IFRS & Solvency II

Positioning for the future

Singapore Actuarial Society
General Insurance Seminar
6-7 May 2009

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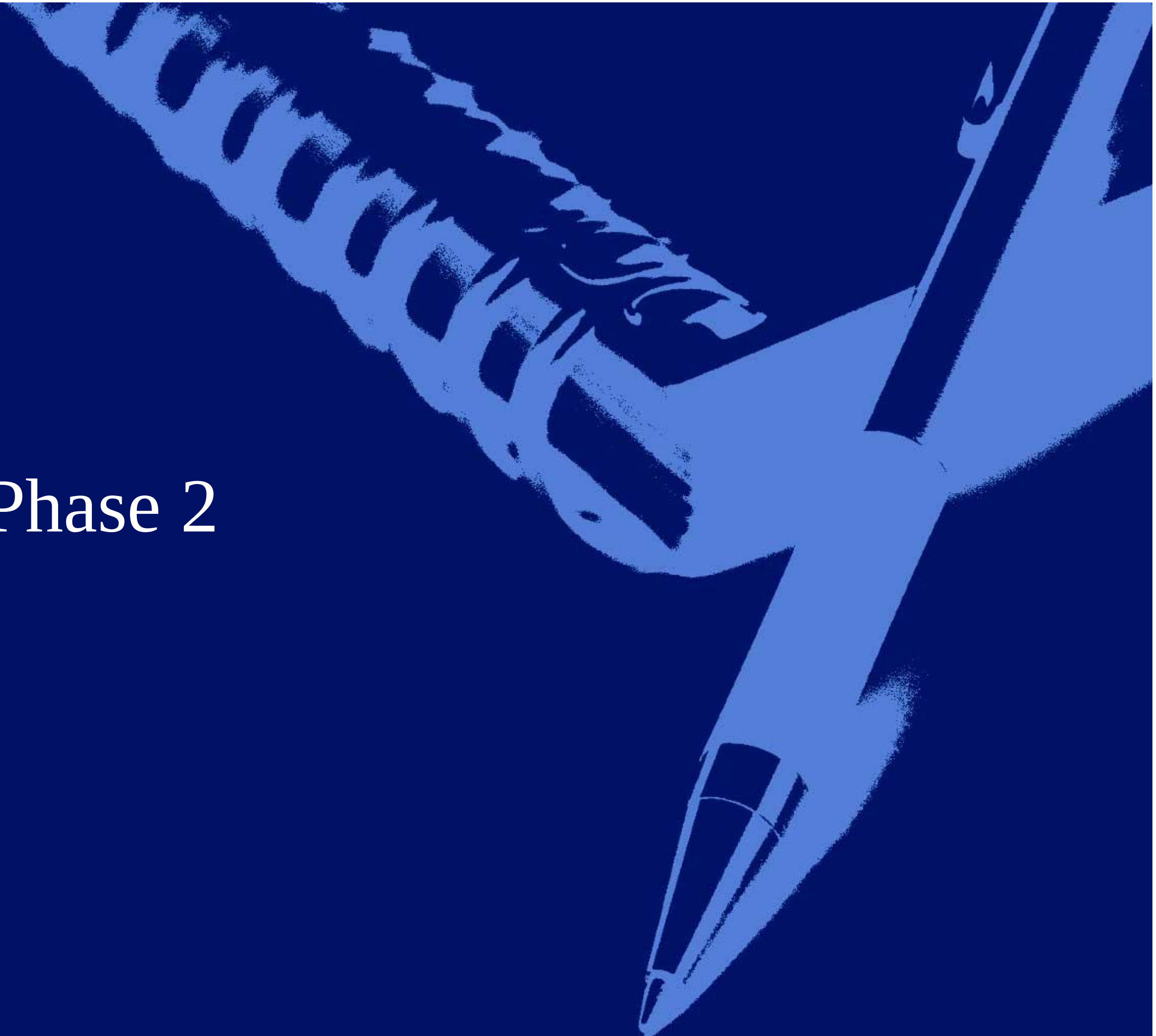
IFRS 4 – Phase 2



IFRS 4 – Phase 2
Agenda

- What is it?
- When is it going to happen?
- Who is it going to affect?
- How does it differ to Phase 1?
- Current issues
- Summary

What is it?

- New accounting regime
  - IFRS 4 relates to insurance
  - many other IFRSs for other industries
  - most now complete, insurance taking longer
- Born out of Europe, increasingly global
  - Driven by desire for more consistency
    - between alternative accounting bases (eg. fair value v. historical cost)
    - between countries within EU
    - between GI and Life, and
    - between insurance and banks
- intended to address the issues of insurers, policyholders and shareholders
- IFRS Phase I in 2005, Phase II now pending
  - limited impact to date so most issues unaddressed

When is it going to happen?

- significant progress made to date…..
- ….. BUT limited progress in some areas, some differences of opinion
- small working party formed to recommend way forward on o/s issues
- targeting completion in time for FY2011, some countries committed to this
- SEC to decide in 2011 whether to mandate from 2014

  - even then not going to apply to all until 2016
- However, 2 or 3 years of comparative accounts will be required

Who is it going to affect?

- will definitely impact European insurers
- will very likely affect US insurers
- will then become new global standard, likely to be adopted by local regulators

……. essentially everyone!

Who is it going to affect?

US

- initially reluctant, FASB now re-integrated
- different regulators
- SEC embracing
  - issued roadmap for change,
  - removing reliance on US GAAP for international consolidation
  - permitting some IFRS filings from 2009
- impacts earnings calculations, not solvency
- CPAs cannot issues public reports using IFRS, not officially recognised
- training & education now recognising prospect of IFRS

How does it differ to Phase 1?

Summary of Phase I

- Limited impact
- IFRS 4 pertains to insurance and reinsurance contracts

  - other issues, eg. asset valuation, dealt with in other regulations, eg. IAS39
- Move away from prescribed bases to principles-based, eg. China IBNR
- Move to fair value accounting for assets, eg. not book value
- Clarification of 'insurance contracts' (limited GI relevance)

How does it differ to Phase 1?

- General Insurance Specific
  - prohibited catastrophe/equalisation reserves
  - introduced liability adequacy test, ie. premium liabilities
  - introduced impairment test for reinsurance assets
  - prohibited offsetting liabilities with related reinsurance assets (ie. requires gross)
  - constrained changes in accounting treatment (reliable/relevant, discounting, DAC, non-uniform accounting treatments in subsidiaries)
- Disclosures
  - assumptions and risk objectives
  - risk concentration
  - movement analysis
  - sensitivities
  - claims development tables

How does it differ to Phase 1?

