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Amendment proposal ED5

Dear Sir/Madam,

We would like to propose the following:

The insurance industry sees a major problem in adopting a full fair value approach for the insurers' liabilities while they use market values for the assets fixed on certain dates. This leads to volatile earnings, which actually could increase the risk of bankruptcy and hinder insurance companies from investing in stocks which might reduce policyholders' and shareholders' returns.

This problem is mainly due to short-term and ever changing mix of valuation elements, which influence the prices on the stock or bond markets given a particular situation. This "real term" valuation is not always done on fundamental grounds but very often influenced by psychological elements. A fair value approach on the liability side on the other hand has to be done on rational fundamental grounds, which are less volatile and more long-term.

We therefore suggest that the IASB sticks to the full fair value approach for Phase II, but that it adopts a fair value approach for the asset side of the balance sheet as well. This should be done on the ground of scientific methodologies, such as CAPM or Security Market Line models or even stochastic modeling. In this case both asset and liability sides would be valued on the same grounds by eliminating especially psychological elements.

...

WestLB

This would reduce earnings volatility without reducing the effort of the IASB to give insurance accounting more transparency. The gap between the fair value and the market value of the investment portfolio should be published in the notes.

Yours sincerely,

WestLB AG
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Enclosure

WestLB Research

Pan European Equity

Financials
Insurance

Europe

European insurers

April 2002

IAS: Insurers will become cyclicals

The planned IAS accounting change in 2005 towards fair value accounting will increase the capital costs of insurance companies and lead to discounts to the fair values of at least 15%, since the results will become virtually unpredictable. The industry's added value in Europe will thus be reduced by €1,927.8m or 21.4% a year. However, we are optimistic that resistance to this change is growing. We are also against an inclusion of the change in fair value in the income statement.

- **The Enron trap.** Like the stricken energy trading company Enron, insurance companies will have the possibility to fully book anticipated profits from a multi-year contract when just signing it. Published earnings will therefore result from an interplay of various internal company analyses which offer little transparency to outsiders.

- **The planned "revolution"** away from a main consideration of incoming and outgoing payments towards recognising new business and the change in expectations does take account of risk control, since assets must match liabilities in their duration. However, the results will become unforeseeable and make a value-oriented control nearly impossible, since a company will practically only be measured by expectations, which will depend largely on the interest rate and capital market development.

- **We describe the current state of planning below**, and the probable consequences for insurance companies and insurance stocks. After 2005, the presentation of the earnings position under commercial law will be totally different. In our view, the cash flow statements will gain in importance. Equity will be subject to even more considerable fluctuations according to the new IAS.

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Insurers will become cyclicals

A uniform accounting system facilitates the comparison of international insurers. For this reason it is planned that the International Accounting Standard (IAS) will replace national standards in Europe in 2005. The result of certain elements of the accounting changes currently under discussion would be an enormous rise in earnings volatility with subjective valuation criteria above all on the liabilities side leading to unacceptable discretionary leeway and fluctuations. Insurance stocks would no longer be stable investments, but rather cyclicals, since financial market fluctuations will be reflected in the balance sheet and in the income statement.

The need for the accounting standard

In the last five years, the International Accounting Standards Committee (IASC) has developed an accounting standard for the insurance industry. At present, there is no special accounting standard for insurance contracts. Insurance companies are also mentioned in IAS 1, IAS 7, IAS 8, IAS 14, IAS 18, IAS 19, IAS 32, IAS 37, IAS 38 and IAS 39. However, the provisions in question normally do not apply to insurance companies.

Major differences in reported earnings

In practice, there are major differences in the way insurers report their results. In particular under US GAAP the risks and guarantees assumed under insurance contracts are reported according to a deferral matching approach (accrual basis of allocation of income and expenditure).

Accrual basis of accounting

In contrast, the IASC committee has drawn up a statement of principles based on the principle of the accrual basis of accounting. In particular, the IASC wants to ensure that "the effects of transactions and other events are reported at the time of their occurrence (and not at the date of receipt or payment of the corresponding monetary or other benefits) and are reported in the financial reports for the periods to which they relate". The deferral matching method used by many insurance groups does not meet this requirement. In the case of deferral matching, expenses are allocated to the corresponding income in terms of time. The actual sequence of the cash flow is displaced by the analogous one.

Recognition of cash flow in the year of acquisition

However, the current approaches regarding a fair value valuation go further: insurance contracts should be fully recognised in the year of acquisition, i.e. all expected future cash flows (regular premiums, expected benefits) are recognised at the time of the conclusion of the contract. The actual cash flows are only recorded in a cash flow statement and in the profit and loss account only deviations from the expectation (delta) are recognised for existing contracts.

