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Accounting Battles

Martin White and
(apologies from) F.James Mcpherson

32nd Annual GIRO Convention

The Imperial Hotel, Blackpool

Accounting battles: IFRS and solvency

- Some actuaries said IFRS would never happen
- Solvency 2 (EU) is happening as well
- Which will get there first?
- Degree of actuarial consensus on each?
- What about consensus in the real world?
  - Some issues heavily discussed
  - Some really sensitive issues largely unspoken

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Accounting battles: IFRS and solvency

- Our objectives today:
  - Brief run through the main decisions being made
  - Discuss relationships between accounting and solvency
  - Focus on small number of issues for discussion – up to you exactly what we cover!

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Solvency drives accounting – and five-versa

- Solvency regime and market pressure together will drive capital requirements
- But without sufficient objectivity and comparability, all measures are meaningless.
  - Which is arguably where we are today.
  - Hence need for both IAS and Solvency 2
- Solvency relies on financial estimates made for accounting purposes – and vice-versa

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Simplistic view of objectives – can we agree on these?

- Solvency – protect the policyholder
- Accounting – report the truth to the shareholders (?)
  - Focus on stewardship
  - What is the “truth” in insurance business – it it volatile, or is smoothing needed to properly reflect reality
- How do management attitudes vary by jurisdiction?

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Standard setters** versus rest of industry

(**include the actuarial profession)

- For IAS, many of the technical questions are approaching consensus amongst the standard setters
- In the wider world, many are not yet comfortable with the implications. Consistent reserving strength is perhaps the key point.
- For Solvency, many of the key questions are still hotly debated
- And some questions may deserve more focus – the purpose of reserve strength for solvency, perhaps?

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Accounting may be influenced by the solvency objective for reserve strength

- Current challenging questions for the IASB:
  - Should the framework for risk margins be the same or different between general purpose and regulatory accounts?
  - What should the risk margin be calibrated to
    - This last is most interesting for actuaries, as well as "how to do it in practice", methodology questions, GRIT and all that. But note the Australians say they have made great strides since a regime was imposed on them

Actuarial controversy on IAS

- Own credit risk! Financial economic madness? Main question here is perhaps what accounts are for – to report on past stewardship, or to place values on future outcomes. Easy to decide for most business, with shorter contract periods than insurance.
- Discounting and risk adjustment as a package – the US will eventually fall into line.
- Basis for risk adjustment (apart from how to do it!):
  - Market value margins (initial theoretical position of DSOP)
  - Margin flowing from risk-theoretic principles
  - Value margin using open market concept, but adjusted to be practical and more consistent over time?
  - Company level or portfolio-invariant? Latter implies calibrate against notional (fairly large) company. Arguments for and against?

Perhaps the most fundamental decisions relate to solvency

- The role and mechanism for safety margins to protect past policyholders
- Ditto for future policyholders
- Explicit capital clearly needed for future policyholders
- But what about past policyholders?

Reserve strength (solvency perspective)

- At a level sufficient, without further capital, for another well capitalised to be prepared to take on the liabilities?
  - Implies, as CEIOPS say, a level of reserve which is portfolio-invariant and fully comparable between companies and within jurisdiction. (This concept is potentially valuable in IAS too)
- Or if the liabilities are not taken on (willingness or legal framework may not be there to permit such transfer), what probability of failure is acceptable – to long tail policyholders and to short term policyholders? At what point does a company say "we don't have the financial strength to pay all current claims in full, because it would be unfair to future policyholders"
- Or do you reserve at (discounted) best estimate and use your explicit capital to cover both past and future policyholders?

Some interesting responses to CEIOPS consultation document CP07

- Lloyd's:
  - Percentile approach not appropriate: opaque, barrier to understanding, provisions highly dependent on levels of aggregation, very concerned that best estimates might not be subject to explicit audit.
  - Don't think reserves should be discounted
  - Time horizon for SCR of 1 year does not sit well with period to ultimate for the reserves.
- KPMG:
  - Comments on the "relatively low level of safety [proposed to be] required for reserves" (suggestion was 75^{th} percentile as a minimum)

Some interesting responses to CEIOPS consultation document CP07 (contd)

- E&Y:
  - Keep the risk margin explicit (i.e disclose no-margin value as well)
  - Don't like confidence levels much
  - "cost of capital" approach may be good way to determine safety margins, especially for non-life
  - Highlighted issue of one year versus ultimate approach
  - Not solely an actuarial business.

Some interesting responses to CEIOPS consultation document CP07 (contd..)

- Danish Insurance Assoc (DIA):
  - Prefer market-driven values to prudence-driven values (surprising?)
  - Would appear to want all the safety to be in explicit capital, and not in the reserves, which should be a best estimate only (note that "best estimate" now generally accepted as meaning expected value, with full recognition of the tail)
  - Discounting is obviously required – it reflects economic reality, and DIA worried that this question should not have been decided already.
    - Note: US antipathy to discounting is still strong

Some interesting responses to CEIOPS consultation document CP07 (contd….)

- CEA: Comite European des Assurances:
  - Consistent with DIA submission.
  - Worried that proposals may not give enough credit for diversification (implies they support percentile approach and not a portfolio-invariant approach)
  - Comment that the definition of tech liabs still open at this stage
  - Argue that the tech liabilities should be based on the "economic value of liabilities"

Some interesting responses to CEIOPS consultation document CP07 (contd…….)

- ABI:
  - Tech provisions should be on best estimate, but believe that capital should capture the margin for risk (possibly consistent with CEA and Danish)
  - Factor based models not good enough – need to incorporate stress and scenario tests.
  - Discounting: essential. They note that a minority of mainly US firms are against it.
- Munich Re:
  - Tech provisions should be on best estimate, but believe that capital should capture the margin for risk (possibly