Implications of Phase II

- Phase I features that will not persist in Phase II:
  - permission for continued use of old accounting bases
  - deferred acquisition costs (DAC)
  - presentation of premiums/deposits
    - is it insurance? If so,
      - if savings part currently recognised, can continue what you were doing?
      - if not currently recognised, will need to be

How does it differ to Phase 1?

Valuation of liabilities : 3 building blocks

- unbiased probability weighted average of all future cashflows

  - written premium basis

- discount rate

  - risk free rate (swap rates maybe OK)
  - consistent in terms of currency, duration and liquidity
  - not historical
  - not risk-adjusted

How does it differ to Phase 1?

Valuation of liabilities : 3 building blocks (cont’d)

- margin for risk and services
  - determined based on Current Exit Value (CEV) concept
    - "The amount the insurer would expect to pay/receive to/from another entity if it transferred all its remaining obligations and contractual rights"
    - does not imply any intention to exit
  - FASB introduced alternative Current Fulfilment Value (CFV) instead of CEV
    - entity-specific cashflows
    - 'additional margin' to avoid Day 1 gains
  - risk margin
    - shouldn't be like 75^{th} percentile, should be based on a cost of capital basis
    - updated annually
  - service margin
    - unbiased estimate of other companies' requirement for rendering services

Current Issues

- IASB and FASB working on convergence
  - fundamentals are agreed but 'the devil is in the detail'
- Credit crisis has had some implications
  - trading assets, disclosures, valuation in illiquid markets
- Very much a work in progress, lots of ongoing discussion

Summary

- this is going to happen
- local implementation may be a little later, could impact MNCs first
- phase II will be more fundamental than phase I
- quite actuarial in concept, may lead to increased demand for actuarial services
- implies a bigger change in some markets than others, and some insurers than others
- won't "go live" for some time but companies' desire to do parallel runs and need for prior year comparatives will lead to earlier impact

Solvency II

Solvency II
Agenda

- What is it?
- When is it going to happen?
- Who is it going to affect?
- How does it differ to Solvency I?
- QIS4
- Summary

What is it?

- a new solvency regime
- EU initiative, will be passed into law by European parliament
- consistent with IFRS, but nonetheless independent of that (politically led, not industry led)
- successor to Solvency I

  - big differences in local statutory reserves
  - more consistency in solvency capital, but still differences
  - for GI, higher of x% of premium and y% of claims
  - not risk-based, inconsistent with other financial services industry

- initiative began in 2001

What is it?

- intended to
  - improve policyholder protection
  - improve efficiency of insurance markets
  - establish common minimum across EU
- focused on
  - risk measurement (quantitative)
  - risk management (supervisory, reporting, disclosure)

When is it going to happen?

- Quantitative Impact Studies
  - QIS 3 : Apr 2007
  - QIS 4 : Apr 2008 (Report issued Nov 2008)
  - QIS 5 : May not now happen
- Directives
  - Framework Directive Proposal : July 2007
  - Framework Directive was scheduled for March 2009, now delayed by 1 year
- National Adoption
  - Dry run in 2010 (?)
  - Full adoption was planned for 2012, now likely to be 2013 (?)
- Delays are largely political
  - change of EU presidency
  - MEP elections

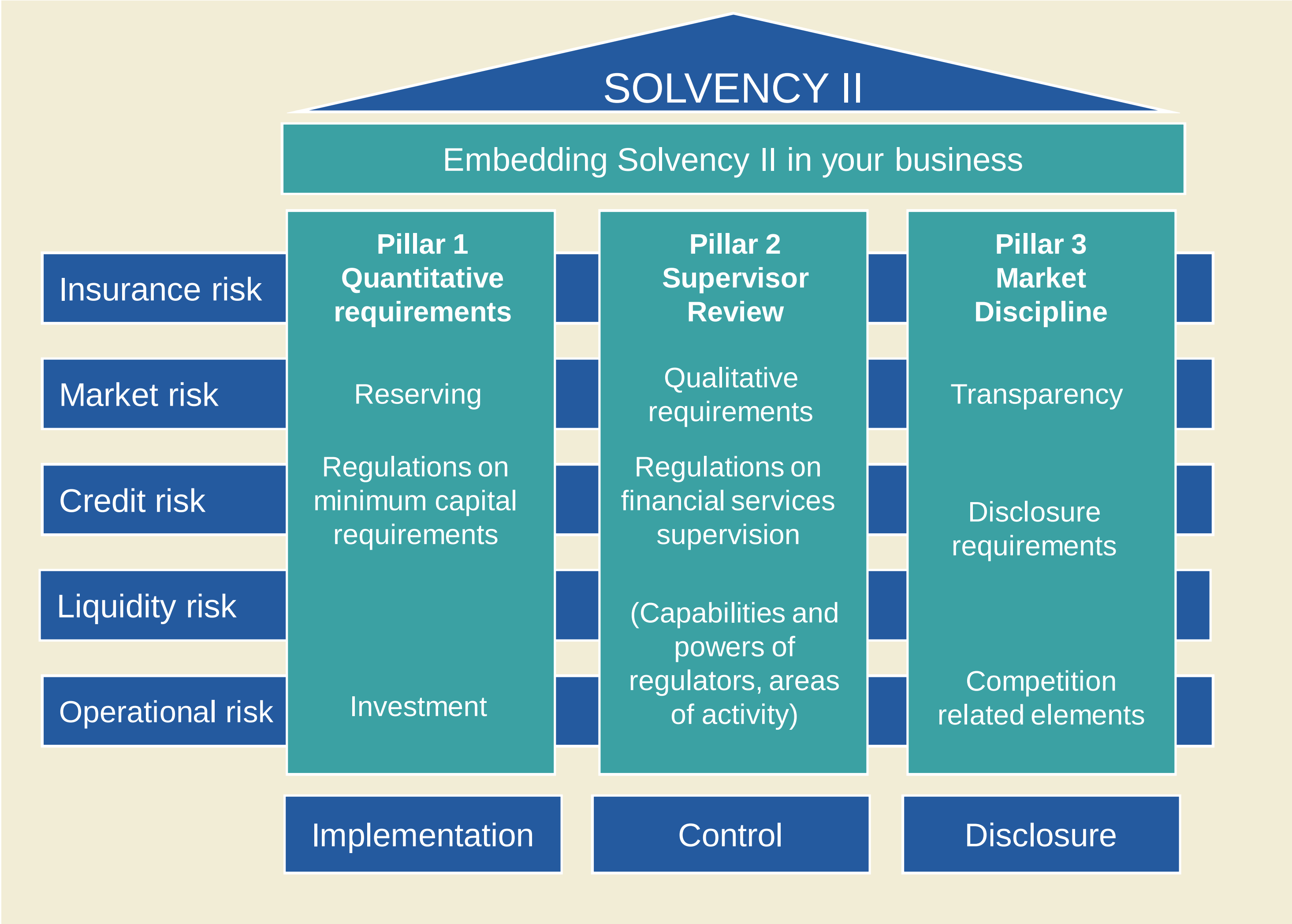
Who is it going to affect?