The IASC's Draft Statement of Principles - DSOP - currently contains 43 principles. There are many varied ways of implementing them at national level. Important principles of this draft statement are:

Principle

1. Insurance liabilities (both generally and in life insurance) have to be discounted and valued on the basis of current estimates of the future cash flows arising from the current contract.
2. Reserves for catastrophes and claims equalisation reserves do not represent liabilities according to the IASC draft statement.
3. Acquisition costs may not be shifted to the future as asset items.
4. Assets and liabilities of insurance companies should always reflect the total risk.
5. Market assumptions should be in line with current market prices.

The introduction of the accounting standards will radically change the balance sheets of the insurance companies. The chapter on presentation has not yet been published. However, the summary of the DSOP project indicates that the following principles will probably be included.

All changes in insurance liabilities are to be recognised as and when they arise.

The income statement will include the following parts:

1. Net profit or loss on the issuance of insurance contracts, which represents the net present value of premiums, claims and expenditure in order to properly reflect the risk.
2. The "interest" on the insurance liabilities.
3. Differences between actual experience (claims experience) and earlier assumptions.
4. Changes to the assumptions.
5. The cash flow statement is presented on a direct basis and shows the premiums received, the payments made to settle claims, the costs paid, etc.
6. The notes to annual reports will contain, inter alia, the following points: statutory capital adequacy, solvency margins, important performance indicators (e.g. retention/expiry rates), information on risk adjustments and sensitivity (e.g. in Germany risk reporting in accordance with DRS 5-20).

Disclosure according to the principle of profits earned

The disclosures are similar to those of the UK life insurers which report on the basis of achieved profit accounting. However, there is a fundamental difference between achieved profit accounting and the reporting proposed under the DSOP. Both methods are discount methods (discounted cash flow - DCF). However, the achieved profit accounting approach only uses an internal basis to project cash flows. In contrast, DSOP explicitly uses market value margins, option prices and stochastic modelling, where it is possible.

Still leeway for valuations

Theoretically, both approaches should lead to largely similar results overall. The cash flows will be identical over the term of the contract. The difference between the two methods is that DSOP offers still leeway for entity valuations.

However, for insurers in continental Europe the proposed accounting alteration represents a paradigm change. The recognition of assumptions has tended to be the exception and in the past changes in market values have had little influence on the income statement.

We have set out the differences between German and the proposed IAS accounting in the following table:

Differences between German and planned IAS accounting

	IAS / Fair Value		HGB	
	Year of acquisition n	**Following years n+...**	**Year of acquisition n**	**Following years n+...**
New business	Acquisition costs +all discounted Premiums +all expected, discounted claims	Difference (delta) to expectation	Acquisition costs + premiums 1st year (generally no claims)	Premiums 2nd year etc. + claims
Existing portfolio	Difference (delta) on expectation (existing portfolio)	Delta on expectation (existing portfolio), Change in discount rate	Premiums 2nd year etc. (existing portfolio) +claims	Premiums 2nd year etc. (existing portfolio) +claims
Difference	- New business recognised in full immediately - Only the delta is booked in the existing portfolio.		- New business only recognised in 1st year - Existing portfolio is regularly updated - Current claims are recognised	
Risk	-Expectation incorrect -> P+L 'incorrect' in first year (poor underwriting) -Loss of transparency		-Expectation incorrect -> P+L 'incorrect' for following years (poor underwriting) Already only partially transparent	
Underwriting assumptions	Premium development Claims development		Claims development	

Four scenarios can be described on the basis on an example:

Scenario 1: There are current premiums of 100 and benefits of 98. The expectations on conclusion of new business were too optimistic by a figure of 2 in the year before. The internally determined value of the new business concluded in the current year is 3. Under IAS/fair value, a net profit of 1 will be reported as against 2 under German commercial law (HGB).

Scenario 2: There are current premiums of 100 against benefits of 102. The expectations on conclusion of new business were too pessimistic by a figure of 2 in the previous year. The internally determined value of the new business concluded in the current year is 3. Under IAS/fair value, a net profit of 5 will be reported as against -2 under German commercial law.

Scenario 3: There are current premiums of 100 against benefits of 98. The expectations on conclusion of new business were too pessimistic by a figure of 2 in the previous year. The internally determined value of the new business concluded in the current year is 3. Under IAS/fair value, a net profit of 5 will be reported as against 2 under German commercial law.

Scenario 4: There are current premiums of 100 against benefits of 102. The expectations on conclusion of new business were too pessimistic by a figure of 2 in the previous year. The internally determined value of the new business concluded in the current year is 3. Under IAS/fair value, a net profit of 1 will be reported as against -2 under German commercial law.

