



INSURANCE

Transparency between Solvency II and IFRS phase II exposure draft

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ADVISORY

Operational objectives of Solvency II

Number 8

- Promote compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB

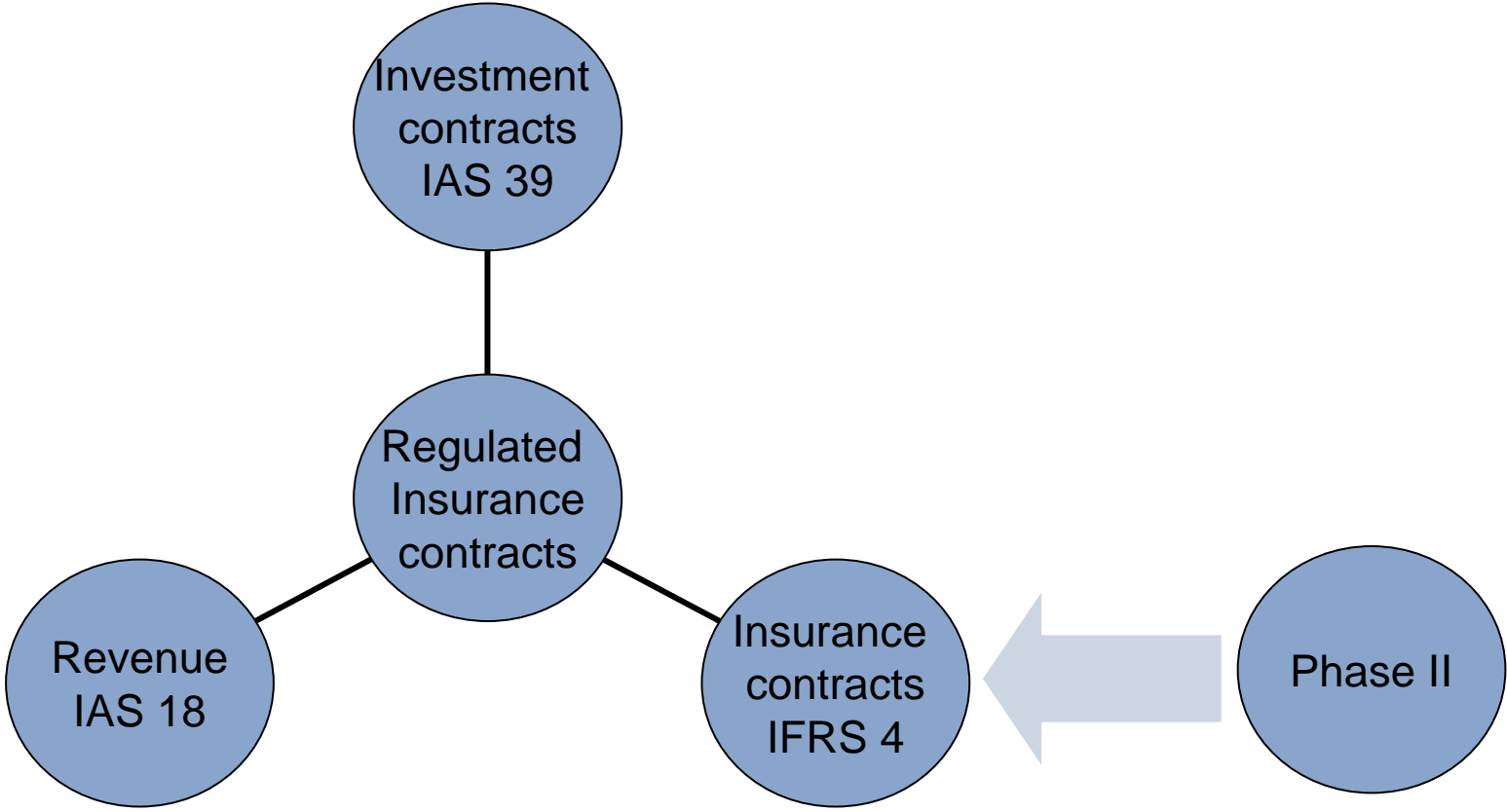
FAQ to QIS 3: number 31 (of 44)

- “The new solvency framework only covers prudential valuation rules and not accounting. That said... care has been taken to ensure that the valuation rules ...are compatible with international accounting developments. In particular, the valuation rules are based on the concept of market consistency.”

