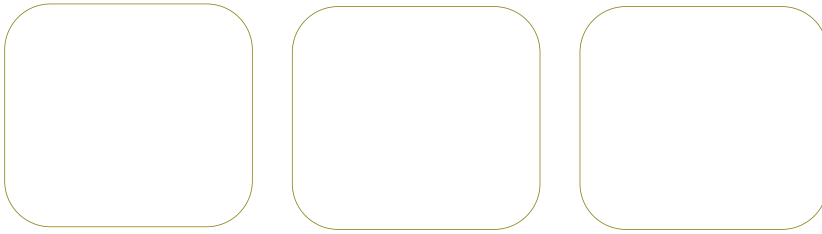


IFRS and Solvency II – perfect marriage or double whammy?



IFRS – Global Reporting Revolution

April 2003



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The IFRS Revolution

Welcome to the eighth in a series of papers dedicated to discussing International Financial Reporting Standards and the impact on the insurance industry. IFRS is much more than just a technical issue and, based on the current proposals, will result in fundamental changes to the way in which the industry does business. Recognising this, the Global Insurance leadership team of PricewaterhouseCoopers is sponsoring a programme of client seminars and briefing papers on the key commercial and technical challenges, delivering information the industry needs to respond to the IFRS revolution.

This paper considers how two major change drivers, IFRS and Solvency II, might be brought together to reduce the different systems management has to monitor and operate.

I hope that you find this paper thought-provoking and insightful. If you would like to discuss any of the issues addressed in more detail, please speak with your usual contact at PricewaterhouseCoopers or those listed at the end of this paper. We would also appreciate your feedback on this paper, as this helps us to ensure that we are addressing the issues that you are most focused on.

Ian Dilks
Chairman, European Insurance Group

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Introduction

The current agenda in the European Union – with the European Commission’s Financial Services Action Plan (FSAP) and the adoption of IFRS in 2005 – presents some major challenges for insurance companies. New approaches to the supervision of insurance groups and financial conglomerates, and an EU passport for insurance intermediaries, will drive changes to the way in which insurance businesses are managed in Europe in coming years. The most dramatic FSAP-inspired changes, however, are likely to come from the revision of the solvency regime for insurance companies, dubbed ‘Solvency II’. The introduction of two new and radical regimes may provide a rational and coherent way forward for insurers to run their finances, the perfect marriage. Alternatively, the two regimes may prove to be inconsistent and over-ambitious, leaving finance functions unable to cope, the double whammy.

Insurance companies are currently beset with a wide array of challenges, not least falling equity markets, the rise of consumer protectionism (as evidenced by the UK’s 1% proposal and the market conduct rules emanating from the International Association of Insurance Supervisors (IAIS)), declining profits and the need to manage credit rating agencies. Responding to these multiple challenges is stretching management to the limit.

However, perhaps the greatest pressure comes from the lack of a coherent view of insurance finances and how the financial structure of the company as a whole can be assessed and, even more importantly, managed.

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The position for insurers is further complicated because some insurance business falls outside the scope of the proposals. This is due to some contracts not including ‘significant’ insurance risk. Consequently, these contracts need to be accounted for as financial instruments under IAS 39. Under IAS 39, however, there is the option to adopt the ‘effective interest rate’ method for these ‘investment contracts’ (which is a passive retrospective accumulation of premiums) rather than the fair value approach. IAS 39 also allows certain options and guarantees to be ignored.

The mixed measurements between the insurance proposals and IAS 39 have led to complexity and also scope for accounting arbitrage. Fundamentally, it means that, for IAS 39 contracts, the technical provisions in the accounts of an insurance business are not necessarily the same as the amount that would be required to transfer away the liabilities.

provisions for liabilities would contain some margins to reflect how the market would value adequate compensation for the uncertainty inherent in underwriting the liabilities. These ‘market value margins’, however, may not be prudent enough for the regulators who would like to ensure that liabilities would be covered in most – foreseeable – adverse situations.