- Primarily EU insurers
- But, US solvency regulation being reviewed
- Liable to become the new global benchmark

How does it differ to Solvency I?

Overview of Solvency II

3-Pillar Approach



How does it differ to Solvency I?

Three Pillars

- Pillar 1 – Quantitative
  - Technical provisions
  - Capital Requirements
    - Minimum Capital Requirement (MCR)
    - Solvency Capital Requirement (SCR)
  - Investment
    - Tier 1, Tier 2 and Tier 3 capital

How does it differ to Solvency I?

Three Pillars (cont'd)

- Pillar 2 – Qualitative
  - internal controls
  - risk management framework
  - potential to add to pillar 1
  - supervisory review process (SRP)

- Pillar 3 – Disclosures
  - reporting and disclosures

How does it differ to Solvency I?

Pillar 1

- Assets
  - standardized valuation across EU
  - consistent with IFRS
  - some quantitative limits to address concentration and liquidity risks

- Liabilities
  - technical provisions to cover obligations
  - best estimate plus explicit, market-based margin for risk

How does it differ to Solvency I?

Pillar 1 (cont'd)

- MCR
  - – absolute minimum

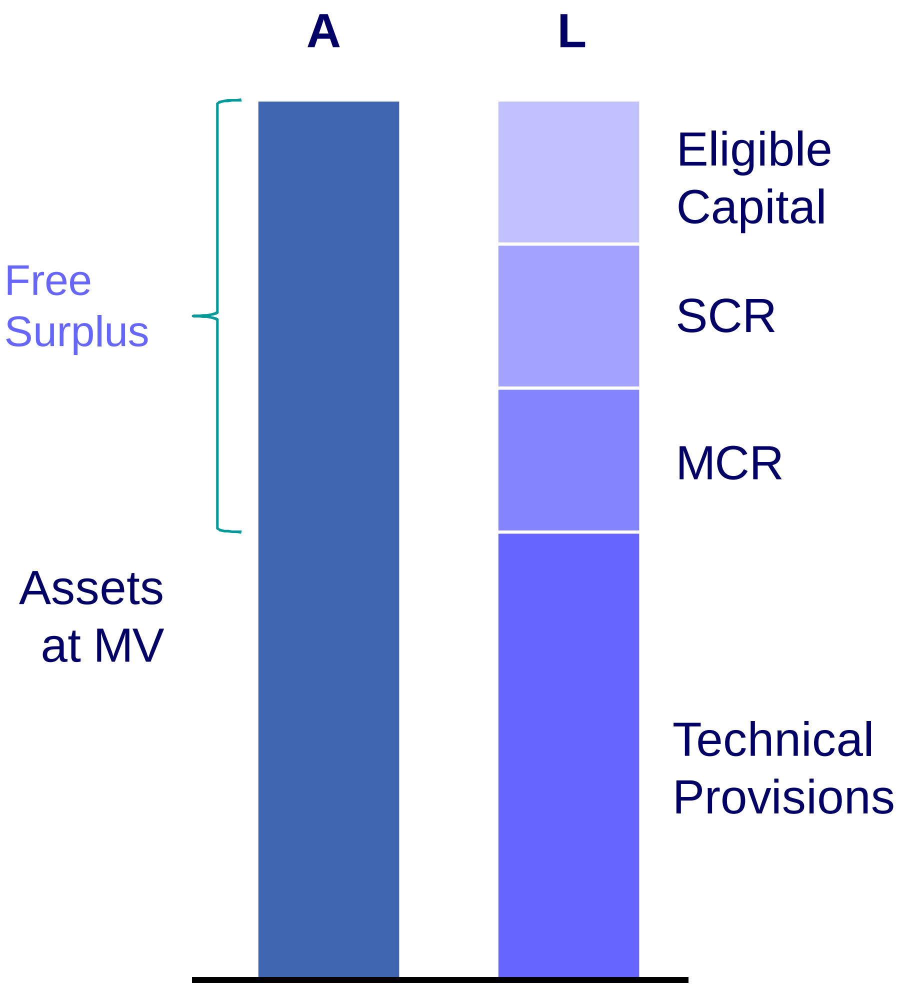
- SCR
  - – capital to absorb unforeseen losses such that P(Ruin) = 0.5% over the next year

- Eligible Capital
  - – tiered classification of shareholder capital

How does it differ to Solvency I?

Pillar 1 (cont'd)

- Balance sheet



Free surplus > SCR

Sufficiently capitalised

Free surplus < SCR and

Free surplus > MCR

Early indicator that action needs to be taken

Free surplus < MCR

Company is technically insolvent

How does it differ to Solvency I?

Pillar 1 (cont'd)

- Technical Provisions
  - – market consistent, best estimate of liabilities + cost of non-market risk

- Market Consistent, best estimate liability =

  PV (Future claims and benefits)

  + PV (Policy expenses and commissions)

  - PV (Future premiums)

- Discounted at risk free rates

- Cost of non-market risk
  - – discounted cost of capital
  - – 6% per annum, more specific basis than under IFRS4-2

How does it differ to Solvency I?

Pillar 1 (cont'd)

- SCR
  - Effectively a Value at Risk approach using stress tests
  - Test impact on free surplus of a variety of specific stress tests
    - no time to go through these now but Google-able and include
      - premium/reserve risk & cat risk (considers class, geography, volume, years of historical data, correlation matrices, etc)
      - asset value changes à -20% for property, - 32% for equities, -45% for hedge funds

How does it differ to Solvency I?

Pillar 1 (cont'd)

- MCR
  - absolute minimum, falling below this would trigger regulatory intervention
  - linear MCR, subject to range between 20% and 50% of SCR
  - subject to absolute minimum of Eur1m (for general insurers)
  - sum of higher of x% of technical provision and y% of NWP for each class
  - 15 specified classes of business
  - x% and y% vary by class of business

How does it differ to Solvency I?