Contents

- Background
- Solvency II links with accounting developments
- Valuing liabilities on present value basis
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Main IFRS applicable to insurance contracts

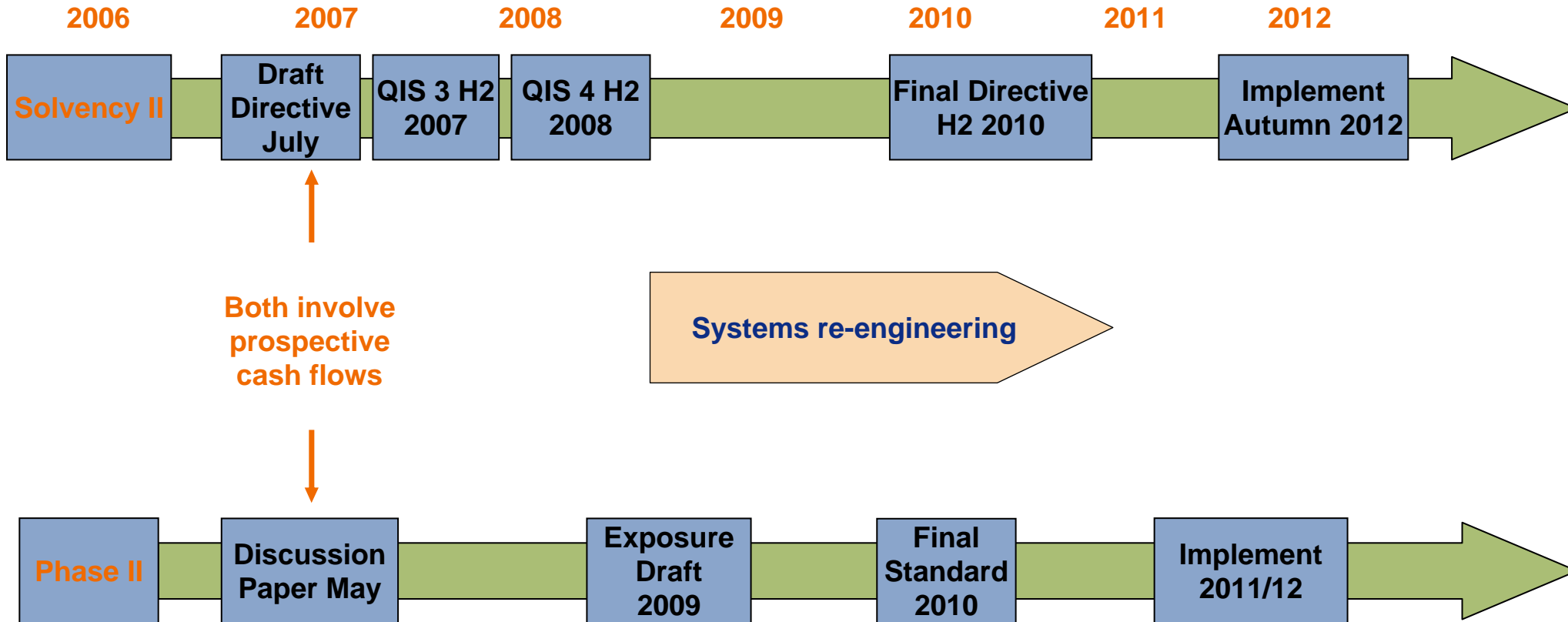


Source: KPMG

Background to Insurance Contracts Phase II

- Phase I = IFRS 4
 - Investment contracts under IAS 39
 - Grandfathering of existing insurance contract accounting policies
- Phase II = new insurance contract requirements
 - Fundamental changes to measurement and disclosure requirements:
 - Single measurement model
 - Prospective valuation
 - Based on concept of a market participant (exit value)
 - Recognition of some future premiums and profits on inception

