

Now for the good news:

Realising the competitive potential of reporting convergence*

November 2008

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Overview: Surer economic footing

Developing a streamlined 'economic' framework for reporting and management information could not only ease the implementation of new reporting requirements, but also enhance decision-making and strengthen stakeholder confidence.

From climate change to financial market turmoil, insurers are facing an increasingly complex and uncertain risk and commercial environment. The pressure on returns is further heightened by capital constraints, volatile asset values, the softening of non-life premium rates and the wider slowdown in the economy.

An effective 'economic' framework for management reporting can help companies develop a more informed, assured and transparent risk-adjusted basis for strategic evaluation and capital allocation. In today's tough business environment, the potential benefits include more effective use of capital and the ability to identify and swiftly take advantage of limited and hard-to-discern opportunities.

An economic approach to strategic planning and performance management is gaining ground within the insurance industry through the implementation of economic capital and embedded value analyses. In June 2008, the European Insurance CFO Forum ('CFO Forum')¹ launched its Market Consistent Embedded Value Principles© (MCEV),² which are expected to set the standard for embedded value disclosure across the insurance industry (see box 'Gauging, conveying and corroborating economic value').

In seeking to convey the prospective value of cash flows on a market-consistent basis, the use of economic frameworks such as MCEV is paving the way for comparable approaches within the planned EU Solvency II and IFRS standard for insurance

contracts (IFRS Phase II). As such, MCEV is road testing many elements of the proposed changes to financial reporting and regulatory disclosure.

The move to a market-consistent approach presents far-reaching implementation challenges, including the need for sophisticated modelling capabilities. Under Solvency II, companies will also need to demonstrate the use of the resulting risk and capital analyses in the management of the business (the 'use test'). In turn, greater transparency could have critical implications for share values and the cost of capital at a time when analysts, investors, regulators and rating agencies are taking an ever keener interest in how effectively risk is managed and integrated into decision-making.

Even where they do not apply,³ these developments are likely to set a benchmark for global disclosure that others may need to follow, particularly in relation to risk. The US Securities and Exchange Commission (SEC) is about to launch consultations on a proposed roadmap for the mandatory adoption of IFRS from 2014. Some eligible firms may be able to switch to IFRS as early as the December 2009 year-end. In turn, the International Association of Insurance Supervisors (IAIS) is promoting a risk- and principles-based approach to solvency regulation around the world.⁴ It is also likely that the prospect of potentially lower capital requirements for groups using internal models under Solvency II may spur their global counterparts to press for a similar risk-based approach to regulation.

Gauging, conveying and corroborating economic value

MCEV provides baseline principles for measurement and disclosure, which have been agreed by CFO Forum members. It should therefore enhance the consistency and comparability of embedded value reporting.

However, some companies may wish to provide further company-specific disclosures that recognise additional earnings over and above the MCEV baseline. This might include their estimate of the future profit stream from spread-based products such as UK or US annuities. Under the MCEV principles, anticipated earnings from such contracts are measured at a risk-free rate, though companies would naturally expect a greater return. Additional disclosure would enable them to convey their estimation of future earnings and their explanation for this projection.

In the wake of recent market events, insurers are also facing heightened analyst scrutiny of managements' own estimation of value. It is therefore important to be able to link MCEV measures and any additional disclosures to how much cash is actually being generated and over what period.

¹ The European Insurance CFO Forum is a high-level discussion group that brings together CFOs from leading European insurance companies (www.cfoforum.nl).