Examples of differences IAS fair value/German commercial law (HGB)

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Premium	100	100	100	100
Benefits	98	102	98	102
Delta on expectation	-2	2	2	-2
Fair value new business	3	3	3	3
Reported profit IAS fair value	1	5	5	1
Reported profit HGB	2	-2	2	-2

Source WestLB Panmure

This example illustrates that the reported profit under future IAS will no longer bear any relation to the results under German commercial law.

The IASC timetable

By 2003 implementation of the EU directive into national law

From 2005, accounting in accordance with the International Accounting Standards (IAS) will become binding for all listed companies (including listed insurance companies). The EU Fair Value Directive must be implemented into national law by 2003. For example, the German Standardisation Council (DSR) has published the proposal on the implementation into the German Commercial Code on the internet pages of the German Accounting Standards Committee (DRSC).

1997	IASC begins the project on accounting for insurers.
December 1999	IASC publishes a discussion paper (Issues Paper).
June 2001-2002	Draft Statement of Principles (DSOP) is published (gradually chapter by chapter).
November 2001	IAS-Board begins to discuss the DSOP.
2002	IASB carries out field tests.
4Q 2002E	Exposure Draft.
2003E	Adoption of the final IAS version.
2004E	Companies prepare for implementation.
2005E	IAS for insurance contracts is implemented.

Source IASC, WestLB Panmure

Problems for the insurers

Concerns about volatility

Companies which are required to change their accounting will not only consider the DSOP to be difficult technically. They will also be concerned about the volatility which these accounting standards will probably bring both into the balance sheet and p+l.

Easing of competitive pressure will make it possible to lift margins

In our view, the new accounting standard will present smaller insurance companies with problems. The larger groups should be able to master the problems. Competitive pressures, which remain strong, will ease somewhat and enable margins to be raised. Accounting according to the fair value principle should uncover weak balance sheets and unprofitable insurance risks. However, the internal valuation of the current value of insurance contracts raises certain problems.

More transparency for investors

Distinction between results from new business and existing contracts

Investors hope that the accounting will give them an insight into the commercial reality. If properly applied, the new method should make it possible to determine where added value occurs. Balance sheets will no longer include assets which are without value for third parties (e.g. acquisition costs set aside). In the income statements, a distinction will be made between the expected profit from new contracts and the "interest" on existing contracts. The management must not only tell their shareholders how they manage the existing business, but must also show how they intend to conclude new contracts at profitable premiums. On the other hand, since changes in the expectations regarding existing contracts are recognised later, a loss of transparency must be feared.

Improved disclosure of cash flow

The new accounting standard promises an improvement in cash flow disclosure. This should enable analysts to assess insurance companies' ability to enhance shareholder value.

Increase in capital costs

From a valuation point of view, the planned standard will lead to higher earnings volatility. As a result, capital costs will rise. This in turn will bring about a reduction in valuations on the equity market. However, the accounting standard will not change the underlying cash flow.

Our expectations:

1. Changes in the way insurance contracts are accounted for will be delayed because of the expected changeover problems.
2. The standard will fundamentally alter the presentation of the insurers' results.
3. The details previously shown in the income statement will disappear (premiums, costs, benefits).
4. The NAV of the balance sheet is likely to increase for the following reasons:
    - Assets are carried at fair value.
    - Liabilities are discounted.
    - The only exceptions are cases with very high latent acquisition costs such life- or health-insurance.
    - The major, well capitalised insurers will master the changeover better than their competitors.

The accounting changes will have no impact on the core recommendations of WestLB Panmure. Our top picks are without exception highly capitalised groups with well diversified business segments.

Effects on valuation

We favour a fair value approach in the notes

While a uniform accounting standard improves comparability, the increased earnings volatility will result in lower stock prices. In the following section, we want to show that we favour a fair value approach, which should however be taken into account only in the notes, and not in the profit and loss account.

P/E no basis for comparison in the past

P/E comparison

	CDAX Insurance	US Insurance	EU Insurance
1992	41.8	12.4	29.2
1993	56.7	19.2	27.7
1994	40.1	15.4	20.9
1995	33.9	16.0	18.0
1996	32.6	15.9	17.6
1997	38.0	18.2	20.6
1998	40.7	19.4	25.1
1999	32.5	19.5	22.7
2000	34.1	27.1	24.4
2001	23.1	25.5	19.0
20.03.02	18.2	34.8	16.2

Source Datastream, WestLB Panmure

Price-earnings ratios are not a suitable basis for comparing valuations of insurance companies, since national accounting standards differ too much. The above table shows the historical difference between German, US and European insurers.

Difficulty of checking embedded value

Anglo-Saxon analysts have been largely responsible for the fact that continental European insurers increasingly disclose a UK-style embedded value. However, this is based on at least six hypotheses (see below), which external readers of accounts can check only with difficulty.

This leads to enormous differences in valuation. As a rule, the assumptions of the actuarial calculation are not published in detail. This makes it much more difficult for outsiders to evaluate a company's own actuarial calculation.