Timelines



Source: KPMG

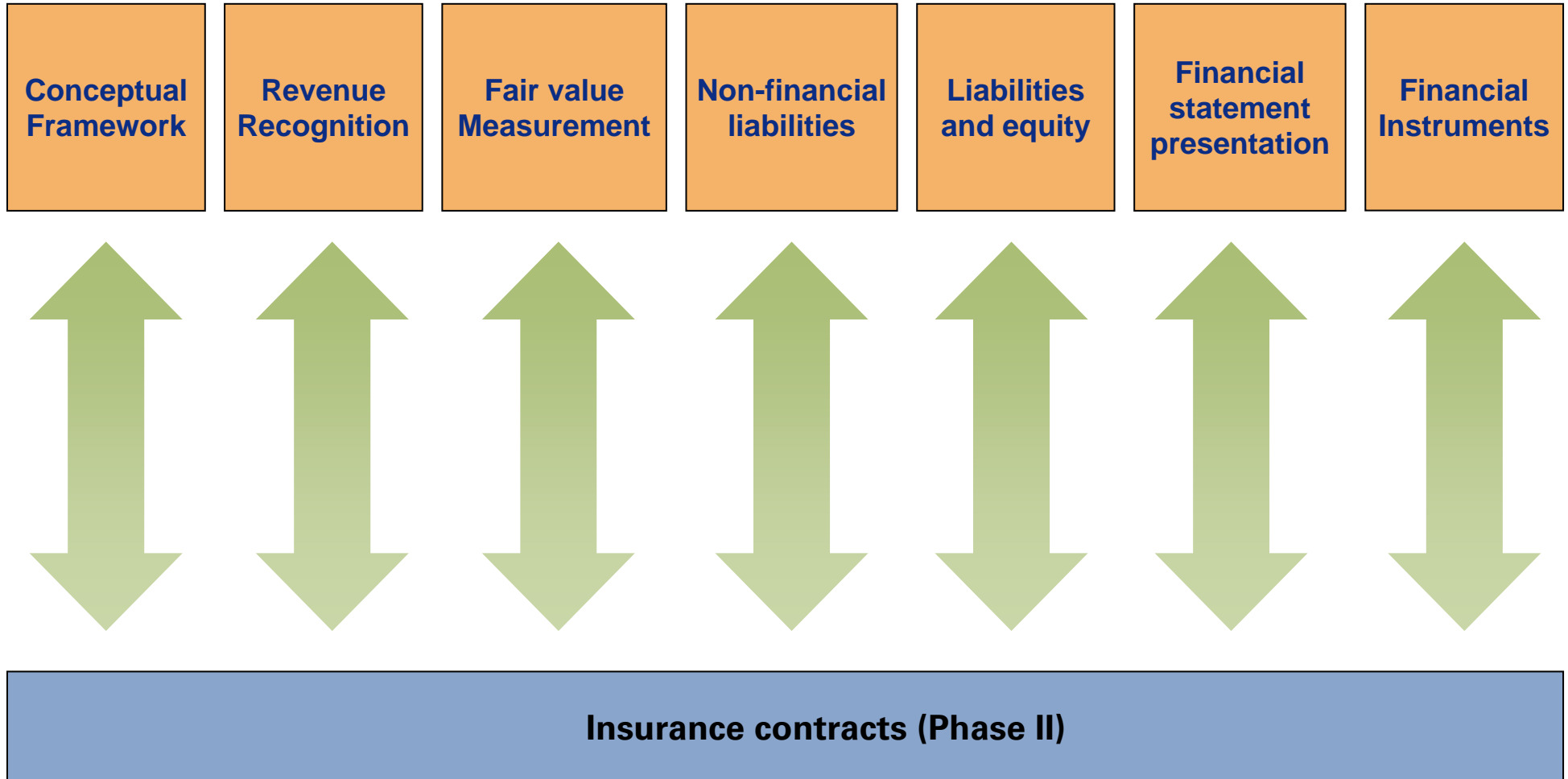
Scope comparison

- Phase II: only insurance contracts, as defined
 - and contracts with discretionary participating features
- Solvency II: all 'regulatory' insurance business
- MCEV: all life business
 - could potentially include mutual funds and service companies

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Other relevant IASB projects

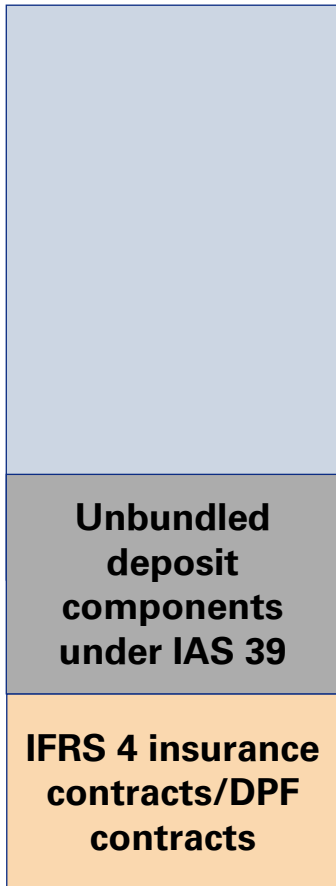


Source: KPMG

Differences in Liability Measurement

Phase II, Solvency II and MCEV

Phase II



Solvency II



MCEV



Different populations of contracts

- Phase II comprises only insurance contracts, as defined (and contracts with discretionary participating features)
- Solvency II comprises all 'regulatory' insurance business (which will include investment contracts)
- MCEV comprises all life business (and could potentially include mutual funds and service companies)

Will there be a future need for MCEV?

