



IFRS and Solvency II

“A CEO’s Perspective”

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The Way Forward – CEO Involvement

- Time is of the essence.
- Your involvement and consensus are needed now if we are to
 - Find and express a global industry voice regarding solutions to the issues caused by the changing accounting and solvency regulatory landscapes and
 - Ensure that accounting standard setters complete the Phase II insurance contract accounting project before the “quiet period” beginning in around 2011.
- Lets move away from confusing “buzz” words like “fair value”, “exit value” and “market consistent” and instead debate the substance of the issues underlying these labels.



The Changing IFRS Landscape

- The US appears likely to adopt IFRS by about 2013, after a quiet period of approximately two years during which no new IFRS standards will be issued.
- The current status of the IASB's Phase II insurance contracts project remains unclear. Increasing pressure is emerging against industry-specific guidance and may hinder IASB adoption of an insurance standard at all.
- Failure to achieve a Phase II insurance contracts accounting standard by 2011 will probably defer a Phase II standard until at least 2015, possibly later.
- Cross cutting projects such as revenue recognition, financial statement presentation, financial instruments etc, are having an important impact on the direction of the insurance contracts project.
- The role and effect of the SEC is uncertain - the head of the SEC is expected to call for creation of a body to oversee the setting of international accounting standards.



The Changing Solvency II Landscape

- European Solvency II seems to be on target for an implementation date of 2013, although there could be slippage.
- It is not clear what the outcome will be on issues such as Group Supervision, Equivalence, Third Countries etc – the level regulatory playing field discussed yesterday.
- The use of internal models for solvency regulation is likely to come under regulatory scrutiny. We recently learned from the UK FSA regulator that, in light of the recent market events, the bar could be raised “much higher” on the requirements for using internal models for solvency measurement.
- The resolution of the accounting debate will impact Solvency II – insurance contract valuation, day-one gains, etc.



Insurance Contract Accounting

- Contract Fulfillment Value (CFV) vs Current Exit Value (CEV)
 - Little support, if any, from the insurance industry and users, for a CEV hypothetical modeled based on a “transfer value” approach
 - CFV would assume fulfilment of the contractual terms with policyholders “in the normal course” pursuant to the terms of the underlying contracts and not a hypothetical transfer or settlement with a hypothetical market participant at the reporting date.
 - CFV places reliance on **actual entity specific inputs** and not on so called “market average” inputs.
- Non Life
 - Discounting – certain liabilities
 - Calibration of risk margins



Accounting should Reflect the Way we Manage our Business

- Life and non-life insurance businesses are managed differently, and often separately
 - Life:
 - Importance of asset / liability matching requires use of portfolio earned rate for discounting liabilities.
 - In life insurance, reserves and investment income merge together in the underwriting and management process.
 - Non-life:
 - Cash flow underwriting has lead to disaster.
- Dual model – life vs non-life insurance
 - The renewals issue of guaranteed insurability arguably goes “too far” for non-life contracts “but not far enough” for life contracts.



Revenue Recognition

- *“I hate day one gains, especially given that one has done nothing. There should be no day one gains, instead the liability should be the cost plus the margin”*
Sir David Tweedie, IASB Meeting, 21 May 2008
- Last week the IASB voted on the direction of revenue recognition strongly supporting a “Customer Consideration Approach”. If the Customer Consideration Approach were applied to insurance contracts
 - No day one gains would be permitted.
 - On day one the valuation of insurance liabilities would be calibrated to the premium charged.
 - The “how” and “when” related to subsequent insurance liability measurement is yet to be considered by the IASB – Contract Fulfilment Value?
- An impossible science to accurately strip out the profit from the risk margin on day one correctly.
 - Typically insurers only know the **actual** cost of the policy issued long after the product has been sold, generally not on day one.
 - On day one, such division between the “profit” and the “risk margin” is not meaningful for accounting purposes.



Financial Statement Presentation

- The insurance measurement model should be aligned with financial statement presentation.
 - However, there appears to be a divide between some life and non-life insurers:
 - Some life companies appear to be supportive of a “margin presentation” approach similar to financial instrument accounting presentation, whereas on the other hand, some non-life companies would prefer insurance premiums been presented as revenues.
 - Such a developing divide provides further weight to the position that life and non-life insurance are managed differently, and accordingly should be presented differently.
- *“Cash should be the rock that new standards adhere to. Clearly, this it not appropriate in every circumstance. However, earnings recognition should adhere to cashflows as closely as possible and deviate only where necessary. The current proposals, in relating earnings recognition to theoretical contract value, bear virtually no resemblance to cash”.*

Merrill Lynch, IASB DP Comment Letter, 16 Nov 2007



Interaction of Due Process with the Changing Landscape

- Global industry concerned with lack of field testing commitment to date by the IASB.
 - The recent consequences from the implementation and adoption of FAS 157 is an example of what could happen in the absence of appropriate field testing.
 - FAS 157 only described “how” not “when” to use fair value.
- The IASB has signalled that the Insurance Contracts Project is on track. However, progress would depend on the availability of staff resources.
 - Vacancy at the IASB for a Senior Insurance Contracts Project Manager as result of Peter Clark’s recent promotion.
 - At the recent Insurance Working Group meeting Sir David Tweedie noted that the IASB has limited staff resources to do the level of field testing suggested by the insurance industry.



Call to Action

- Use CEO involvement to drive further efforts such as the May 13th Geneva Association sponsored roundtable on solvency to produce a more aligned global industry voice.
- Use CEO involvement to encourage completion of the Phase II Insurance Contracts Accounting Project before the 2011 quiet period. Meetings with the IAIS, the IASB, and the FASB.
- Use existing forums to wider communicate the industry's position i.e. Financial Services Forum, Transatlantic Business Dialogue, IIF insurance committee.