Comparison price/embedded values (August 2001)

	Reuters Symbol	Price/EV (EV=NAV+In Force Value)
Hannover Rück	HNRGn.DE	1.38
Swiss Re	RUKZn.VX	1.71
SCOR	SCOR.OL	0.88
Allianz	ALVG.DE	1.34
AXA	AXAF.PA	1.54
Aegon	AEGN.AS	1.62

Source companies, WestLB Panmure

"Wishful thinking" on the part of insurers raises embedded value

Analysts generally apply a factor with which they multiply the new business margins to determine a fair enterprise value. Under certain circumstances, the temptation may well arise to "enhance" the picture for the analysts. A company reports renewable contracts such as group insurance as new business every year. Any losses are allocated to the past business. The only matter of interest are the new business margins.

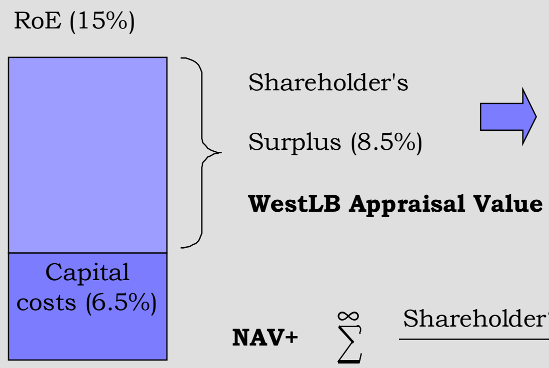
Goal: make hypotheses understandable

Determining value added plus own funds

To lower the number of hypotheses and above all to make them comprehensible, WestLB Panmure developed its own valuation model in 1999 - the West Appraisal Value Model - which determines the fair value of an insurance enterprise on the basis of its value added plus its own funds measured at market value.

RoE and long-term growth assumptions are the determining factors

WestLB Appraisal Value Model



WestLB Appraisal Value =

$$\textbf{NAV+} \sum_{i=1}^{\infty} \frac{\text{Shareholder's Surplus}_i * \text{Book Value}}{(1+\text{CoE})^i}$$

Source WestLB Panmure

This method is based on the fact that a company earns a higher RoE than its capital costs in the long term. The capital costs are computed by means of our security market line, which is based on the CAPM. The hypotheses are mainly restricted to the discount rate, which in turn is determined by means of three risk classes (prediction risk, financial risk and market liquidity). Long-term growth assumptions for life and non-life business are included as a second hypothesis. We derive the RoE and NAV from our estimates for the p+l. The hypotheses can thus be clearly understood and investors may even change these.

Comparability despite different accounting standards

This makes it easier to compare insurance stocks despite the various accounting standards in Europe. Of course, we would also welcome a uniform standard to obtain a correct picture of the return on equity.

Companies themselves should determine fair values for assets and liabilities

Fair values on the assets and liabilities side

According to the proposals of the International Accounting Standard Committee (IASC), insurance companies worldwide should move to a fair value accounting system from the very start. This means that the companies themselves and not the analysts should determine fair values for the assets (i.e. investments) and also liabilities (i.e. technical reserves). The aim is that an undercover or financial distress can be detected at an early stage - in other words the assets should match the liabilities. This is the basic principle of asset-liability management. Each year, a revaluation must be made and the liabilities must be adjusted to the assets by means of an inflow or outflow of profits. As a result, earnings volatility increases, since even a change in interest rates leads to considerable fluctuations.

Goal: introduction of an asset-liability approach

The desire for an effective asset-liability approach plays a major role in these proposals. We fully support this. In view of the advances in medicine, the consideration above all of the mortality and longevity effects which are then also carried forward into the future, transparency appear especially important to us. Nevertheless, an internal valuation remains "controllable" since an outsider is unable to check the assumptions of the technical risks in particular. In our view, an external valuation by the capital markets can however convey a completely different picture.

The hypotheses required are just as numerous as for the computation of the embedded value.

The most important hypotheses for the assets side:

- Return assumptions for the various asset classes
- Loan defaults
- Market values of the liquid assets

The most important hypotheses for the liabilities side:

- Interest assumption (technical reserves are discounted)
- Cancellation probability
- Mortality/longevity effects

The following case is an example of distorted assumptions which are difficult to detect. In conjunction with the weak equity markets and falling interest rates, the capital market returns have fallen under the surplus participation formerly promised in capital-sum life insurance contracts. Hannoversche Leben for example bought so-called step-down bonds in 2001 for €600m. In the first year, 12% interest is payable on these bonds; thereafter the rate falls to 4.5%. In our opinion, trust in rising investment returns represents a risk for the policyholders, while consumer magazines such as Finanztest emphasise such behaviour in particular as being positive. It should be clear that no match with the technical risks that are underwritten can be obtained here.