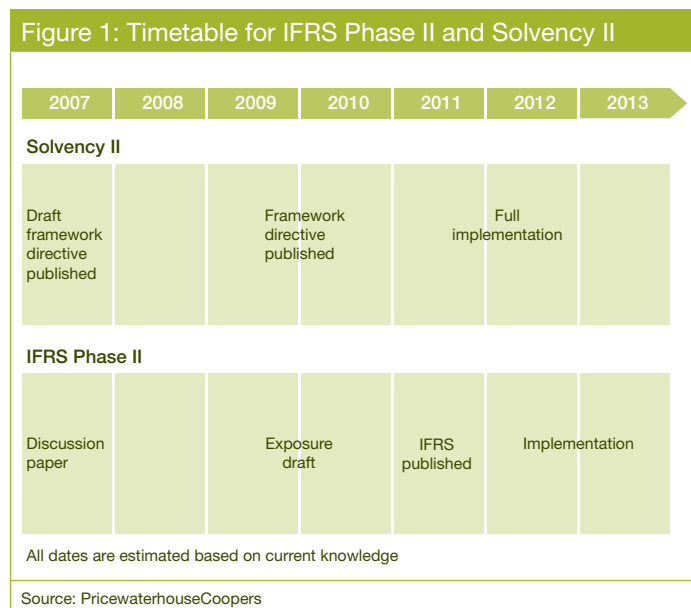
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³ Solvency II will primarily affect insurance firms that operate in the European Union. MCEV is a supplementary basis of disclosure geared to life insurance that will only be mandatory for members of the CFO Forum. Significant parts of the world have not currently adopted IFRS.

⁴ IAIS media release 'IAIS issues key guidance papers on solvency assessment', 22.10.07.

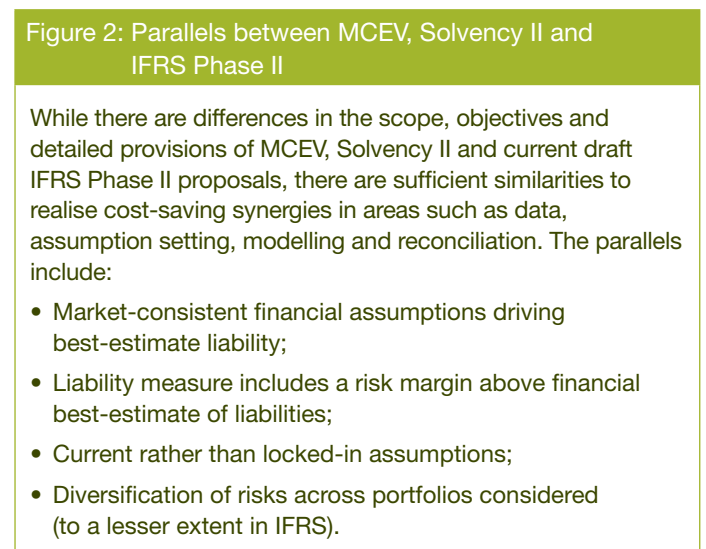
Recent market events have led some to question the risk-based capital approach and the modelling that underlies this under Basel II, a framework which has parallels to Solvency II. The problems experienced by many institutions certainly highlight the need for improvement in a number of key areas, including better use of model outputs, more effective stress testing and a better understanding of liquidity risk. However, Solvency II is likely to be more exacting and sophisticated than Basel II, especially in the Pillar 2 principles for governance and embedding, requirements that have led some to characterise the proposed directive as a 'Basel III'.

Implementation and development of Solvency II and IFRS Phase II are likely to be demanding. The good news is that parallels in the timings (see Figure 1) and bases of valuation



(see Figure 2) could open up cost-saving synergies in areas such as data, assumption setting, modelling and reconciliation. More fundamentally, insurers could use these developments as an opportunity to enhance the quality and consistency of reporting to different stakeholders including management, analysts, investors, supervisors and rating agencies. A key benefit would be the opportunity to strengthen stakeholder confidence by being able to convey a single view of the business that more closely reflects the way it is run internally.

As we outline in this paper, closer alignment between certain risk and finance activities will be critical in meeting evolving reporting demands and developing a more risk-sensitive approach to strategic evaluation and capital allocation.



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The real risk-adjusted return: What is an economic approach and how can it provide a more useful measure of value and performance?

