In 2016, as part of Accounting Standards Update 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities,” the U.S. Financial Accounting Standards Board (FASB) issued new rules that will require companies holding equities in their general accounts to include fair value (i.e., market value) changes of those investments in their current-period income. (The new rules are effective for fiscal years beginning after Dec. 15, 2017, so effectively Jan. 1, 2018, for calendar year filers.) For companies that have classified their equity investments as “trading,” the new change will not affect their accounting. However, for those that used the classification “available for sale,” this change is likely to increase income volatility.

Under current U.S. GAAP accounting for equity investments classified as “available for sale,” the value of the investment is shown on the balance sheet at fair value, but any changes in fair value change equity directly—without affecting the income statement. Currently, changes in fair value are booked as “Other Comprehensive Income” (OCI). Only dividends on equities or any realized gains or losses are reflected in current period income. Because dividend income is relatively stable and realized gains or losses are mostly within the discretion of management, the impact on income is relatively manageable through the selective sale of assets. Once fair value changes directly affect income, however, management can no longer selectively recognize the gain/loss portion of a company’s investment, since all changes go through income immediately—regardless of sales activity.

Hypothetical example of insurance company impact

To provide some perspective on the effect this change would have, consider the U.S. property and casualty industry, which had a 2016 year-end equity allocation of approximately 21.84% of invested assets. Given this equity allocation, even a single calamitous market event could disproportionately affect the entire year’s results. Take, for example, the events of October 19, 1987, when the S&P 500 Index experienced a one-day decline of 20.5%. If this happened again, the one-day impact to income would amount to a sizeable 4.48% of invested assets. This is significantly higher than the industry’s full-year 2016 return on average assets of 2.41%, and would turn 2016 income for the entire industry negative. Even assuming a much smaller move equal to one standard deviation of single-quarter equity returns of 8.35%, the property and casualty industry would still experience a reduction in annual income of 66.1%.

Contributor
– Mike Earley, Head of Client Solutions, Americas.

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1 Source: Deutsche Asset management calculations based on data from Standard and Poors’, quarterly returns of the S&P 500 index from 6/30/1997 through 12/31/2016. Past performance is not indicative of future results. Forecasts are based on assumptions, estimates, opinions, and models or analysis which may prove to be incorrect.
A re-think on accessing equity asset class

For a company that files GAAP statements, this potential for direct income impact changes the risk profile of an equity allocation. From a total return perspective, nothing has changed, but the new accounting will introduce significant volatility to income and, thus, earnings per share (EPS), which can directly affect the valuation/market capitalization of a publicly traded insurer. While detailed disclosures will allow analysts to back out the impact of equity market moves in their analysis, and the price-to-book ratio is unaffected relative to today’s accounting, there will be increased attention on managing the downside market risk of equity portfolios to reduce EPS volatility.

Companies should understand the potential impact of a range of price movements on their balance sheets and re-examine their equity allocations. In addition, we recommend giving increased attention to strategies designed to help control downside risk, such as low volatility index strategies. During the financial crisis of 2008, for example, the S&P 500 Vol Control 12% Monthly Index experienced a peak-to-trough decline of 15%, compared with an overall decline in the S&P 500 index of 50%.

Other potential opportunities include hedging and overlay programs.

2 “Volatility control: taming the beast,” The Actuary, November 29, 2012. Past performance is not indicative of future results. Forecasts are based on assumptions, estimates, opinions, and models or analysis which may prove to be incorrect.

Conclusion

While the economics of equity investing will not change, the accounting that translates corporate economic decisions into financial data will. Thus far, the argument for insurers using available-for-sale accounting has been that it reflects the multi-year earnings cycle of their products and a long-term buy-and-hold approach to investing. While these tenets have not changed, the accounting consequence of FASB’s new rule change will have a significant effect on the primary income statement. Companies should assess the impact now to be prepared for the first quarterly report in 2018.

Source: Data from SNL Financial except where indicated otherwise.
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