The 1990s present a false picture

The 1990s presented an incorrect picture of the insurance business. The investment income above all from the equity holdings made it unnecessary to match the durations, i.e. maturities, with the written risks. Generally, hidden reserves were seen as a buffer for unforeseen events.

Performance DAX (equity index), Stoxx 50 and Rex at 31.12. each year

	1994	1995	1996	1997	1998	1999	2000	2001	05.04.02	CAGR (%) since 1987	CAGR (%) 1997-2000
DAX	1,774.95	1,857.29	2,334.95	3,393.21	3,933.96	5,409.33	4,934.85	3,887.48	3,952.36		
Change (%)		4.6	25.7	45.3	15.9	37.5	-8.8	-21.2	1.7	3.89	4.64
Stoxx 50				2,862	3,352	4,806	4,767	3,706.93	3,623.60		
Change (%)					17.1	43.4	-0.8	-22.2	-2.2	6.08	9.01
Rex Bond Index	99.90	109.18	110.37	111.14	118.15	110.71	112.35	113.13	117.49		
Change (%)			1.1	0.7	6.3	-6.3	1.5	0.7	-3.9	1.40	0.59
Equity allocations of life insurers (%)	12.70	12.80	14.30	17.50	20.80	23.50	26.40	25	25		
Index hidden reserves equities Germany (1995=100)		100	115.7	166.8	188.1	249.8	205.4	135.5	134.2		
Index hidden reserves equities Europe (1997=100)				100.0	117.1	166.2	154.9	106.7	103.7		
Index hidden reserves fixed-income (1995=100)		100	99.1	99.8	106.1	99.4	100.9	101.6	105.4		
Index hidden reserves Reserves total (1995=100)		**100**	**101.4**	**111.5**	**115.8**	**124.9**	**121.8**	**106.5**	**108.8**		
Assumed degrees of realisation equities (%)			8	8	8	10	15	25	10		
Assumed degree of realisation fixed-income %			2	2	2	0	2	2	2		

Source WestLB Panmure

60% of hidden reserves melt away in 2001

However, this business model is passé after the equity markets crisis in 2001. 60% of the hidden reserves which had been built up since the liberalization of the insurance markets in 1994 have disappeared compared to 2000, as the above table shows. In our view, an asset-liability approach which practically passes on risks associated with changes in interest rates to the policyholders - because the securities are held to maturity - is the only model with which both life and non-life business can be profitably written for shareholders.

Investments in sectors which benefit from higher life expectancy

It is not enough merely to distribute unit-linked life policies. As a result of the pension problem, the longevity risks in particular will have to be covered in the future. Insurers cannot achieve this by leaving the asset allocation decision to the customers. In our opinion, the insurance companies will only be able to counter longevity effects by investing more aggressively or more defensively in accordance with medical progress - and above all in sectors which will benefit from a rise in life expectancy (e.g. life sciences, consumer stocks for older people, tourism stocks, etc.).

Fair value: a task for the auditor or for the analyst?

We feel that the IASC has gone too far. We have the impression that reporting and value control hae been squeezed into a corset which does not necessarily fit. According to the proposals of the IASC, the fair values of the assets have to be compared with those of the liabilities at the end of each reporting period. If there are more assets than liabilities - for example because equities have performed well - a profit is reported in the income statement.

If there are more liabilities than assets, a loss will be shown. However, it will be difficult even for auditors to verify an actuarial calculation of the value of the current policy portfolio for example.

Analysts will no longer be able to estimate earnings

Of course, this will result in a matching of assets and liabilities - and this is also desirable. However, the more subjective hypotheses on the liabilities side mean that analysts will no longer be able to estimate earnings, which management will still be able to control. In addition, the risk of bankruptcy -and thus the risks for the policyholders - will rise.

Let us assume that the equity markets fall although interest rates remain relatively stable - as happened in 2001. The technical reserves remain unchanged. Depending on the portfolio structure, the losses in the equity portfolio may exceed the gains in the bond portfolio. An insurer could be forced to report a loss which nearly exceeds the equity.