Pillar 2

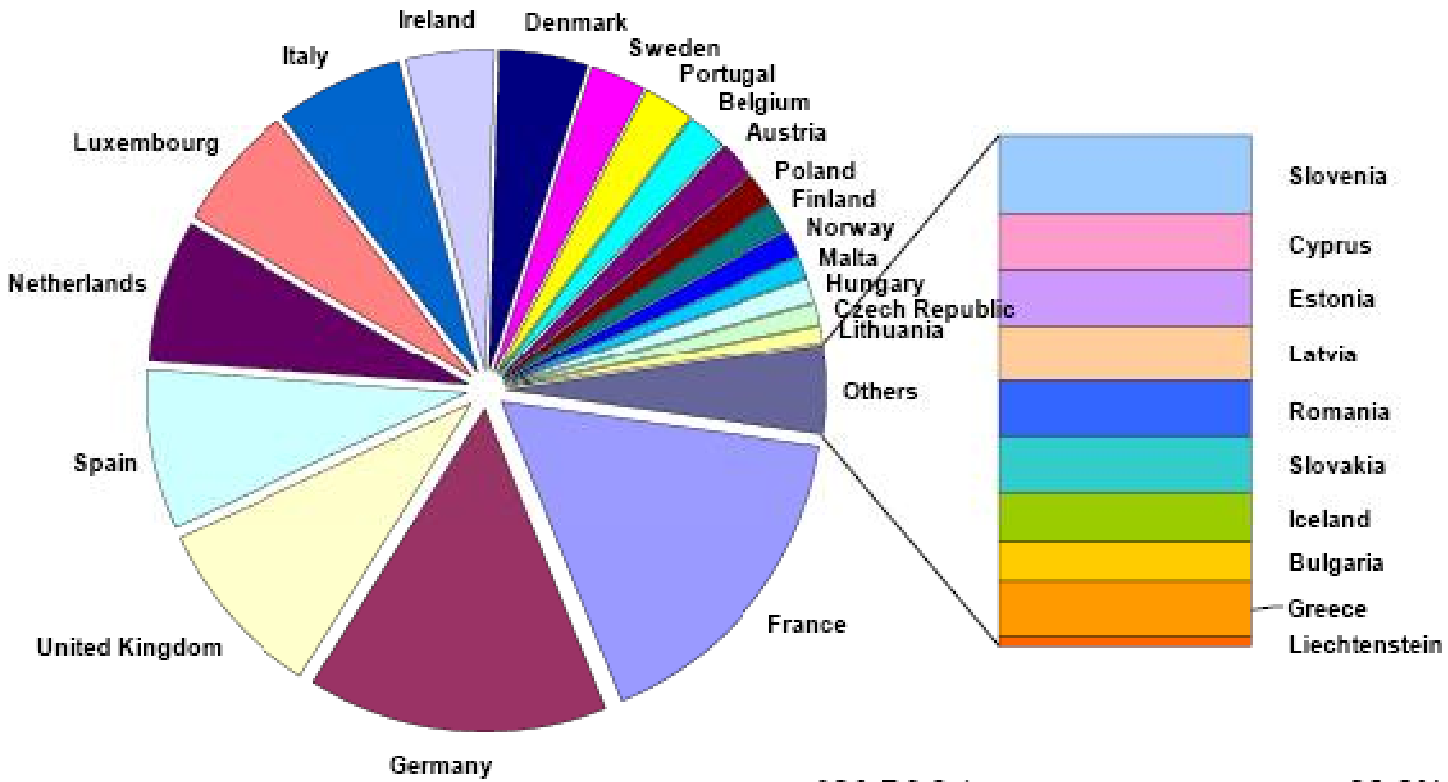
- Deals with the qualitative aspects of a company's:
  - Internal controls
  - Risk management processes
- Explains how supervisors will review overall SCR
- Will make further allowance for risks that have not been adequately quantified, eg. group risk and strategic risk, by adjusting the SCR levels
- Increasingly, the nature of supervision will depend upon the risk profile of individual insurers and their approach to meeting Solv II requirements
- If supervisors are dissatisfied with a company's assessment of their risk-based capital, they will have the power to impose higher capital requirements

How does it differ to Solvency I?

Pillar 3

- Enhancing disclosure requirements to increase market transparency
- Aims to provide insight into the actual risk and return profile of an insurer
- Companies must interpret the disclosure requirements, develop a strategy for disclosure and educate key stakeholders on the potential impact
- Onus is placed on firms to design the information which through public disclosure will be available to regulators, analysts, rating agencies and shareholders alike
- Must also develop the internal processes and systems to produce these reports
- Disclosure requirements not very specific but companies must:
  - publish disclosures at least annually……covering their solvency and financial condition……where the information is consistent in its coverage with the information provided as part of Pillar II
- Similar to those under IFRS4, but much more extensive
- Disclosure of RBC requirements will put pressure on quality of values
- Difficult in practice to set one level of disclosure to satisfy all stakeholders