- There may be a reduced need for MCEV reporting as IFRS numbers should be consistent from company to company and from country to country

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Common building blocks



A: Cash flows

- Explicit, unbiased, current estimate
- Probability-weighted net present value of future cash flows
- Arising from contractual and constructive obligations
- From a market participant's view

B: Discounting

- Current market rate

C: Margins

- Explicit, unbiased estimate
- From a market participant's view
- For bearing risk and providing other services

Block A: Cash Flows

Solvency II

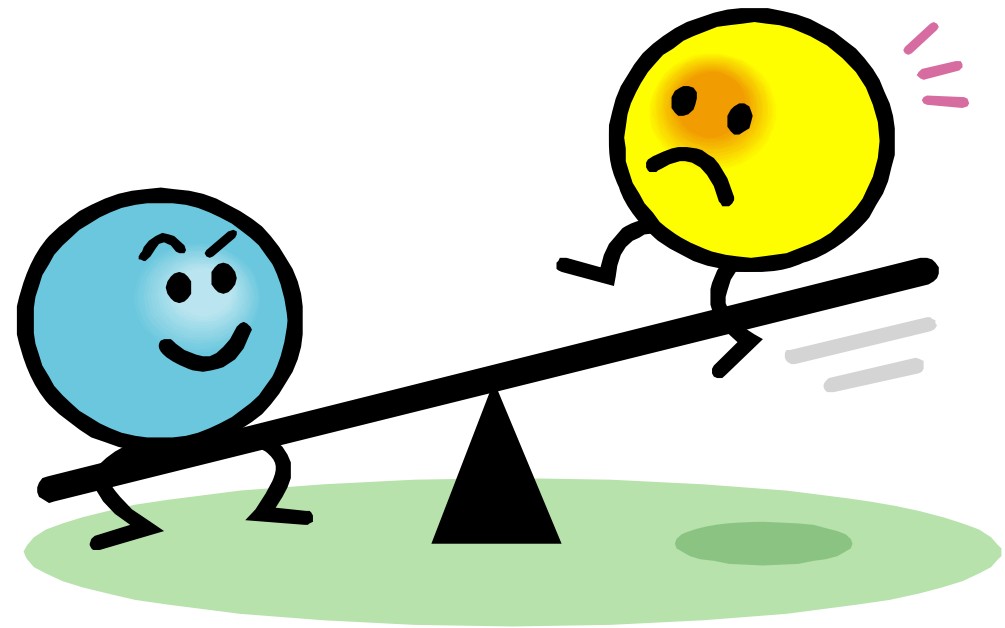
- All future cash flows required to settle insurance obligations
- Realistic assumptions
- Actuarial methods

Phase II

- From contractual and constructive obligations only
- Market-consistent assumptions
- Scenario based