The IASB proposals are proving controversial for a number of reasons, not least the inevitable volatility that would arise because insurers would be unwilling or unable to match exactly the fair values of the assets and liabilities. On the other hand, there is considerable support for the proposals because of the increasingly transparent, if somewhat transient, view of the financial progress of the insurer’s business they would provide. Supporters argue that not only shareholders but also policyholders would be able to see more clearly the extent to which an insurer was making profits and hence strengthening, not eroding, prudential capital.

The impact of IFRS

National GAAP is diverse and often less than relevant for international companies. From a European perspective, the improved transparency necessary for a functioning single market relies, to a significant extent, on harmonised accounting rules. Although insurance business is currently largely excluded from the coverage of the International Financial Reporting Standards, the requirement for EU listed companies, including insurers, to meet IFRS standards on a consolidated basis in 2005 has given focus and momentum to the IASB to develop a standard for insurance.

The IASB proposals suggest that insurance business should follow broadly a ‘fair value’ approach – fair value being the value a purchaser would require in order to take certain liabilities from the original insurer. This obviously would necessitate prospective realistic assessments of the value of the liabilities, including marking to market any financial or insurance options. Technical

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Market value margins

Market value margins reflect the market's view of the additional cost which would need to be charged to cover the uncertainty of taking on insurance liabilities from another insurer. There are different approaches as to how such margins might be quantified. One approach is to set the market value margin equal to the cost of the capital an insurer would need to hold to ensure that liabilities would be honoured with a reasonably high level of probability. For example, if an insurer wanted to be 'AA' rated, the insurer would need to allocate a certain amount of capital to back any new portfolio of liabilities to ensure the rating agencies continued to grant it an 'AA' rating. The cost of maintaining this additional capital is the extra margin that an insurer would want to receive in order to take on the liabilities.

Based on this logic, the market value margin will be lower if the risks in the portfolio are well managed and less capital is required to reach the target credit rating. This means that risk management and measurement both determine the market value margins and points the way towards how the margins can be kept to a minimum. Clearly the IFRS proposals are closely and directly linked to the risk management of the insurer. This is key to developing the coherent financial link to prudential supervision.

Key issues around Solvency II

There has been much discussion over the direction that the Solvency II project – aiming to provide the next generation of solvency management for EU insurers – should take. Recently, a consensus has been taking

shape around the adoption of a 'three pillar' approach, reflecting the Basel Committee proposals for the banking industry. The European Commission's working paper, released in December 2002, acknowledges this consensus.

The 'three pillars' adopted for the insurance industry would not be identical to those of Basel II. **Pillar 1** would establish a basic minimum capital requirement. **Pillar 2** would encourage proactive solvency management, recognising amongst other things that both insurers and regulators need to consider a wide range of possible adverse circumstances in their financial management. The **third pillar**, like Basel II, would emphasise disclosure, requiring that the insurer publicise its approach to the financial management of the business. Each of the three pillars will be affected by the risks that an insurer writes.

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In other words, if liabilities exceeding assets in the financial accounts can be seen by the prudential regulators as the final trigger level in their range of intervention options, then policyholders and shareholders are more likely to understand the rationale for the regulatory regime. Further, if the accounting provisions are expressed as the amount at which the insurer can transfer away its obligations then the regulatory regime can take the practical step of requiring an insurer to transfer its obligation to another, stronger, insurer if the assets fall to equal the level of the liabilities.

Bringing together the IFRS and Solvency II projects

As argued above, both IFRS and Solvency II projects need to be consistent with the risk management of the insurer. The IFRS proposals require market value margins. It can be argued that market value margins reflect

The ‘three pillar’ approach does not depend directly on any particular accounting measure as its minimum capital requirement is calculated on the basis of the total risks in the portfolio of liabilities, not just on the risks in excess of those covered by the accounting provisions. Indeed, as noted above, the latest proposals for IFRS for insurance business represent a mix of prospective and retrospective measurement and as such are not very suitable to reflect the risks in the business.

Nevertheless, the ‘three pillar’ approach, as with all solvency regimes, is indirectly dependent on the basic accounting measures. Asset values, and basic information on liabilities, are needed for the solvency regime. If these amounts are already subject to audit, greater assurance is provided to the solvency system. It is also very helpful if the regulator’s view of ‘insolvency’ is consistent with the accounting view.