An economic management framework seeks to judge the value of rewards in light of the associated risks and capital required to earn them. The value of the profit should reflect the risk and potential for loss to which an organisation was exposed in generating that return. For example, if the earnings from an investment in a volatile or high-risk business line are failing to beat the return from a lower risk counterpart by an appropriate margin, then the former is clearly not a good bet.

MCEV seeks to provide an economic measure of shareholder value, being the sum of the risk-adjusted future profit stream arising from existing business and the adjusted net worth of the enterprise (the realisable market value of the capital and surplus).

Economic capital seeks to gauge the amount of capital needed to meet policyholder obligations within a given level of confidence, taking account of the risks inherent in the business written. As such, economic capital provides management with a useful measure of how much capital is being tied up by a particular risk or set of risks (the confidence levels can be equated to more tangible credit ratings or one in a number of years' loss probabilities).

While there are therefore important distinctions between MCEV and economic capital, they can be seen as two sides of a performance measurement coin. Bringing the two evaluations together can provide a more telling indicator of performance than many existing formulas.

Performance is typically measured by dividing the profit (numerator) by the required capital investment (denominator). Traditionally, these calculations have not been appropriately adjusted for risk. Examples include statutory or local GAAP profits over rating agency capital.

Dividing the change in MCEV (numerator) by economic capital (denominator) can provide a better measure of the trade-off between risk and reward and therefore how well a particular component of the business is performing; how effectively capital is being deployed and how this equates to an overall risk appetite.

How well developed is this economic approach?

PricewaterhouseCoopers' recent global survey of enterprise risk management (ERM) in the insurance industry found that an increasing number of smaller and medium-size insurers are joining their larger counterparts in implementing economic capital capabilities.⁵ Convergence in the approach used to measure economic capital is also evident from the survey results.

However, most participants recognised that they still have some way to go before they realise the full benefits of implementing an economic capital model. Nearly **three-quarters** did not believe that the output from their economic capital model had gained full acceptance from business units or that it influences day-to-day decision-making. Barely a **quarter** discerned that their economic capital modelling provides substantial value in defining their risk appetite, setting risk limits or improving strategic planning. Looking to the future, however, most respondents were confident that further development of these capabilities would deliver significant value, including better allocation of capital and more effective assessment of the value of different strategic options.

⁵ 'Does ERM matter? Enterprise risk management in the insurance industry 2008', a global study published by PricewaterhouseCoopers in June 2008 (www.pwc.com/insurance).

Taking full account of risk

The development of an economic framework for management reporting could help insurers to steer a successful course through an increasingly tough risk and commercial environment.

Timely and relevant management information capable of providing a balanced perspective between risk and reward can improve an insurer's ability to manage the challenging times ahead. However, the supply of data can often be too slow. As our ERM survey highlighted, moreover, many insurers have yet to fully embed risk considerations into business planning and strategic execution.⁶ In many cases, management information is also based on inconsistent data, assumptions and models across multiple valuation bases, which can diminish its usability and credibility at Board level. Disparities can often result from different areas of the business using separate data feeds, models and assumptions to generate MCEV, IFRS (or local GAAP) and economic capital information.

The advanced actuarial models being developed to map insurers' evolving risk profiles are providing valuable insights. As our ERM survey further highlighted, however, making sure that data, assumptions and model controls are reliable enough to ensure that model analysis is trusted and accepted within the business is proving to be a significant challenge.

An economic framework for management reporting could help companies ensure that decisions reflect the real risk-adjusted returns. It would also enable companies to move from multiple 'versions of the truth' to a more streamlined, consistent and credible basis of evaluation. The result would be a more precise and reliable foundation for risk selection, pricing, reserving and reinsurance strategies. At a time when margins are coming under increasing pressure and the economic slowdown is limiting business development opportunities, an economic approach could also help companies pinpoint openings that may be missed by their competitors and target investment where it can earn its best return.

