinsurer became insolvent then these capital requirements come back on the insurer. These are off-balance sheet exposures that deserve to be reported.

Floors for these sources of hidden leverage are high. At year-end 2002 Great-West had at least \$5.2 billion, Manulife \$6.2 billion and Sun Life \$3.7 billion. With floors so high, do insurers have a roof over their heads? Insurers might have hard assets, but their liabilities are soft. □

Floors for Hidden Leverage ( December 31, 2002 )		
	Reserve Deficiencies (billions)	Net Reinsurance Asset (billions)
Canada Life Financial <sup>1</sup>	\$1.709	\$1.431
Great-West Lifeco	\$0.673 <sup>2</sup>	\$1.379
Manulife Financial	\$2.897	\$3.306
Sun Life Financial	\$1.916	\$1.805
1 Canada Life was acquired by Great-West Lifeco in 2003		
2 Great-West Lifeco reserve deficiencies exclude U.S. operations		