



**Standard & Poors**

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# **International Accounting Convergence**

Are we heading in the right direction?

- A non-life perspective

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“The Discussion Paper proposes that the **measurement attribute** for insurance liabilities should be the **amount** the insurer would **expect to pay** at the reporting date to **transfer** its remaining contractual rights and obligations immediately to **another entity**”

- Does hypothetically imply what amount an insurer could expect to transfer the insurance liability to a hypothetical marketplace participant.

**But**

- We do not believe this measurement objective will provide useful information that help users make economic decisions.

**Because ....**

# General Reactions

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- Does not accurately measure the economic reality of the actual transactions between the insurer and insured
  - Based on a hypothetical transfer value between the insurer and a hypothetical third party,
  - Instead of the expected outcome between the insurer and actual insured.
- Is not representative of the way users evaluate and analyze insurance business, given relies on
  - Market average expenses,
  - Market consistent cash flows,
  - Compensation (not cost) required by hypothetical third party for assuming risk.

- Is not representative of the way insurers manage the business
- Is potentially misleading
- Is an invitation to potential manipulation
- Will increase cost of capital
- Will create artificial volatility in the Income Statement
- And, with the interaction with Solvency II, could unintentionally create an unlevel global playing field...



# Key Non-Life Concerns

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- A one size model for life and non-life does not fit all
- Determination of an appropriate risk margin
  - Cost of capital approach and other suggested methodologies, do not appropriately capture the riskiness of ‘unknown, unknown’ liabilities
    - An uncalibrated cost of capital approach is no more ‘market consistent’ than today’s existing established practices. More model risk.
    - There are significant differences between ‘transfer’ and ‘settlement’
  - Of course, practically, possible to discount claim reserves
  - However, expected cash flow timing is uncertain, far more so than for most life liabilities,
  - But the explicit risk margin is uncalibrated for non-hedgeable risks
    - Requires a compensation (not the actual cost) for bearing risk!

- Regulators in Europe, the United States, and globally are considering new approaches to solvency regulation
- EU regulators are specifically concerned to link Solvency II to the IASB Insurance Contracts Phase II insurance project
- What could be the impact of this link?

- Solvency II is based on an economic balance sheet approach
  - Assets at market value
  - Technical provisions – ‘current exit value’
  - Which, is identical sounding to the IFRS DP proposals
    - But, without concern for accounting issues (e.g. profit recognition)
  - But, Solvency and Accounting objectives do differ!
  
- Current Solvency II proposals result in lower technical insurance liabilities than IFRS proposals with no gain at issue
  - Arguably, it should be the other way round...
  - But, recognition of artificial profit margins on day one is not the way to lower accounting technical liabilities
  - More important to get the objective and measurement of Solvency II right!



## What is happening in US today?

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- Regulatory and accounting based on different methodologies, for different purposes
- Currently active revisions in:
  - Risk Based Capital
  - US GAAP
  - NAIC Principles Based Approach for Life
  - FASB Invitation to Comment on DP
- **Which don't all fit together because have different purposes!**

- Drive for regulatory and accounting consistency
  - Both Solvency II and IFRS DP proposals are based on the ‘current exit value’ approach
- Strong drive to enhance EU competitiveness
- Currently active revisions in:
  - European Embedded Value
  - Solvency II Proposals
  - IFRS and
  - Now the Phase II Discussion Paper
  - **All intended to fit together somehow !**

## **Will this create a competitive disadvantage?**

- **Possibly Yes**
- **Why?**



# Unlevel Global Playing Field

	<b>European Insurer</b>	<b>US Insurer</b>
<b>Solvency and accounting</b>	Similar methodologies	Different methodologies / different purposes
<b>Cost of capital rate</b>	Likely to be artificially low	Higher
<b>IFRS / Solvency II technical provisions</b>	Likely to be artificially low depending on line of insurance business	Higher
<b>Solvency II diversification credit</b>	Diversification credit permitted for EU insurers worldwide business	Diversification credit not permitted for US insurers third country business
<b>Organizational restructuring costs</b>	Not applicable given domiciled in EU.	Higher costs due to, proposed Solvency II Holding Company requirement for third countries EU business
<b>Financial information</b>	More integrated financial information presented for external users	Separate financial and regulatory information presented for external users

Potential lower EU capital requirements could result in different ratings in Europe vs US for similar business

- Rating requirements for similar business, driven by different measurement bases, should be rated consistently assuming same quality of management and earnings
- Proposed Solvency II third country diversification rules discriminate against US insurers
- Regulation must recognize diversification and risk mitigation regardless of geographical domicile!

We are in favor of convergence that takes place in a stepwise fashion that:

- Is appropriately field tested,
- Recognises the economic reality of our insurance business,
- Minimizes market disruption,
- Maximizes the quality of the ultimate global standard, and
- Maintains a competitive and level playing field!