However, while greater alignment of risk and finance metrics can be helpful, full operational integration of risk and finance would, in our opinion, be a mistake as it may miss the fundamental differences and complementary roles that are essential to the effective running of the business. This includes distinct areas of expertise – financial management in areas such as tax planning, capital raising and financial engineering; actuarial in areas such as pricing, reserving and reinsurance; and risk management in fields such as process improvement and the enforcement of limits and controls. More broadly, effective strategic evaluation requires the ability to formulate and challenge prospective decisions from a range of different perspectives, which may be blurred within a fully integrated approach to risk and finance.

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Understanding the trade-off between risk and reward

Closer cooperation between risk and finance activities in management reporting could help ensure that risk becomes a more visible and telling element of business planning and capital allocation. The overriding aim is the development of common metrics capable of bridging risk and reward (a 'common language'). The potential benefits include:

- Greater application of risk disciplines in key business processes such as strategy, planning and valuation;
- More robust financial plans and projections (e.g. by challenging management to consider ranges of upside and downside outcomes it requires them to better define their appetite for earnings volatility);
- A more coherent and consistent view of the business from risk and finance;
- Reduced costs – both direct and indirect. For example, greater alignment of risk and finance could avoid needless duplication in data management, systems and personnel;
- Better, faster and more robust decisions based on common data.

⁶ 'Does ERM matter? Enterprise risk management in the insurance industry 2008', a global study published by PricewaterhouseCoopers in June 2008 (www.pwc.com/insurance).

Navigating the storm

Insurers are facing the challenge of regulatory developments that will overhaul risk, capital and financial reporting. Leading companies are looking at how to turn the necessary investment to their advantage.

Risk and finance teams find themselves weighed down by a welter of financial statements and regulatory returns. The pressure to meet external reporting deadlines means that the analysis and insight that could support more effective decision-making often has to take a back seat.

The challenges are particularly acute for large international groups. Under current IFRS, national accounting practices for liability measurement have been largely left in place, creating a patchwork of often inconsistent valuation bases for subsidiary and group financial statements. Many companies are also forced to work with a number of potentially incompatible legacy systems, a problem that has been compounded by acquisition and consolidation in recent years. Further complications often stem from an inefficient silo-based approach that demarcates risk, finance and actuarial operations within many companies.

Initially at least, MCEV, Solvency II and IFRS Phase II could heighten the demands on already hard-pressed reporting functions. Key implementation challenges include aligning risk and financial data as part of the market-consistent approach to liability measurement, which is the cornerstone of all three frameworks. Evaluation will require considerable additional risk and financial information and the development of sophisticated and appropriately controlled modelling capabilities. Many international groups also face the prospect of moving from multiple local GAAPs to a single harmonised financial reporting standard.

The overriding aim of IFRS 7 'financial instrument disclosure' is to enable users of accounts to look at the risks insurers run and their potential impact on the business through the 'eyes of management'. As such, this standard could be seen as a forerunner of the 'use test' that will form part of Solvency II, under which insurers will be required to demonstrate that their publicly disclosed risk and capital evaluations are fully embedded into business planning and capital allocation (see box 'Using an internal model under Solvency II'). Comparable

requirements already exist within many rating agencies' financial strength evaluations (see box 'Rating agency financial strength evaluation'). If companies are not using economic capital for IFRS 7 then by definition they are not using it for management of their business and would therefore be likely to fail the Solvency II use test.