QIS4
Participants

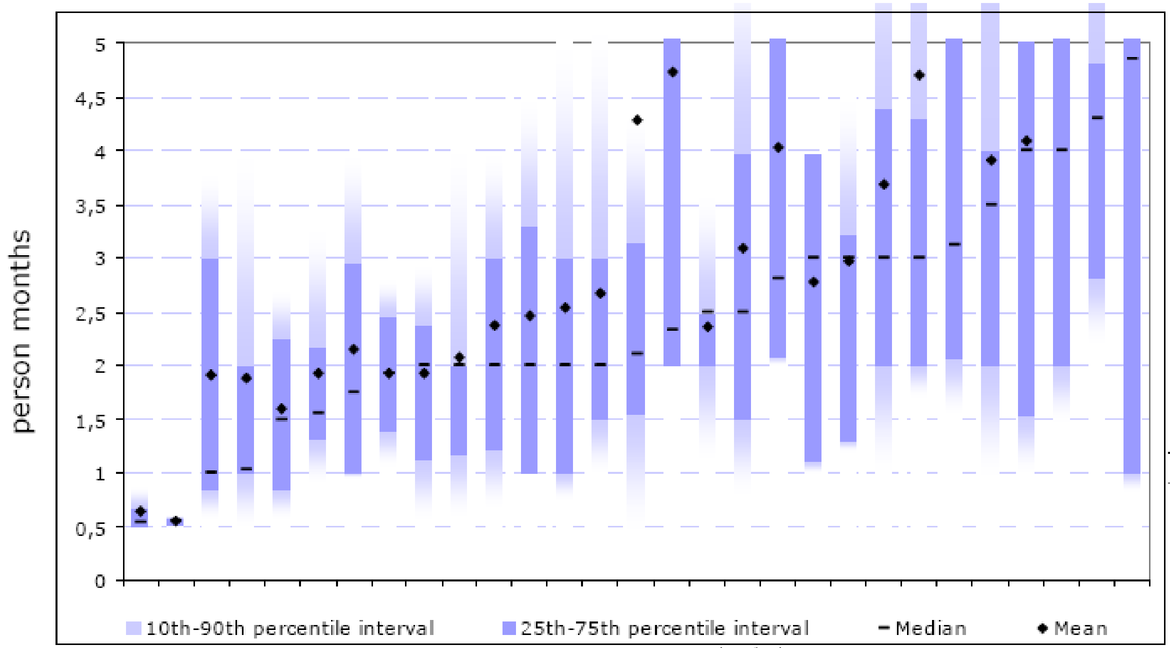


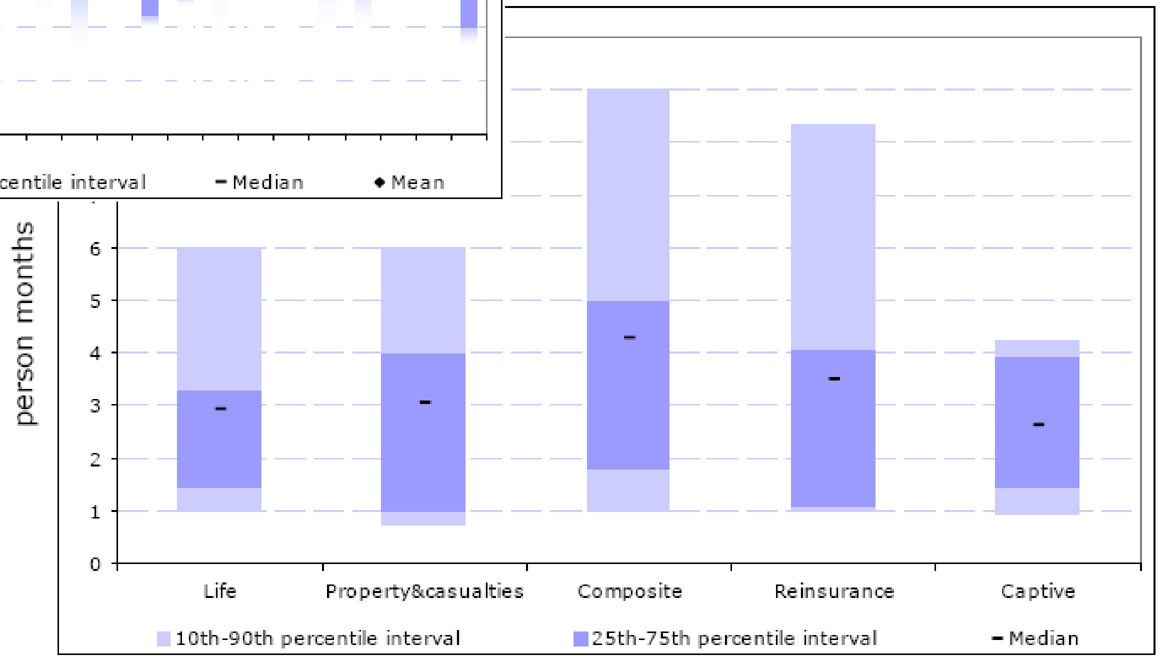
1412 Solo Insurance Companies

Overall participation rate: 33.6%

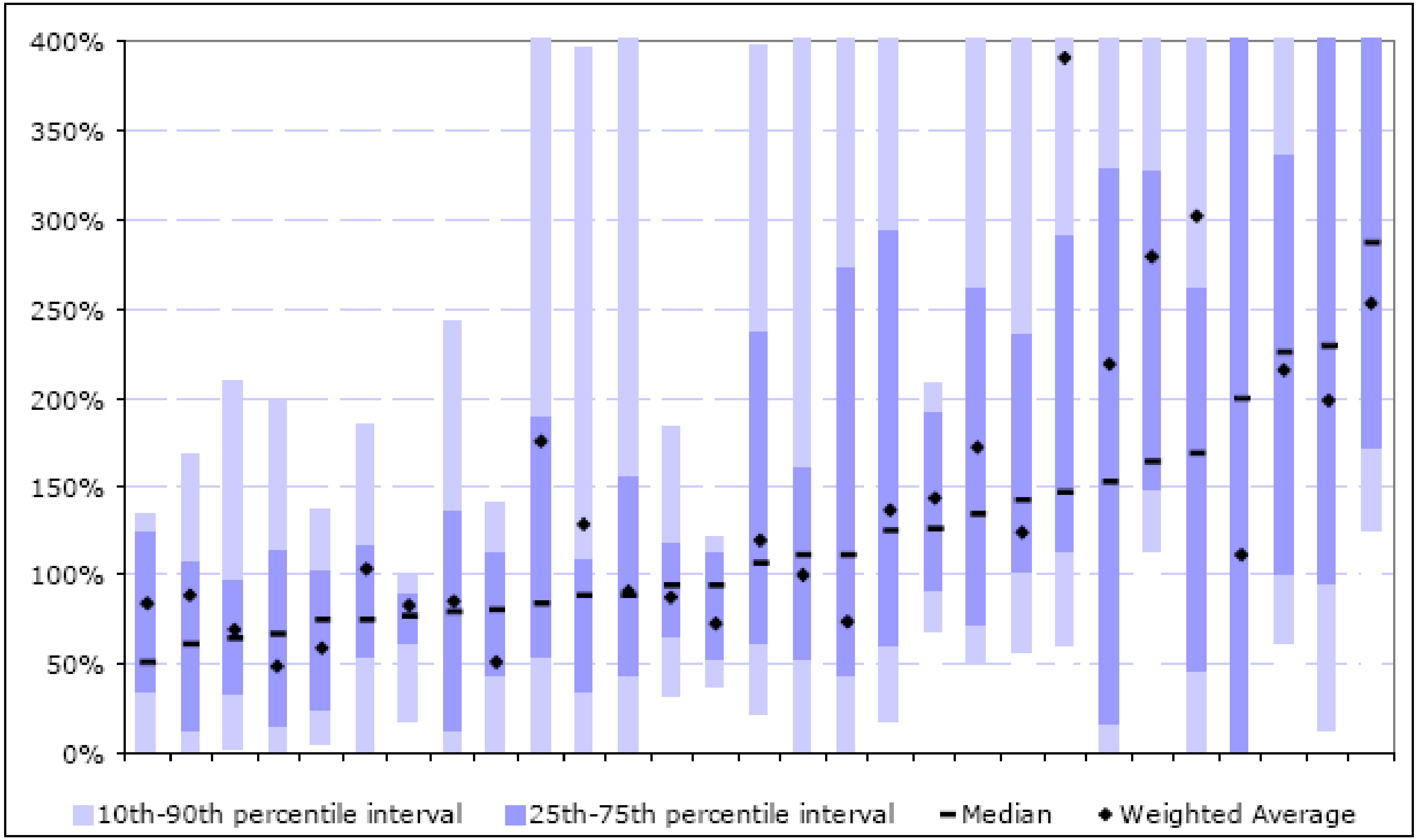
686 P&C-Insurers:	32.0%
351 Life-Insurers:	41.5%
227 Composite-Insurers:	31.9%
49 Reinsurers:	27.1%
99 Captives:	19.2%

