

# **IFRS and Solvency II – Key Issues and Strategic Implications**

**Geneva Association General Assembly  
June 8, 2007**

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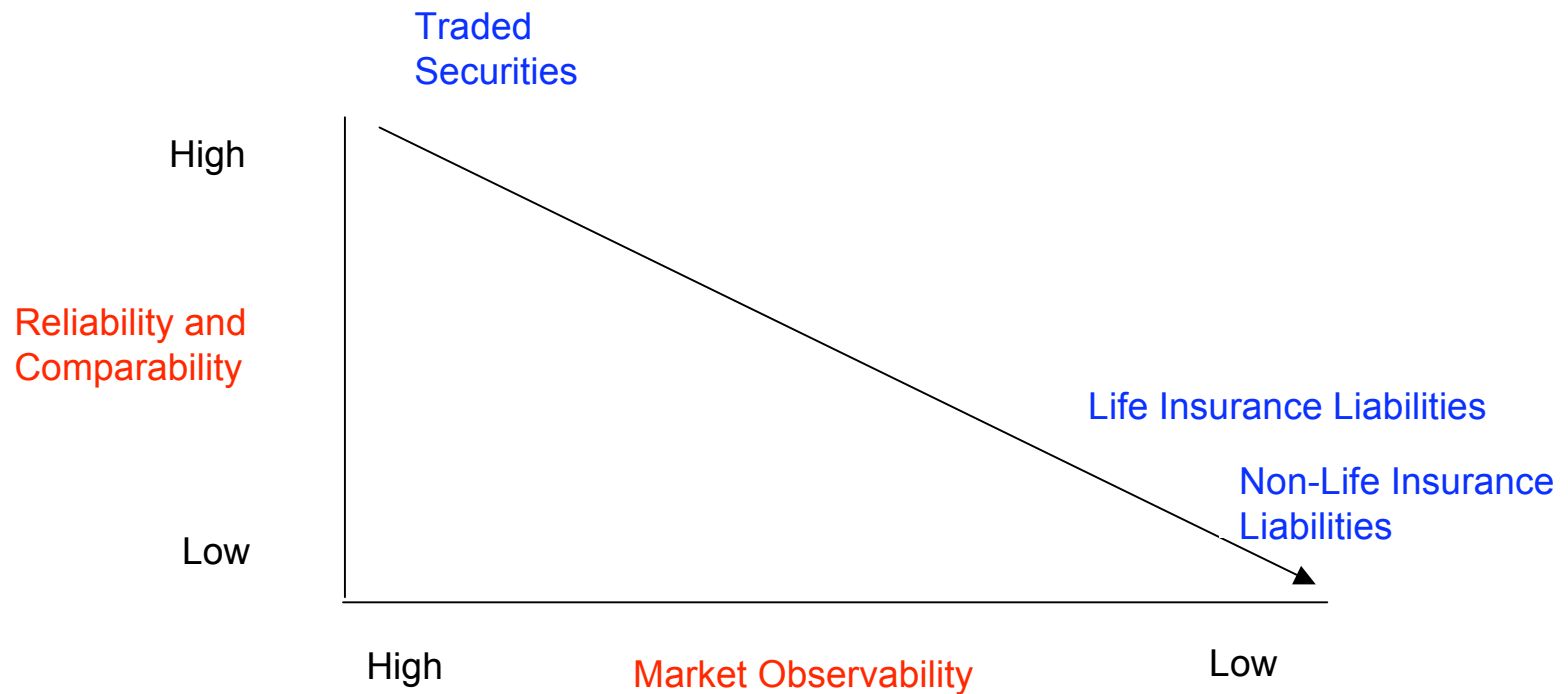
- Senior Vice President, Finance, AIG
- Executive Chairman, Group of North American Insurance Enterprises (GNAIE)

- Market versus entity-specific assumptions
  - Calibration of Risk Margins
  - Gain at Issue
- Discount rate
- Own credit risk
- Long-tail non-life – principal area of global industry disagreement
  - Different models for life and non-life insurance
  - Risk Margin and discounting
- Other related IASB projects – performance reporting, revenue recognition
- Linkages to Solvency II

	Life	Non-Life
<b>Period of coverage</b>	<b>Extended</b> (unknown duration)	<b>Short</b> (fixed duration)
<b>Probability of insured event occurring</b>	<b>Certain</b> (unless policy lapses)	<b>Unknown</b> (can be multiple claims in a single period or none)
<b>Timing of loss payments</b>	<b>Very predictable</b> (mortality and lapse rate assumptions can be reliably estimated for a portfolio of policies)	<b>Often unpredictable</b> (no reliable method for predicting payment dates for many long-tail lines)
<b>Amount of loss if insured event occurs</b>	<b>Fixed</b> (generally equals face amount of policy)	<b>Unknown</b> (subject to per policy and per claim limits) (wide range of losses for many long-tail lines)

- Market consistent liabilities – an aspirational goal ?
  - Estimation error - ‘day one gains’
- Are there observable and reliable secondary markets for insurance liabilities?
  - There are NO reliable market-based cash flow patterns, discount factors or risk margins
  - Most reinsurance transactions are unique and not legal replacements of one insurer for the other
  - Most, if not all, policy liabilities end up being settled with the insured rather than transferred
- “Market transactions” generally only include
  - Life transactions: Investments linked to liabilities
  - And are only coming into existence - insignificant