Raising the bar part one: Using an internal model under Solvency II

Under Solvency II, insurers can seek approval for use of their own internal model in calculating their solvency capital requirement. Approval depends on their ability to demonstrate that they meet six key tests:⁷

- **Use test:** Senior management needs to understand, endorse and use the risk and capital evaluations from the internal model as a key basis for its business planning and strategic decision-making.
- **Statistical quality:** Evaluations need to be based on timely, reliable, consistent and comprehensive risk data and be underpinned by current, credible and verifiable risk assumptions.
- **Validation:** Evaluations and underlying assumptions need to be regularly sense-checked against actual experience.
- **Calibration:** Outputs need to be calibrated to a 99.5% value at risk (VAR) or equivalent measure and benchmarked against market practice.
- **Attribution:** Companies need to regularly check whether the categorisation of risk and attribution of profit/loss in their models reflect the causes and sources of profit/loss within business units.
- **Documentation:** Companies need to keep regularly updated records covering the design, operation, mathematical basis and underlying assumptions of their model.

⁷ Solvency II amended draft framework directive, published by the EC on 26.2.08.

Raising the bar part two: Rating agency financial strength evaluation

Assessment of an insurer's ERM capabilities and related risk-based capital is now an increasingly significant element of rating agencies' financial strength evaluations. Recent market events are likely to accelerate this trend.

The approaches being developed by the different rating agencies vary from an explicit score for ERM to its implicit incorporation into the overall ratings assessment. However, all the methodologies seek to gauge whether the entity is holding sufficient capital to match its risk profile, its risk appetite and the relative rigour of its risk management, which is an approach that has parallels with economic capital. Rating agencies are also looking at whether risk considerations are integrated into decision-making and whether the risk analysis that underpins this is sound, an approach that mirrors the use and other key tests built into Solvency II (see box 'Using an internal model under Solvency II'). Standard and Poor's has now taken this approach further by offering to assess a selected number of insurers' economic capital models,⁸ a move that highlights the growing importance of external validation in demonstrating effective economic management to stakeholders.

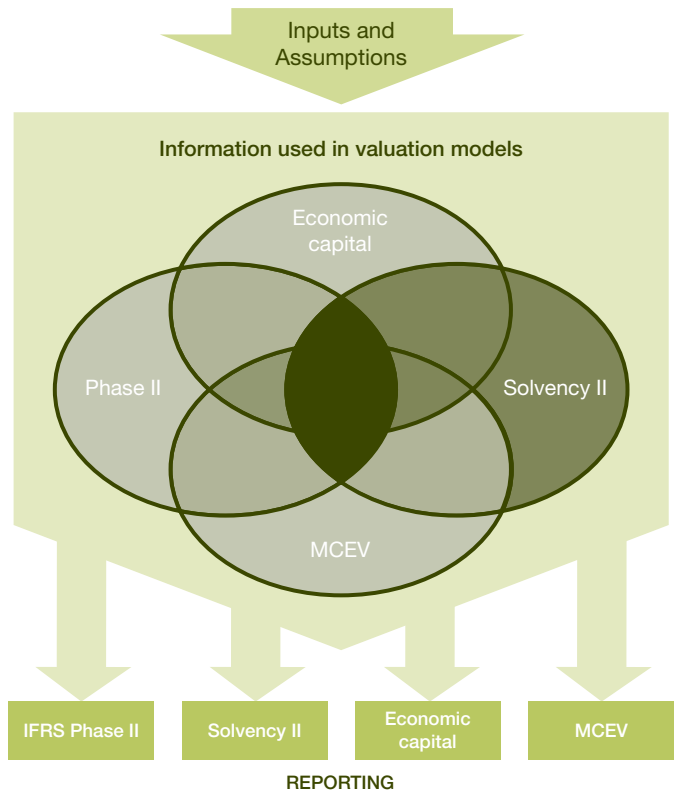
Potential synergies

Common data and systems requirements underpin much of the necessary information that will be required under Solvency II and IFRS Phase II (see Figure 3). Exploiting these synergies will allow insurers to avoid some of the costs, duplication and potential disruption of applying and managing the frameworks separately. By streamlining and improving the efficiency of the reporting process, risk and finance teams will have more time to provide valuable input into business and strategic decisions.