QIS4
Time Needed

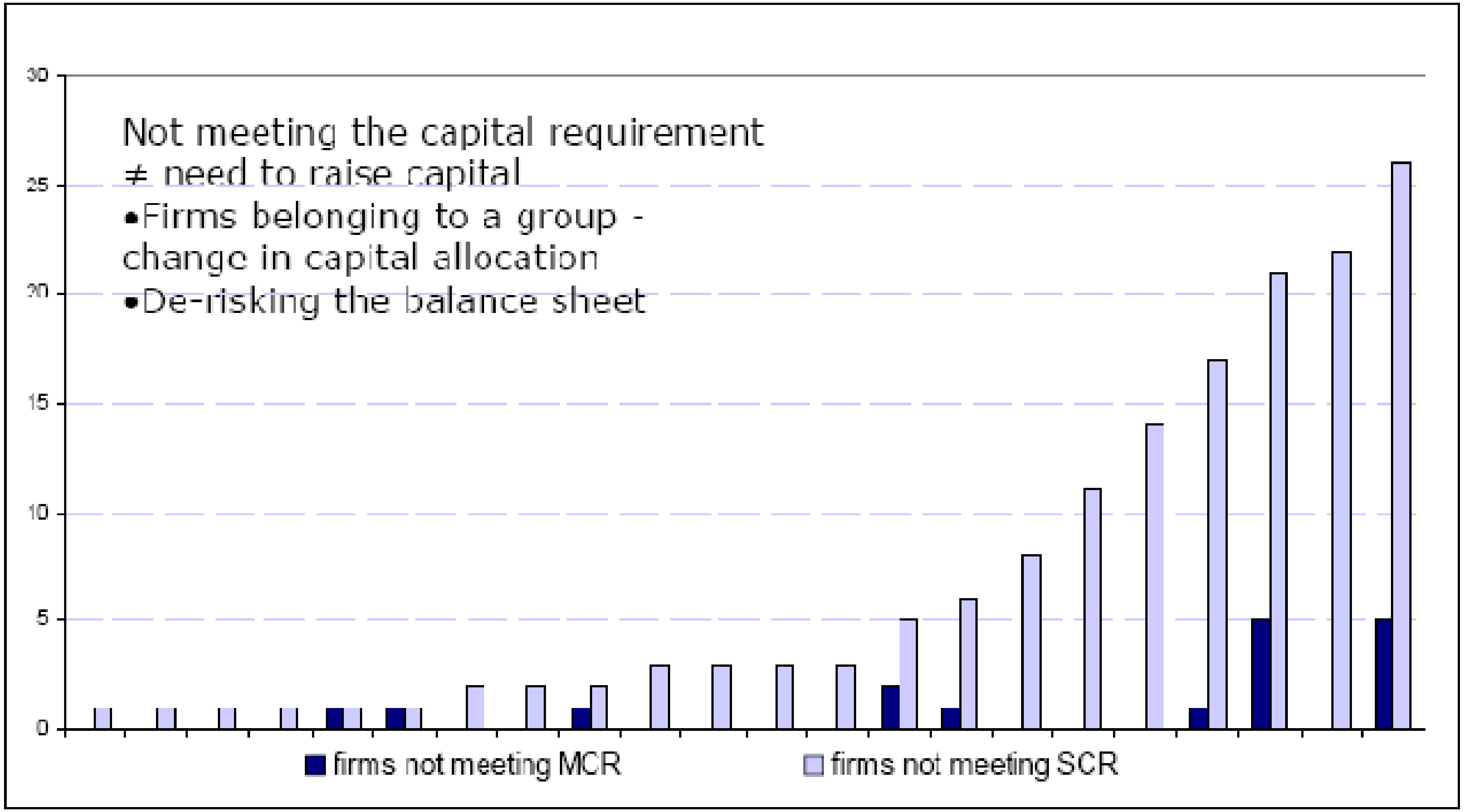




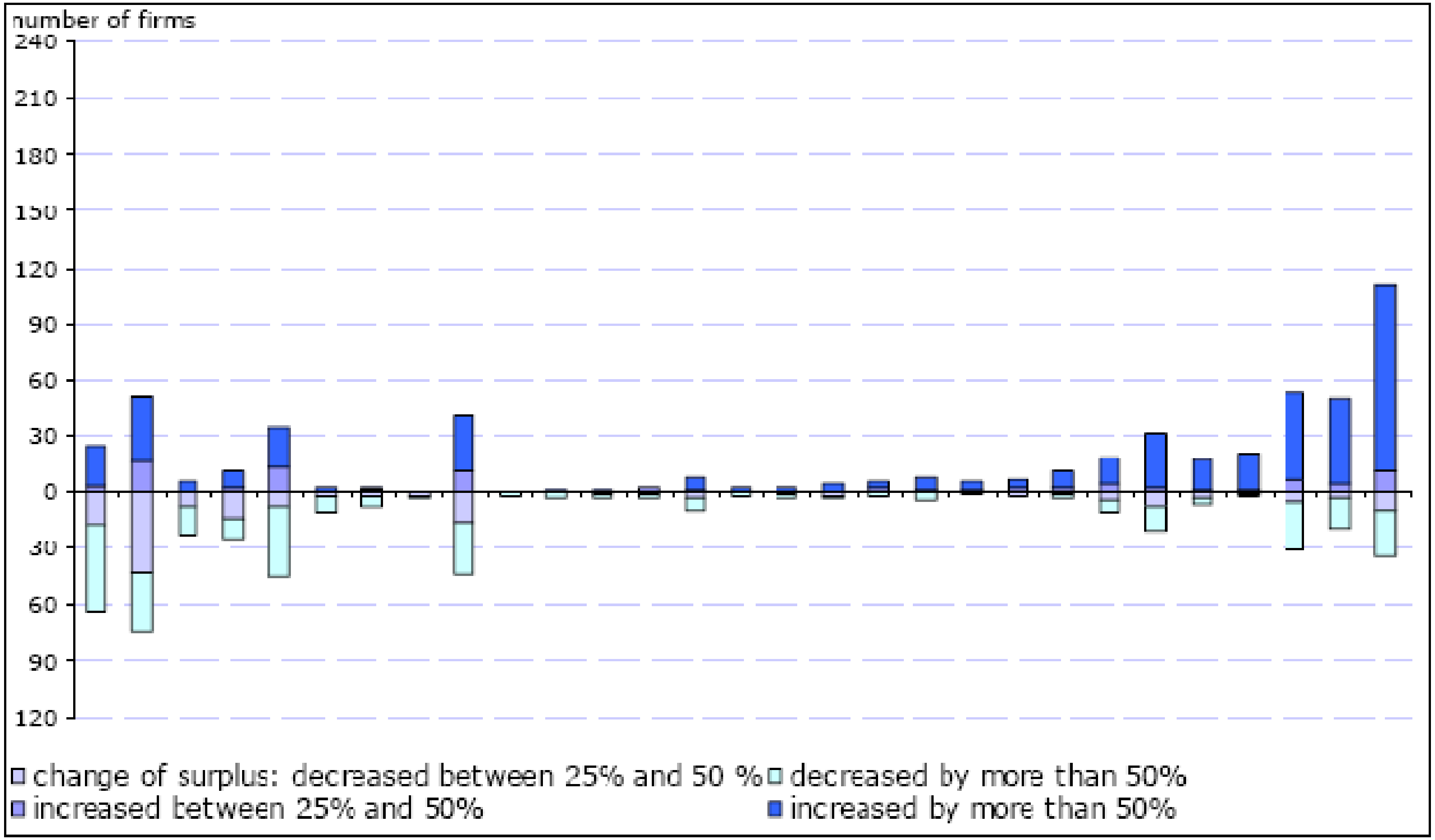
QIS4
Solvency II Ratio / Solvency I Ratio