- The discussion paper suggests that the new accounting model “i.e. current value” meets the objectives of these attributes
- However, the IASB defines these attributes broadly and thus, their effect on the new model is unclear and untested
- Performance reporting questions asked in the discussion paper (DP)
  - How is this new information going to be communicated to the investment community for the first time?
  - Little focus on the Income Statement to date
- Other projects which significantly affect the insurance contracts, but little progress has been made to date
  - Revenue Recognition – reconcile to gain or loss at issue
  - Financial Instruments - ‘blue sky thinking’ being proposed
  - Conceptual Framework – definitions of asset and liability could impact problems in the DP (e.g. life renewal premiums and participating dividends)
  - Liability/Equity - definitions could affect participating contracts



Solvency	Accounting
Liabilities based on probability ranges	Liabilities based on “best estimate”
Focus is on total balance sheet (liabilities + equity) measured against risks	Separate focus on assets, equities and liabilities
For <i>regulators</i> to focus on monitoring financial capacity to satisfy policyholder obligations – consumer protection	For <i>investors</i> to focus on performance, operating results and current financial position – capital market information
Regulators focus on insurers’ ability to satisfy obligations related to unexpected losses	Shareholders focus on maximising value in relation to risk

- While it is important that the definition of liabilities for accounting and solvency purposes be consistent and reconcilable – ***it’s not necessary that they be the same.*** The split between risk provisions included in liabilities and those in capital requirements is not important for solvency purposes (‘total capital requirement’ concept).
- The risk premium demanded by providers of capital may differ from what regulators consider is an appropriate level of return on that capital
- Therefore, consistency between solvency and accounting is not required!

- Solvency II is based on an economic balance sheet approach
  - Assets at market value
  - Technical provisions calculated on a “market consistent current value approach”
  - Which, is very similar to IFRS proposals
    - Without concern for accounting issues (e.g. revenue recognition)
  - But, Solvency and Accounting objectives do differ!
- Current Solvency II proposals resulting in lower technical insurance liabilities than IFRS proposals
  - Arguably, it should be the other way round...
  - But, recognition of artificial profit margins on day one is not the answer just to lower accounting technical liabilities
  - More important to get the objective and measurement of Solvency II right!

- Access to capital markets and cost of capital
- Level regulatory playing fields – competitive considerations
- Different capital requirements for identical policies issued on different sides of the pond
- Regulatory equivalence
- Industry financial strength and industry credibility
- Income statement reflecting performance

- Need to determine what capital “counts” when evaluating insurer solvency
- Identical insurers writing exactly the same business, assuming same quality of management, should be treated identically from a solvency viewpoint, regardless of domicile
- Solvency II should accurately reflect both diversification and risk mitigation
- Solvency II group diversification benefits have been designed with EU groups in mind
  - Little consideration given as to how Solvency II should be implemented in groups that have “Third” countries as primary regulators
  - Attainment of Third Country Equivalence cannot be an “after-thought” - serious competitive considerations are at stake

Field testing is a must to reduce the risk of a failure

- How does Solvency II compare to standards in the US and elsewhere?
- Will there be market disruptions caused by insurers being forced out inappropriately?
- Or does a well-designed system allow insurance consumers to benefit from existing insurers and allow new EU and non-EU insurers to compete on a level playing field?
- Market consistent - methodology challenge for non-tradeable risks, which to date has not been properly calibrated or modelled

- More industry agreement than disagreement
  - Areas of disagreement are significant, but needn't stop industry finding its global voice
- US Regulators, users and rating agencies engagement needed
- CEO Leadership
  - Industry communication challenge
  - Commitment and co-ordination

The logo for GNAIE is located at the top left of the page. It consists of a dark blue rectangular area with the letters 'GNAIE' in white, bold, sans-serif font. To the left of this rectangle is a vertical stack of colored bars (orange, red, blue, green, yellow). To the right of the rectangle is a light blue rounded rectangle that overlaps the dark blue one.

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# APPENDIX

- Endorses an “entry value-style” approach, as defined in GNAIE’s Life and Non-life Principles [www.gnaie.net](http://www.gnaie.net)
- The ability of the income statement to appropriately measure financial performance in a decision useful manner should be directly addressed in the development of an insurance model
- Separate models, particularly liability measurements, for life and non-life
- Life – include discounting and risk margins
- Non-life – exclude measures since will result in financial information, that is not decision useful
- **The Income Statement Does Matter!!!**

- Two Components:
  - Pre-Claims Liability – calibrates to transaction price during policy coverage period
  - Post-Claims Liability – estimate of nominal future loss payments (best estimate)
  
- Key Concerns with IASB Proposal
  - The valuation of non-life liabilities are extremely complex and subjective as evidenced by historical development of loss reserves
  - Compounding of current GAAP judgments with new judgments for risk margins and discounting will render resulting financial information meaningless to use as a basis to assess financial performance

- **Key Concerns with IASB Proposal**

- Gains at issue should not be allowed on day one
- All expected future premiums and future policyholder dividend payments (including non-guaranteed payments under UL contracts) should be allowed
- Discount rates before application of risk margins should be based on the company's best estimate of future returns net of expected defaults and related expenses
- Unbundling should be required only when elements are clearly not dependent on each other
- Own credit standing should not influence the liability measurement

- Release from risk” should determine the pattern of profit recognition for insurance contracts, no “day 1” profit
- Measurement should be on a portfolio basis
- No unbundling or bifurcation
- “Own credit risk” is not appropriate in liability valuation
- A separate customer intangible asset should be recognized
- Liabilities should include the best estimate of future policyholder benefits and expenses
- There is no market for transferring insurance liabilities, so calculations must be based on amounts to be ultimately paid, not hypothetical “exit” value