The move towards an economic basis for external reporting provides companies with a powerful impetus to do the same for management reporting, especially as they will need to demonstrate to regulators and rating agencies that risk awareness is embedded within the fabric of their business. Convergence of management reporting around a central economic basis could also enhance market confidence by enabling insurers to convey a single view of their business that reflects the way it is run internally. This would be an important step forward for a sector whose reporting has often been regarded by analysts and investors as opaque and with too many bases of reporting to be intelligible. The potential benefits of these changes include share values that more genuinely reflect the true performance and potential of the enterprise.

Figure 3: Developing the common model

- Data underpinning the accounting models will be common, but
- Need to understand the different outputs that data need to populate



Source: PricewaterhouseCoopers

'By streamlining and improving the efficiency of the reporting process, risk and finance teams will have more time to provide valuable input into business and strategic decisions.'

⁸ Standard and Poor's 'Ratings Direct', 15.05.08.

Making it happen

Developing an effective economic reporting framework requires careful planning and coordination, underpinned by a clear and realisable vision of what companies expect to achieve.

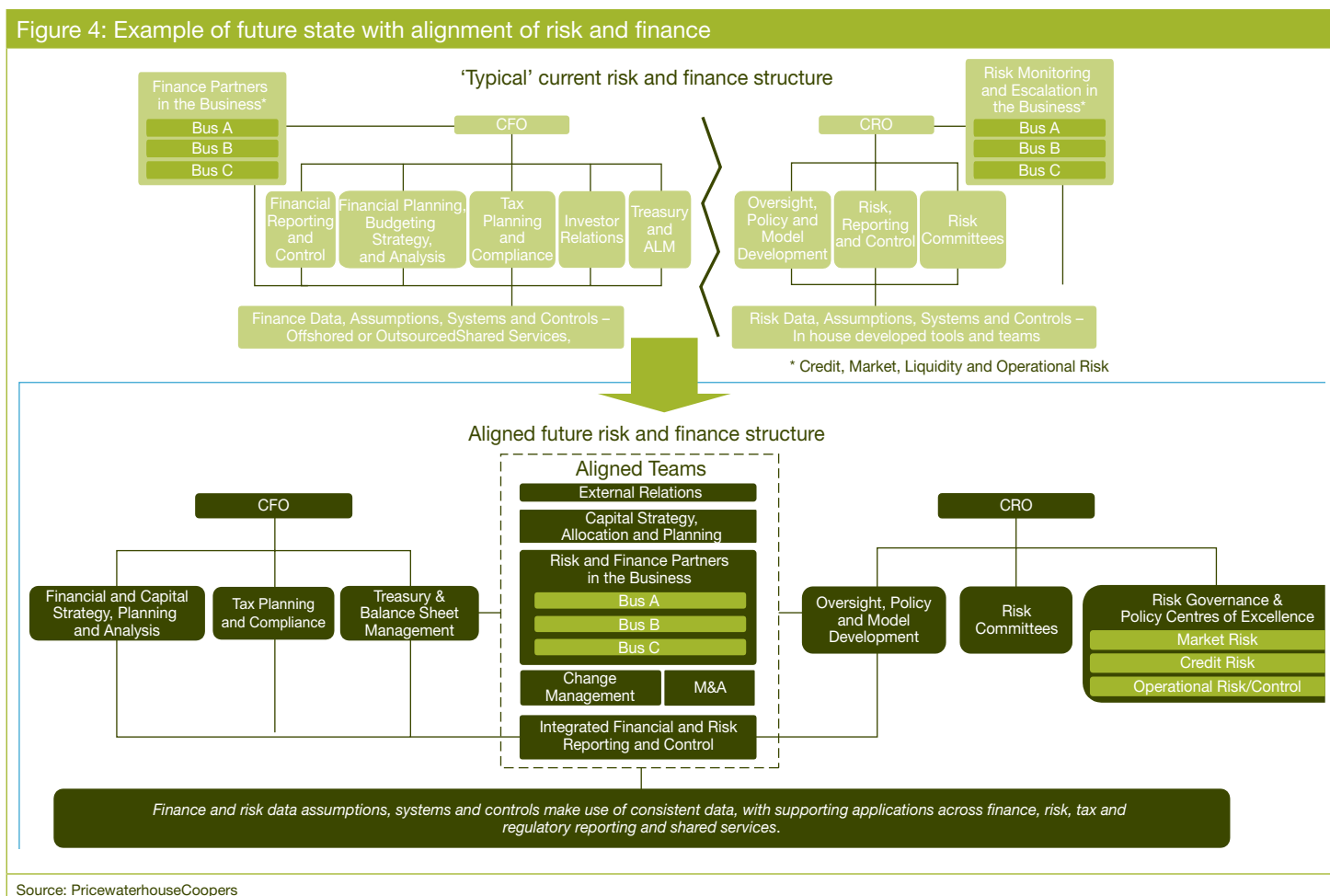
In moving to an economic footing, insurers clearly need to work within the constraints of cost, organisational structure and ever more pressing implementation deadlines. The assessment of what is achievable and how it can be achieved should ideally be underpinned by thorough gap and cost-benefit analyses covering such areas as data supply, systems capacity, model control and the availability and training of key personnel. The resulting framework needs to balance management requirements and stakeholder expectations, while articulating how the business will be managed in the interim to minimise potential disruption.