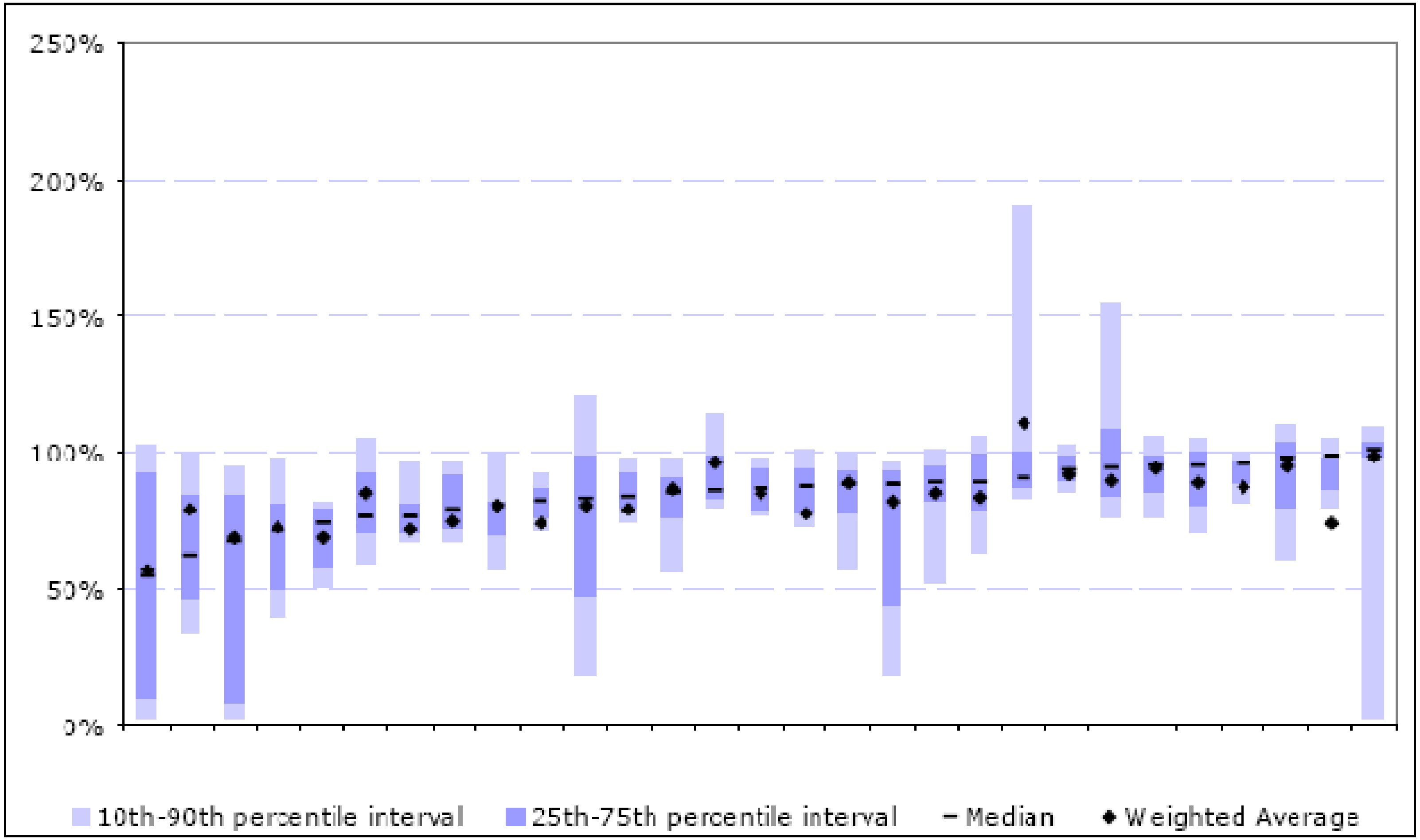
QIS4
Firms not meeting SCR or MCR



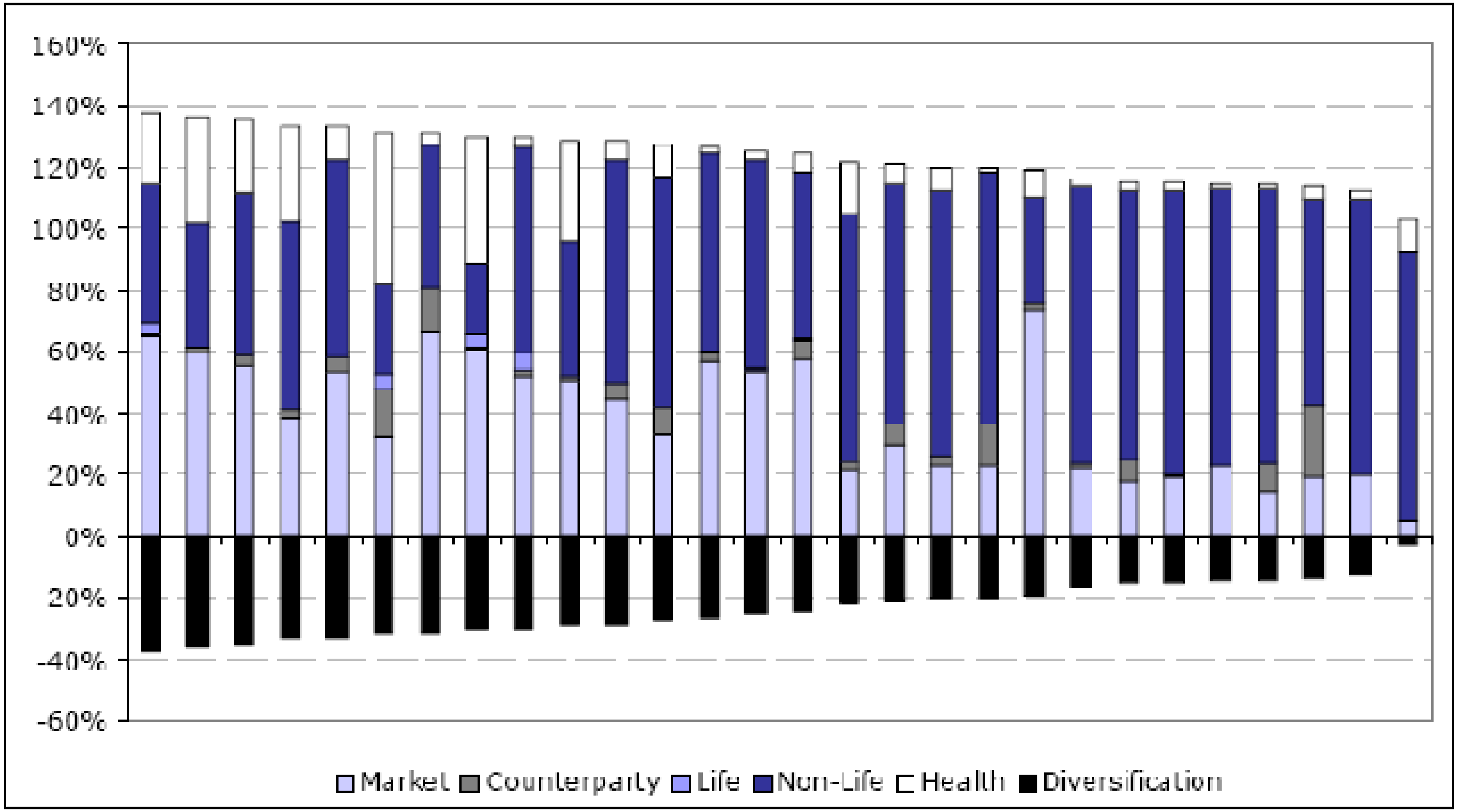
QIS4
Change of Free Surplus from Solvency I to Solvency II



