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IFRS v Solvency II – GIRO WP

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1. Introduction & overview

Our preliminary research findings indicate:

- IFRS reports not helpful (what is?)
- SII still not clear (what should be?)
- Need for 'third way'?
  - Cash flow statements a source of valuable insights, but
  - Current reporting needs major overhaul

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2. GIRO Working Party: Progress Report!

Terms of Reference (1 of 3)

Help to understand an accountant's perspective on the principles of accounting as applied to GI firms

- Existing UK GAAP, SORP and IFRS Phase I (IFRS 4);
- Proposed IFRS (Phase II)
- Compare and contrast to evolving FSA and Solvency II requirements

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Terms of Reference (2 of 3)

Challenge and appraise proposed IFRS and SII in terms of the following:

- Policyholder protection
- Effectiveness of financial reporting for the purposes of shareholder reporting
- Managing the business, including links with ERM

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Terms of Reference (3 of 3)

Influence external thinking through identifying other opportunities to communicate our ideas to

- The actuarial profession
- GIRO
- External bodies

3. Crisis in insurance firm financial reporting

Crisis in financial reporting

- No obvious early warning of impending problems from pre-crisis results
- AIG reported large profits and high returns up to the point the crisis struck (.. combined profit of £11bn in 2007!)
- Rating agencies focused too much on earnings and apparently strong capital ratios - assumed 'going concern' and prudential management (?)
- Credit crunch: need to escape 'fair valuation' and earnings management straight-jacket
- Cash flows presently not linked to other financial statements – IASB/FASB proposals?

The impact of fair value

- **Split valuation of assets and liabilities:**
  - Amortised cost: DAC technical provisions?
  - Fair value: Trading securities and available-for-sale investments and liabilities (including derivatives)
- **Differences in accounting treatment:**
  - Fair value recognises unrealised gains, historical cost only realised gains
  - When assets fall in value, under fair value assets written down to their new fair value, under historical cost impairment provision made

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Problems with fair value

- Valuing assets and liabilities when there are no market prices (mark-to-model)
- Conflict between DAC/provisions recorded at amortised cost and derivatives used to hedge interest rate exposure recorded at fair value
- Perverse effects of decline in value of liabilities
- Scope for management to arbitrage between fair value and historic cost
- Standards setters vulnerable to Government and industry lobbying (IASB rule changes in October 2008, FASB (US) in April 2009)
- Lack of articulation between change in FV, P&L

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4. Cash flow statement – a source of new insight?

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The importance of cash flows

- **Enron - managing analyst 'expectations' vs. real cash flows!**
  - Whatever the headline earnings, true financial picture often only revealed by dissection of the core cash flows
  - Arguably, cash flow analysis even more important to understanding the health of financial institutions
- **Presumably, main objective of insurers is capital transformation via intermediating cash flows**
- **Insurers vulnerable both to:**
  - deteriorating cash inflows (provisions represent cash payable on claims outstanding but not yet paid), and
  - rapid cash outflows (premiums withdrawable on demand, need to refinance/roll-over large debt security issues)

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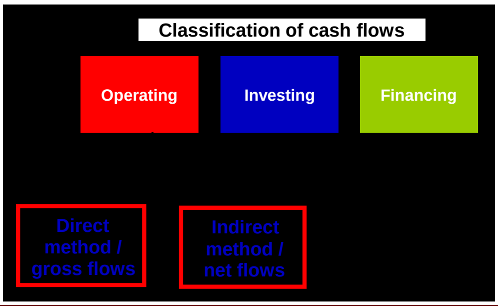
IAS 7 overview



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Cash flow reporting: latest developments

- IASB and FASB reviewing financial statement presentation (Discussion Paper of October 2008)
- Objective: more cohesive financial picture of firm
- More consistency between P&L, balance sheet and cash flow statement in line items, their description and their order of presentation
- Paper favours use of direct method for operating cash flows
- Critique: Change in Fair value – where shown?
- New schedule to reconcile cash flows to income
- Exposure Draft expected in 2010

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GAS 2-20

- Requires German insurance firms to include minimum classification requirements
- Recognises that insurance firms differ from industrial firms because they:
  - record high cash surpluses from operations when the business is growing (no distribution!)
  - receive premiums before services performed
  - Cash inflows invested to meet future obligation

GAS 2-20 Operating CF -minimum

1	Net result before extraordinary
2 +/-	Change in technical provision
3 +/-	Changes in deposits with cedings/reinsuers
4 +/-	Change in other receivables
5 -/+	Gain/loss on disposal of investments
6 +/-	Change in other balance sheet items

GAS 2-20 InvestingCF -minimum

1 +	Cash receipts from disposals
2 -	Cash payments for acquisitions
3 +	Cash receipts from disposal of investments
4 -	Cash payments from acquiring investments
5 +	Cash receipts from disposing investments held on account and at risk of policyholders
6 -	Cash payments for acquiring investments held on account and at risk of policyholders

GAS2-20 Financing CF-Minimum

1 +	Cash receipts from issue of capital
2 -	Cash payments to owners
3 -	Dividends paid
4 +/-	Receipts and payments from other
5 =	Cash flows from financing

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5. Survey of problems applying IAS 7 to insurers

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Survey of problems applying IAS 7 to insurers

- IAS 7 applies to all enterprises
- Surveyed CF reporting by large UK and Eurozone banks
- Classification into operating, investing and financing cash flows poorly suited to banks
- In non-financial firms, investment and financing captured as investing cash outflows and financing cash inflows
- In banks, growth (in loans and investments) and its financing (deposits, debt securities) are operating flows
- "Indirect method" allows insurers to net entries for key operating assets and liabilities
- Insurers inconsistent in treating liquid / Treasury asset flows as operating or investing cash flows

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Non-financial firm vs Insurer

Non-financial firm

OPERATING cash flows:
- reconcile PBT to operating cash

INVESTING cash flows cover:
- investment in / sale of tangible & intangible assets
- acquisitions & disposals

Insurer

- OPERATING cash flows:
- reconcile PBT to operating cash
- PLUS flows relating to DAC, deposits, D tech provisions

- INVESTING cash flows cover:
- investment in and sale of tangible & intangible assets
- acquisitions & disposals
- AND may also include flows relating to liquid / Treasury assets

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Recommendations

- IASB and FASB reviewing financial statement presentation, including cash flow statement (for all firms) ... specific issues relating to banks?
- Mandate direct method ... gross operating asset (new loans and repayments, etc) and liability (new deposits and withdrawals, etc) flows need to be fully reported
- Review lessons from other standards (eg German standard GAS 2-20 for financial institutions and insurance firms respectively)
- Cash flow risk analysis would help users understand impact of credit crunch on AL mismatches and performance

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Examples of CF reporting

- Transparent
  - Allianz AG
  - Munich RE
- Translucent
  - AIG
  - Berkshire Hathaway
- Opaque
  - ?

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