Banks' experience of implementing Basel II offers important lessons for insurers. In particular, many institutions underestimated the scale of the task – not only in developing appropriate systems, but also in ensuring that they were embedded into governance and decision-making structures, a key aspect of the use test. In some cases, this meant that ambitious plans for the accreditation of internal models had to

be shelved in favour of straightforward compliance. Moreover, systems were often designed and developed by technical teams in isolation from the wider organisation. Business units need to be involved in planning from the outset to help win their buy-in and ensure that the resulting systems provide useful information that can help enhance their decisions and deliver competitive value.

Laying the foundations

Close alignment between risk and finance functions is the bedrock of an economic approach. Achieving better alignment rests on the standardisation and simplification of the reporting, control, modelling, transactional and data elements of risk and finance, alongside enhanced efficiency through shared services and data warehousing. Figure 4 outlines how this alignment of risk and finance might be structured in practice on governance structures, as well as capital requirements.



Identification and prioritisation of the key steps will clearly be crucial ('establishing a critical path'). For example, the quality of data and validity of assumptions are essential in ensuring the accuracy of models and would therefore need to be addressed before bringing any newly developed or upgraded models on line.

As part of the operational manifestation of an economic approach, effective ERM can help insurers develop consistent firm-wide procedures for risk identification, measurement and monitoring ('informing the input') and ensure that risk limits and controls reflect the risk appetite and overall strategic objectives of the business ('enforcing economic behaviour').