Simplified balance sheet of an insurance company

Assets	Liabilities
Investments 2020, of which	Equity 120
equities 606, bonds 1201, real estate 202	Retained net profit 12.6
Cash 12.6	Technical reserves 1900
Total assets 2,032.6	Total liabilities 2032.6

Source WestLB Panmure

In this simplified balance sheet we assume an estimated equity ratio of 6.5% in accordance with the average in Germany (including valuation reserves) and a 15%

RoE in respect of operating business (rather optimistic), of which 30% will be distributed as dividends. Let us take the developments in 2001 when the DAX lost 21.2% excluding dividends and the 10-year Bund gained 0.7%. We assume that real estate remains unchanged and we disregard the interest rate development (4.942% vs. 4.872 at the end of 2000. In such a case, the investments would have resulted in the following value adjustments:

Insurer's assets

Asset Class	€
Equities	-128.5
Bonds	+8.4
Real estate	0
Total value adjustments	**-120.1**

Source WestLB Panmure

With value adjustments of -120.1, the equity would be used up without the gain just made. The insurance company would have to file for insolvency. As a consequence, it is highly likely that, if the new IAS standard were already in force today, many German insurers would have had to file for bankruptcy even though they have still been able to show sufficient liquidity. The cannot be the aim of the change in the accounting standard, since it jeopardises continuity in the insurance industry. This would be an incalculable risk for investors.

Such a case actually happened in Australia with the Australian company HIH. After interest rates rose strongly, the company ran into financial difficulties, since its equity was used up. It was then acquired by Allianz.

Financial analysts will hardly be able to forecast

From hedge to cyclicle

The foreseeable inability of financial analysts to make earnings forecasts will be reflected concretely in an increase in capital costs. In the past, insurance stocks have been a hedge against cyclical stocks from the engineering, technology, automobile and other sectors. The proposed accounting changes will subject the profit and loss accounts of insurers to market cyclicality with the consequence that insurance stocks will no longer be a hedge, but on the contrary, as a result of the subjective hypotheses, will even be considered more volatile. In addition to the business development, the full market volatility would be reflected in the profit and loss account. This will result in lower stock prices - if the new standard is adopted. This does not only affect insurance companies, but also other sectors, such as banks and utilities, where also common standards are currently discussed.

Fair valuation drops by at least 12 %

It is difficult to estimate how high the valuation discount will be. However, we believe that the assumed betas will worsen in the financing note and in the prediction risk. On the assumption under our valuation model, this would be 23 basis points on average. The average fair valuation level of insurance companies in Europe would thus fall by at least 15%, since our model does not work with multiples and the beta has a non-linear influence. However, we estimate the possible discount through multiples at 10-20%. This figure hardly shocks in view of the huge volatilities in the past. Nevertheless, in the case of Allianz this increase in capital costs represents a loss of added value for the shareholders of €240m a year or 37% less than without the accounting change.

Value added development from changeover to IAS

	Reuters Symbol	Price*	Value added 2003	Value added	Δabs	Δ%
Aegon	AEGN.AS	€28.45	1,311.755	1,458.106	-146.35	-10.04
AGF	AGFP.PA	€56.40	176.0094	233.9266	-57.9172	-24.76
AMB	AMBG.DE	€116.50	83.80404	111.5464	-27.7423	-24.87
Alleanza	ALZI.MI	€10.90	305.3205	327.2776	-21.9571	-6.71
Allianz	ALVG.DE	€272.55	408.9353	649.28	-240.345	-37.02
AWD	AWDG.DE	€30.80	18.6846	19.82471	-1.14011	-5.75
AXA	AXAF.PA	€25.26	-263.687	-48.8971	-214.789	439.27
AXA-Konzern	COLG.DE	€77.00	56.20791	67.72193	-11.514	-17.00
CGNU	CGNU.L	GBP7.73	1216.225	1342.594	-126.37	-9.41
CNP	CNP.PA	€39.49	158.0355	201.4964	-43.4609	-21.57
COFACE	CFAS.PA	€60.60	0.90946	5.974332	-5.06487	-84.78
DBV-Winterthur	DBVG.DE	€38.50	0.356721	7.866126	-7.5094	-95.47
Euler	ELE.PA	€43.50	22.78418	30.1003	-7.31612	-24.31
Generali	GASI.MI	€27.99	1166.891	1282.904	-116.013	-9.04
Hanover Re	HNRG.DE	€81.30	46.68815	50.15393	-3.46578	-6.91
Friends Providence	FP.L	GBP1.87	165.9399	272.2753	-106.335	-39.05
L & G	LGEN.L	€1.62	236.1995	283.4057	-47.2062	-16.66
Mannheimer	MAVG.DE	€51.53	3.673031	5.2743	-1.60127	-3.04
Mapfre	MAP.MC	€7.62	-13.459	-4.10947	-9.34955	227.51
Mediolanum	MED.MI	€9.99	100.8003	105.9899	-5.18961	-4.90
MLP	MLPG_p.DE	€74.60	85.38126	88.03452	-2.65327	-30.14
Munich Re	MUVGn.DE	€287.90	265.2571	447.1585	-181.901	-40.68
Nürnberger	NLVGn.DE	€104.00	0.371615	7.576044	-7.20443	-95.10
Pohjola	POHBS.HE	€20.25	-10.4684	-8.15789	-2.31048	283.22
Prudential	PRU.L	GBP7.38	751.849	812.0054	-60.1564	-7.41
RAS	RASI.MI	€14.46	141.0781	178.8967	-37.8186	-2.11
Royal Sun Alliance	RSA.L	GBP3.22	-99.613	-36.5837	-63.0293	172.29
Sampo	SAMAS.HE	€8.92	87.0312	112.9606	-25.9294	-22.95
SCOR	SCOR.PA	€38.30	40.35211	50.64148	-10.2894	-20.32
Skandia	SDIA.ST	SEK51.00	40.157	61.19086	-21.0339	-34.37
Storebrand	STB.OL	NOK51.00	-29.7369	-8.89327	-20.8436	234.38
Swiss Life	RAn.VX	CHF587.00	-90.2447	-51.6793	-38.5654	74.62
Swiss Re	RUKZn.VX	CHF167.00	824.6564	975.8675	-151.211	-15.50
tecis	TESG.DE	€27.50	5.609372	5.882936	-0.27356	-4.65
Topdanmark	TOPC.CO	DK228.64	14.75778	20.61035	-5.85257	-28.40
W & W	WUWGn.DE	€17.00	-114.104	-93.1442	-20.96	22.50
ZFS	ZURZn.VX	CHF402.50	-32.8069	44.30257	-77.1095	-174.05
Σ			**7,081.6**	**9,009.38**	**-1,927.78**	**-21.40**