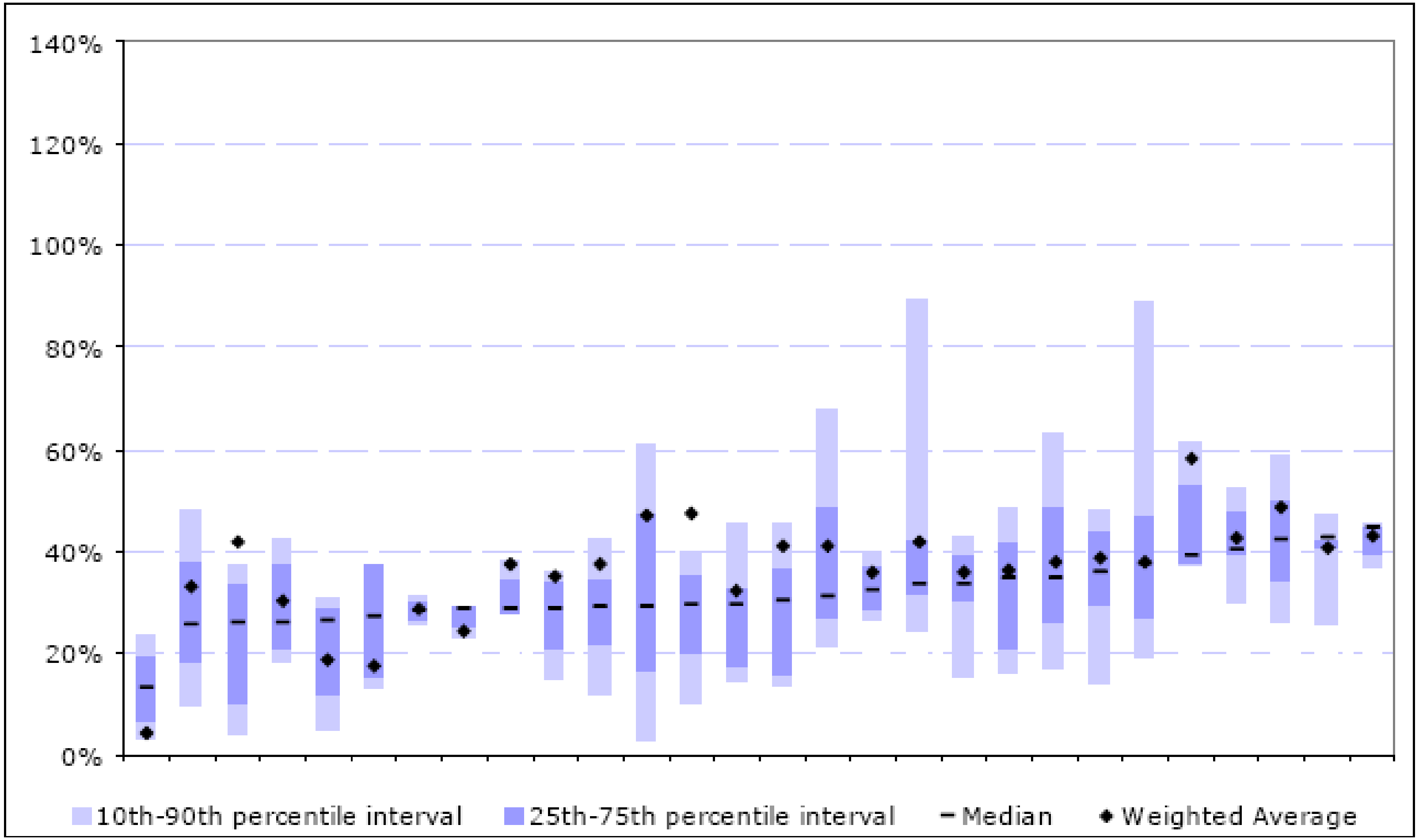
QIS4
Technical Provisions QIS4 / Solvency I: Non-Life



QIS4
Composition of Basic SCR: Non-Life



QIS4
Linear MCR / SCR: Non-Life



Summary

- only affects EU insurers but could change global landscape
- independent of IFRS but consistent in concept
- more specific than IFRS
- may take effect around 2013

Impact in Asia

- disclosures will be a cultural challenge
- less diversification credit
- could reduce competitiveness of some risky classes (eg. EC in HK)
- Singapore
  - aligned with IFRS, monitoring S2 developments and will consider adoption
  - recently strengthened risk management and solvency by way of RBC
- Taiwan
  - regulator made general commitment to international insurance reporting, no date
  - big impact in needing to recognise negative spreads
- HK
  - regulator made general commitment to intern'l insurance reporting, no date
  - no capability to consider Solvency 2 until IA becomes independent

Impact in Asia

- China
  - no formal announcements but following developments
- Australia
  - already adopted principles-based approach, but not Solv II
  - may converge to Solv II but not soon
- USA
  - not committed to S II
  - moving to principles-based capital reporting with similarities
  - currently state-driven, not federal. Makes changes more difficult