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

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

Working party - Current membership

- Profession:
  - Martin White
  - David Sanders
  - Sarwar Grami
  - Shailesh Malde
  - Shreyas Shah
  - John Charles
  - Paul Cook
  - David Simmons (FSA)

- Others:
  - Paul Klumpes (Chair)
  - Andres Reibel (ICL)
  - Wendy Hawes (Shadow)
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

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

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
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
  - $EP$ = 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

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

<table>
<thead>
<tr>
<th>Objective</th>
<th>Solvency II</th>
<th>IFRS</th>
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<tbody>
<tr>
<td>Policyholder protection</td>
<td>+ve</td>
<td>Shareholder reporting - realistic</td>
</tr>
<tr>
<td>prudence</td>
<td></td>
<td>+ve</td>
</tr>
<tr>
<td>Capital Req.</td>
<td>Stronger than past regime</td>
<td>+ve</td>
</tr>
<tr>
<td>Risk mgmt.</td>
<td>massive focus; ORSA</td>
<td>+ve</td>
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</table>
### Policyholder protection – Solvency II vs IFRS

<table>
<thead>
<tr>
<th></th>
<th>Solvency II</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Quality of Capital</strong></td>
<td>Quality-based tiers 1-3: basic &amp; ancillary</td>
<td>No distinction</td>
</tr>
<tr>
<td><strong>Comparability</strong></td>
<td>Applicable to all insurance entities</td>
<td>Only publicly quoted entities</td>
</tr>
<tr>
<td><strong>Valuation</strong></td>
<td>Fair value (= exit value); Marked to market (where possible)</td>
<td>Fair Value (= exit value)</td>
</tr>
</tbody>
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<tr>
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<tr>
<td><strong>Discount Rate</strong></td>
<td>Risk free rate (CP 40) or Replicating portfolios</td>
<td>Asset-based rates not prohibited (?)</td>
</tr>
<tr>
<td><strong>Risk Margin</strong></td>
<td>Cost of Capital model; extensive guidance (CP 42)</td>
<td>Market view of risk; comparability issues</td>
</tr>
<tr>
<td><strong>Cat./Equalist. provision</strong></td>
<td>SCR component; not allowed in tech provision</td>
<td>Not allowed in tech prov; (doesn’t require but also no prohibition on using other means e.g. ret. profits, RBC)</td>
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<th>IFRS</th>
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<tr>
<td><strong>Goodwill</strong></td>
<td>Valued at ‘nil’ (CP35)</td>
<td>Recognised in business acquisition</td>
</tr>
<tr>
<td><strong>Intangible</strong></td>
<td>Valued at ‘nil’ if can’t be fair-valued else IAS38 (CP35)</td>
<td>IAS38: reliable cost measurement; probable future benefits</td>
</tr>
<tr>
<td><strong>Property</strong></td>
<td>Investment: IAS 40 (FV only) Occupied: revaluation (IAS16): 3-yr external</td>
<td>Investment: IAS40 (cost or FV) Occupied: IAS16 Comparability issues</td>
</tr>
</tbody>
</table>
Policyholder protection – Solvency II vs IFRS

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<td>Own credit rating</td>
<td>Ignored</td>
</tr>
<tr>
<td>Profit on sale</td>
<td>discount &gt; risk margin; (UEP vs pre-claims liability)</td>
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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

Managing the business
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
    - $MV(\text{liabilities}) = MV(\text{Assets}) - \text{Surplus}$
    - Surplus is hard to measure consistently, particularly as regards potential impact of options and guarantees

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?

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
Discussion