

IFRS v Solvency II

GIRO Workshop, 8 October 2009

Agenda

- Introduction
- The working party
- The paper
- Discussion

Introduction

- Background to issues
- Why a working party?

The working party

- Terms of reference
- Current membership
- Meetings held

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Working party - Terms of reference

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

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

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

- The actuarial profession / GIRO / External bodies

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Working party - Current membership

- | | |
|--|--|
| <ul style="list-style-type: none"> ▪ Profession: ▪ Martin White ▪ David Sanders ▪ Sarwar Grami ▪ Shailesh Malde ▪ Shreyas Shah ▪ John Charles ▪ Paul Cook ▪ David Simmons (FSA) | <ul style="list-style-type: none"> ▪ Others: ▪ Paul Klumpes (Chair) ▪ Andres Reibel (ICL) ▪ Wendy Hawes (Shadow) |
|--|--|

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Working party - Meetings held

1. October 24
2. November 11
3. December 4
4. January 15
5. February 5
6. March 18
7. April 23
8. May 14
9. June 11
10. July 15 & 28



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What we put in our paper

1. Introduction
2. General insurance valuation principles
3. Alternative perspectives on Solvency II
4. Alternative perspectives on IFRS phase 2
5. The IASB's proposals for IFRS phase 2
6. Unresolved issues in insurance accounting
7. Conclusion

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1. Introduction

- How to reflect risk in published financial statements
 - Consistency with non-insurance transactions
- IFRS phase 1 w.e.f. 1.1.2005
- IFRS phase 2: fair value
- Multiple purposes of accounts
 - Stewardship
 - Performance / Efficiency,
 - Conservative valuation

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2. General insurance valuation principles

- SAP and GAAP (economic profit basis)
 - Earned premiums
 - Incurred losses
 - Different treatment of acquisition expenses
 - Consistency with non-insurance transactions
- IFRS: $\Delta SM = [EP - (LP + \Delta PVL') - (E/WP)EP - D] - T + IG'$
 - EP = earned premiums
 - LP = paid losses
 - PVL' = present value unpaid earned claims
 - E/WP = underwriting expense ratio
 - D = policyholder dividends
 - T = income taxes
 - IG' = investment income + realized and unrealized capital gains



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3. Alternative perspectives on Solvency II

4. Alternative perspectives on IFRS 2

- Policyholder protection
- Shareholders' perspective
- Management perspective



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Policyholder protection – Solvency II vs IFRS

	Solvency II		IFRS	
Objective	Policyholder protection - prudence	+ve	Shareholder reporting - realistic	-ve
Capital Req.	Stronger than past regime	+ve	NA	-ve
Risk mgmt.	massive focus; ORSA	+ve	NA	-ve



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Policyholder protection – Solvency II vs IFRS

	Solvency II		IFRS	
Quality of Capital	Quality-based tiers 1-3: basic & ancillary	+ve	No distinction	-ve
Comparability	Applicable to all insurance entities	+ve	Only publicly quoted entities	-ve
Valuation	Fair value (= exit value); Marked to market (where possible)	+ve	Fair Value (= exit value)	+ve

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Policyholder protection – Solvency II vs IFRS

	Solvency II		IFRS	
Discount Rate	Risk free rate (CP 40) or Replicating portfolios	+ve	Asset-based rates not prohibited (?)	-ve
Risk Margin	Cost of Capital model; extensive guidance (CP 42)	+ve	Market view of risk; comparability issues	+/-
Cat./Equalist. provision	SCR component; not allowed in tech provision	+ve	Not allowed in tech prov; (doesn't require but also no prohibition on using other means e.g. ret. profits, RBC)	-ve

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Policyholder protection – Solvency II vs IFRS

	Solvency II		IFRS	
Goodwill	Valued at 'nil' (CP35)	+ve	Recognised in business acquisition	-ve
Intangible	Valued at 'nil' if can't be fair-valued <i>else</i> IAS38 (CP35)	+ve	IAS38: reliable cost measurement; probable future benefits	
Property	Investment: IAS 40 (FV only) Occupied: revaluation (IAS16): 3-yr external	-ve	Investment: IAS40 (cost or FV) Occupied: IAS16 Comparability issues	-ve

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Policyholder protection – Solvency II vs IFRS

	Solvency II		IFRS	
Own credit rating	Ignored	+ve	Recognised	-ve
Profit on sale	discount > risk margin; (UEP vs pre-claims liability)	-ve	Net gain, subj. to market evidence	-ve

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Shareholders' perspective

- Volatility of reporting
- The impact of the Underwriting/Reserving cycles
- Range of best estimates
- Reporting framework and disclosures
- Measurement issues
- Stewardship

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Managing the business

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5. IASB Proposal for IFRS Phase II

- Issues Paper 1999 & DSOP by IASB Steering Committee
 - Diversity in global insurance accounting practice
 - None in line with what the Committee envisaged
 - Assumed IAS39 to be replaced by full FV basis
 - Problem: no liquid active secondary market for insurance liabilities
 - Deferral and matching approach ruled out
 - Deductive methodology also not feasible
 - $MV(\text{liabilities}) = MV(\text{Assets}) - \text{Surplus}$, but surplus is hard to measure consistently, particularly as regards potential impact of options and guarantees

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6. Unresolved Issues in Insurance Accounting

- IASB DP 2007
 - Insurance contracts = Financial instruments?
 - Fair Value – appropriate for insurance liabilities?
 - Volatility?
 - How to apply Fair Value?
 - Fair Value of Intangibles?
 - Individual contracts or Group of contracts?
 - FV should be at group level
 - Credit risk: entry value or exit value?
 - Entry value if no valid market info available?

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7. Conclusion

- Can split out fair value balance sheet to show component sources of credit, market and business risk
- Risk disclosures can overcome mismatch between economic and accounting performance measurement of these fair value components
- IFRS4 disclosures: amounts in financial statements and the amount, timing and uncertainty of future cash flow
- Can go further and identify areas of risk allocation, e.g. operational risk and information about internal risk models, that are not generally covered by a fair value reporting system
- Rayman (2006) proposed new conceptual dual valuation framework that can address the various multiple roles served by general insurance actuaries in both valuation and accountability contexts

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Discussion