The basic capital required by Pillar 1 will reflect the risks the insurer runs while Pillar 2 encourages a proactive attitude to the management of those risks. Pillar 3 will allow commentators to compare the approach that different insurers are taking to risk.

An insurer with a greater appetite for risk should carry a higher capital requirement for the same credit rating. A regulator’s minimum requirements for an insurer might be seen as a form of minimum credit rating (albeit not necessarily expressed as a particular rating). The insurer would be able, of course, to target a higher credit rating than the minimum required by the regulator if this served its corporate aims. If such a higher target were publicised, then the insurer would need to ensure it maintained the appropriate risk management and level of capital to support its claims.

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the cost of the capital requirements needed to support the insurer's target credit rating. The current proposals for Solvency II would allow insurers to run their internal capital regime to achieve a target credit rating, provided this is higher than the basic capital requirement, which acts as a form of minimum credit rating.

If, then, the IFRS regime and the Solvency II regime were to work towards the same target credit rating, as selected by the management, the systems would be consistent and coherent. Moreover, if the pricing of the products incorporated the same market value margins as the IFRS provisions, not only would the policies service the insurer's capital requirements but also the financial framework would be economically viable.

This approach assumes that the IFRS provisions and the Solvency II capital measures depend on

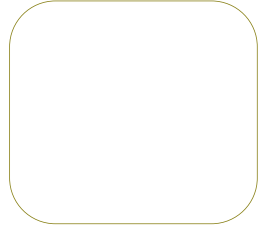
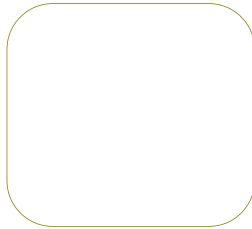
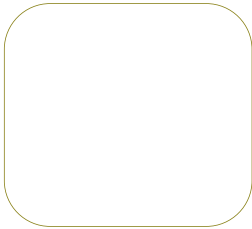
the same cashflows and on the same set of assumptions about the insurer's future experience (albeit the assumptions need to be stochastic; that is, they need to consider a wide range of possible future experience and to attach probabilities to those ranges). Theoretically this is achievable. However, in practice, it requires sophisticated systems and extensive data on which to base the projections. There are a significant number of practitioners who believe the techniques will take many years to perfect and are, in any case, unsuitable for smaller companies without access to adequate expert resources.

The mixed model for insurance business accounting being offered by the IFRS also hampers this approach. A solution would be for regulators to require insurers to prepare a set of accounts for prudential supervision purposes based solely on the proposed IFRS 'fair

value' approach. If, for convenience, the insurer also chose to report both its insurance and investment contracts under IFRS using the same 'fair value' approach, as is allowed under IAS 39 as well as under the IFRS proposals, then the insurer would gain the advantage of only needing to produce one set of accounts. The downside would be that the accounts would be potentially subject to greater volatility than they would using a mixed measurement accounting approach. It would also imply that IFRS would need to be applied to both listed and unlisted companies.

One further consequence of the coherent approach outlined above is the greater alignment of the views of rating agencies and regulators, since a re-rating of debt or equity would imply potential problems with risk management practice.

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Conclusions

It is possible to bring together the IFRS and Solvency II proposals provided that both are implemented consistently with the insurer's risk management regime. However, this perfect marriage comes at a cost. The accounting regime would need to be based on the fair value method for both assets and liabilities, which in turn brings different drawbacks. The marriage is also dependent on the definition of market value margins allowing an insurer to reflect its target creditworthiness.

If such a system were achievable it would have the additional advantages that the regulator would, in theory at least, be able to find a buyer for the portfolio of a failing insurer at something close to the accounting value and would be alerted to problems by a downgrading in an insurer's credit rating. While theoretically desirable, such a system would in practice take considerable time, effort and expert resources to achieve. What might prove a perfect marriage for the largest insurers could be a double whammy for the smallest.

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If you would like to discuss any of the issues raised in this paper, please speak with your usual contact at PricewaterhouseCoopers.

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