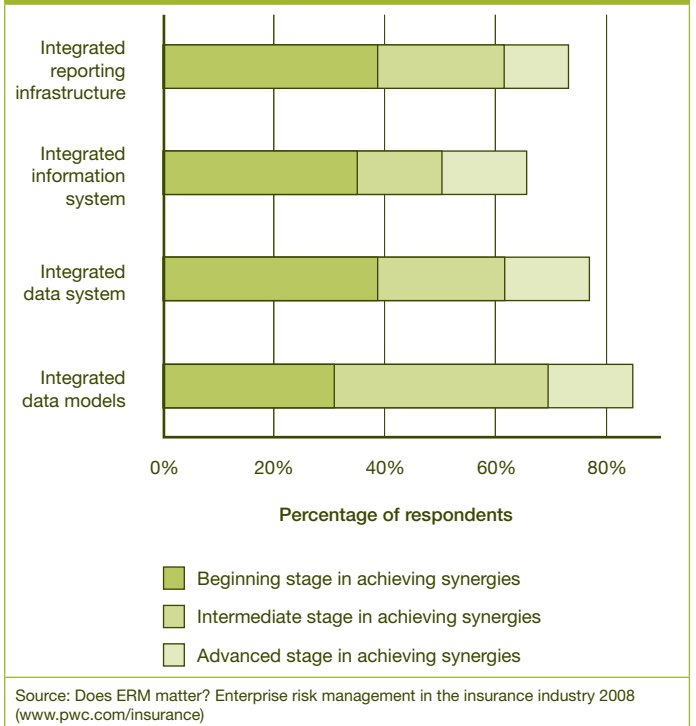
Embedding this risk-adjusted economic approach into the business will require risk teams to be involved in decisions from the outset, and an appropriate tone from the top to ensure that effective risk management is a priority. It may also require significant changes in the way performance and related bonuses are judged. In many companies this will require a shift away from targets based on top-line and one-year combined ratio results towards risk-adjusted criteria and long-term growth in shareholder value. In an interview with the BBC in September 2008, Stephen Green, Chairman of HSBC, stressed the importance of ensuring that 'remuneration schemes operate in a way that is lined up with the long-term interests of the owners of the business. There has been far too much focus on payments that are very short-term focused, people who pick up the tab for short-term profits, without having to bear the costs of long-term impairments.'⁹

How aligned are risk and finance currently?

Alignment can be demonstrated in a number of ways, but one of the key barometers is the consistency of the metrics between risk and finance. However, our global ERM survey revealed that only around a quarter of respondents were confident that they have an efficient basis to link risk with other financial information.

Nonetheless, greater alignment does appear to be moving up the agenda. Over 60% of respondents expect to leverage the development of capital and risk management practices with the requirements of Solvency II and IFRS Phase II. Further, most respondents expect to realise synergies between financial and regulatory reporting in areas such as data modelling and reporting infrastructure. Nonetheless, most participants are only just beginning to achieve these anticipated synergies (see Figure 5).

Figure 5: Areas where companies are looking to exploit the synergies between financial and regulatory reporting



⁹ BBC News 'Leading Questions', 13.09.08.

Weighing up the options

The challenges and corresponding opportunities presented by MCEV, Solvency II and IFRS Phase II can be divided into three components:

Systems and organisation:

Enhancing the speed, efficiency, consistency and cost-effectiveness of the reporting process

Management reporting:

Providing a basis for more informed and assured decision-making

Stakeholder relations:

Developing more credible, intelligible and comparable disclosure

Some insurers may prefer to watch and wait until details of Solvency II and IFRS Phase II are approved. However, what is likely to be a brief timeframe between finalisation and implementation could make this a high-risk option. Any delay or under-estimation of the impact of these changes could also exacerbate an already stressed reporting environment and lead to potential meltdown in the longer term.

A tactical approach that seeks to overlay compliance with the new requirements onto existing systems may be a cost-effective option for some smaller and less complex businesses. However, reliance on 'band aids' to patch up key gaps and weaknesses may lead to error and confusion during the transition, especially within larger companies. A piecemeal silo-based approach may also lead to duplication and inefficiency, while making long-term application costlier and harder to sustain.

Many forward-looking insurers are therefore adopting a more strategic approach, which aims to streamline their reporting infrastructure as part of a holistic move to a common economic management framework. The potential benefits include removing the need for separate models and processes and using investment that will be required anyway as a catalyst for strengthening the quality of management information and decision-making.

In a rapidly evolving and increasingly tough business environment, the potential competitive advantages include the ability to strike a more sustainable balance between risk and reward, more efficient use of capital and greater assurance for the Board and financial markets.

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- 'Gearing up to Solvency II: Making Solvency II work for the business', September 2008
- 'Does ERM matter? Enterprise risk management in the insurance industry – a global study', June 2008
- 'Countdown to Solvency II – bridging risk and capital', May 2008
- 'Getting closer to the finish line? Insurance contracts accounting under IFRS', March 2008

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