* all prices are from April 18, 2002 **Source** WestLB Panmure

Further changes lead to earnings volatility

Acquisition costs not to be passed on to customers in the future

In the future, it is intended that acquisition cost for new business will affect the profit immediately. Capitalising or "zillmering" - in the past the acquisition costs for traditional contracts have been passed on directly to the customer after conclusion of the contract - are no longer desired. This means, first, that existing commission arrangements will have to be renegotiated and, second, a company can only write new business to a limited extent in boom phases, since otherwise too high a loss would be a burden on the equity. As a consequence, a large "supply" of equity is required, which in turn is bad for the return on equity. The motivation to manipulate fair value is already beginning to be created here. In addition, companies such as mutual insurance associations which have difficulty accessing the capital markets will be disadvantaged.

Company comparisons based on premium income and sales will become less meaningful

Furthermore, in the future premiums are only to be recognised for contracts which cover a certain risk. Even today, pure, fund-linked contracts in which the policyholder bears the investment risk, are no longer counted by the IAS as such contracts. In our view, this has no significant influence on earnings volatility. However, the insurance industry will have to become accustomed to the fact that comparisons on the basis of premium income will no longer be possible. Even sales revenues comprising premium income and fees do not represent a clear figure for comparative purposes in view of the differing margins. Rather, operating results (without change to the fair value) and market capitalisation will be significant with regard to the description of a company's size.

Many questions remain

Which figure will be the new basis for corporate taxation?

We are of course also concerned about the costs of the changeover which will eat into profits. Small insurers in particular will be adversely affected. In addition, the question of dividend policy arises. Which earnings figure will be used as the basis for the distribution rate. A further issue is the future of corporate taxation. Again, the question is: which figure should it be based on? It is doubtful whether a created enterprise value should be directly taxed whether an incentive for non-objective valuations would thereby be given. The latter point above all makes us sceptical as to whether the change will take place in time for 2005.

Not everything is bad

Temporary price fluctuations acceptable provided reliable earnings forecasts can still be made

In principle, a harmonisation of the accounting standards is to be welcomed. We also consider information on fair value to be good, since this makes a mismatch between durations of assets and liabilities clear to investors. However, investors accept temporary fluctuations if, as a consequence, the result is not continually influenced and made unpredictable. As analysts of WestLBPanmure, we therefore argue either for a fair value statement in the notes or for a direct netting against equity without going through the income statement as is already the case with the investments. In this connection, the hypotheses for the fair value of the liabilities would however have to be disclosed in the notes. A disclosure of all assumptions and dependencies is already required as a matter of urgency now - as for example in schedule 20F attached to US financial statements.

Notes

The Draft Statement of Principles

The IASC's Draft Statement of Principles - DSOP - currently contains 43 principles. There are many varied ways of implementing them at national level. Important principles of this draft statement are:

Principle

4.1 Insurance liabilites (both generally and in life insurance) have to be discounted and valued on the basis of current estimates of the future cash flows arising from the current contract.

4.10 Reserves for catastrophes and equalisation reserves do not represent liabilities according to the IASC draft statement.

4.11 Acquisition costs may not be deferred into the future as asset items.

5.1 Assets and liabilities of insurance companies should always reflect the total risk.

5.3 Market assumptions should be in line with current market prices.

Entity specific values vs. fair values

The DSOP proposes two similar values which however differ in detail: entity specific values (ESV) and fair values. The differences between these two values and the current deferral matching basis are summarised in the table below (which represents an extract from table 2.1 of the DSOP).

IASC tends towards ESV

Although IAS 39 remains in its current form, the IASC will probably recommend the use of ESV. ESV in the sense of an insurance liability is the "present value of costs which will be incurred by the company to settle the liability to policyholders .... in accordance with the contractual conditions over the term of the liability."

The fair value of an insurance liability is "the amount for which it could be settled between knowledgeable, willing parties in an arm's length transaction".

Since there is no trading platform for insurance contracts comparable to those for other assets, the ESV is a method for estimating a fair value for insurance contracts.

Overview of the various approaches

Subject (Principle)	Deferral/Matching	Asset/Liability – proposed approaches	
Aim (2.2)	Deferring of revenues and expenses so that they match	Measuring assets and liabilities arising from insurance contracts	
Measurement (3.1)	Varies – often on the basis of the accumulation of past transactions	Entity specific value	Fair value
Valuation of fixed assets (4.1)	Mixture of historical costs and fair value	Held-for-trading investments at fair value; investments held to maturity at amortised costs	All financial investments at fair value
Valuation of general insurance liabilities (4.1)	Discounting - not usual	Discounting on basis of current estimates of future cash flows applying risk-free interest rates, adjusted for all risks not reflected in the cash flows	
Valuation of life insurance liabilities (4.1)	On basis of future cash flow estimated at the beginning, discounted, taking into account expected long-term income from actual or fictitious investments to secure the liability.	Discounting on basis of current estimates of future cash flows applying risk-free interest rates, adjusted for all risks not reflected in the cash flows	
Assumptions (4.4)	Valuation on basis of entity-specific assumptions on cash flows which are not available to other market participants	Valuation on basis of entity-specific assumptions on cash flows not available to other market participants	Assumptions which other market part-icipants also usually apply
Net income from long-term contract (13.4)	Arises from a predetermined allocation model. Differing practice with regard to adjustment for experience divergence and changes in estimates and assumptions.	A certain profit or loss on first-time recognition (profit from new business). The rest arises when the insurer is released from its risk and when actual experience diverges from expected experience (profit from existing contracts)	

Source DSOP, WestLB Panmure

Discounting of liabilities even though risks have been adequately taken into account

The fair value of the net assets are higher than the currently fixed asset value in the case of most insurers. The likely reason is that the discounting of insurance liabilities would substantially reduce the amount of liabilities even if the risks were appropriately taken into account by stochastic models. The only exception would be companies whose balance sheets contains assets which would be without value for a third party at arm's length basis (e.g. set aside acquisition costs).

Presentation and disclosure

The introduction of the accounting standards will radically change the balance sheets of the insurance companies. The chapter on presentation has not yet been published. However, the summary of the DSOP project indicates that the following principles will probably be included.

All changes of insurance liabilities should be recognised as and when they arise.

The income statement will include the following parts:

Net profit or loss on the issuance of insurance contracts, which represents the net present value of premiums, claims and expenditure in order to properly reflect the risk.

The "interest" on the insurance liabilities.

Differences between actual experience (claims experience) and earlier assumptions.

Changes to the assumptions.

The cash flow statement is presented on a direct basis and shows the premiums received, the payments made to settle claims, the costs paid, etc.

The notes in annual reports will contain, inter alia, the following points: statutory capital adequacy, solvency margins, important performance indicators (e.g. retention/expiry rates), information on risk adjustments and sensitivity (e.g. in Germany risk reporting in accordance with DRS 5-20).

Disclosures based on those of UK life insurers

The disclosures are similar to those of the UK life insurance companies which report on the basis of achieved profit accounting. However, there is a fundamental difference between achieved profit accounting and the reporting proposed under DSOP. Both methods are discount methods (discounted cash flow - DCF). However, the achieved profit accounting approach only has an internal basis for projecting cash flows. In contrast, DSOP explicitly uses market value margins, option prices and stochastic modelling.

Theoretically, both approaches should lead to largely similar results overall. The cash flows will be identical over the term of the contract. The difference between the two methods is that the DSOP offers less discretionary leeway for entity valuations.

Regulatory authorities for insurers

Clear valuation of the economic activities in the audited year

Regulatory authorities and rating agencies for insurers are likely to welcome the DSOP proposals. The accounting treatment based on ESV and fair value enables the effect of the commercial activities carried on in the audited year and the group's financial position at the balance sheet date to be clearly valued. This goal is not achieved by the current statutory accounting. In November 2001, the FSA - the UK regulatory authority - made the following commentary:

"The FSA supports the change to a fair value model for accounting in the insurance industry and has worked closely with the international standard committees to influence the development of the model. In conjunction with the work on "Solvency II" this should contribute towards resolving the problems which arise from the current lack of transparency."