Both

- Identification of market participant



Solvency II

Phase II

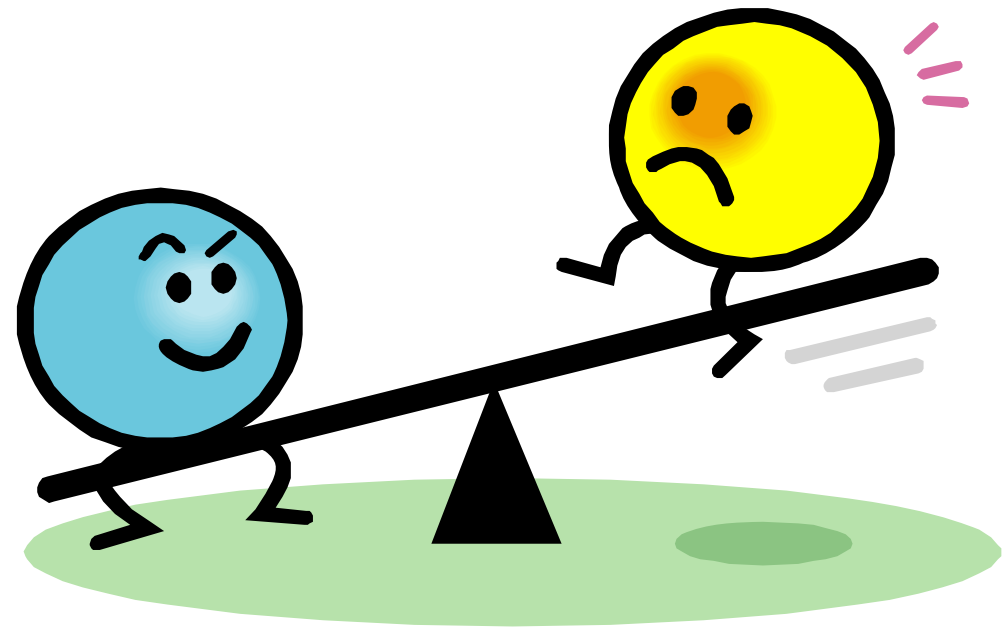
Block B: Discounting

Solvency II

- Risk-free rate yield curve based on the liability concerned
- No adjustment for own credit standing

Phase II

- Consistent with observable current market prices
- Reflect credit characteristics of the contract
- Asset based rate only for cash flows that depend contractually on flows from matching assets



Solvency II ?

Phase II ?

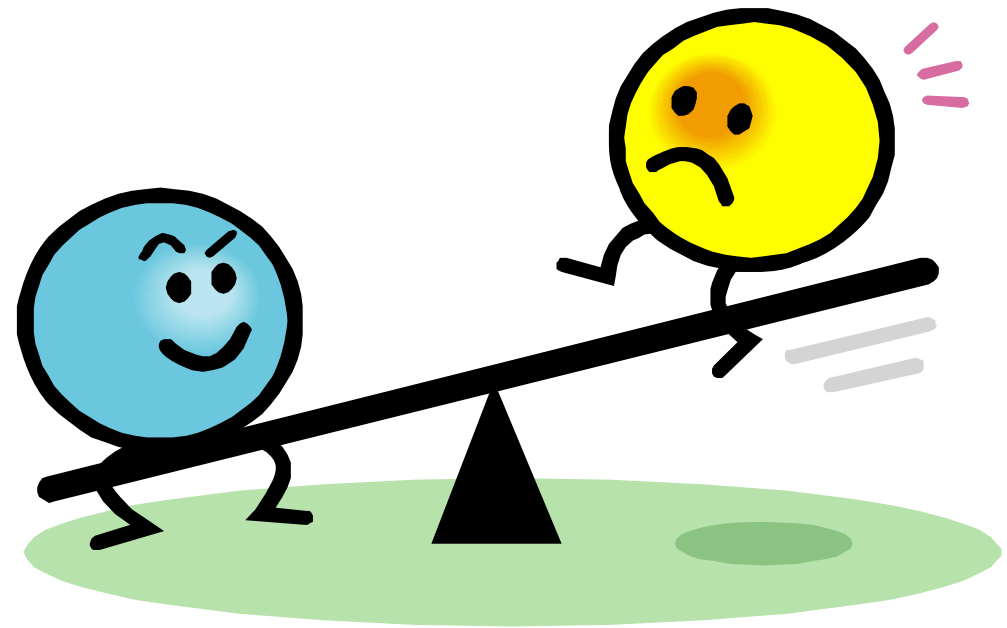
Block C: Margins

Solvency II

- Cost of providing necessary capital to support run-off of the business
- Cost of capital approach using common rate

Phase II

- Not prescriptive
- Explicit, unbiased estimate of market demands for:
 - Risk margin
 - Service margin



Phase II ?

Solvency II ?

IFRS Phase II – some concerns

- Relevance and reliability
- One model for all insurance contracts
- Lack of market
- No consensus on risk margins
- Entity specific assumptions more meaningful
- Contractual v non-contractual cash flows
 - Guaranteed insurability
 - Beneficial policyholder behaviour
 - Discretionary Participation features
- Unbundling

Technical provisions

How do IFRS phase II and Solvency II line up?

QIS 4 guidance – best estimate	Phase II
All potential future cash flows incurred in meeting liabilities to policyholders	✘
All potential cash flows in measuring future premiums	✘
Use of best estimates (e.g. discount rates, future premiums, expenses)	✔
Best estimate equals expected PV of all future potential cash flows (probability weighted average of distributional outcomes), based upon current and credible information, with regard to all available information	✔
Best estimate should be assessed using a relevant and reliable actuarial method. The method retained by participants should be part of actuarial best practice and should capture the technical nature of the liabilities most adequately	✔

Technical provisions

How do IFRS phase II and Solvency II line up?

OIS 4 guidance – best estimate	Phase II
Projection horizon used should cover the full lifetime of the portfolio	✓
The realistic assumptions should neither be deliberately overstated nor deliberately understated	✓
Cash flows reflect demographic, legal, medical, technological, social and economic developments	✓
Appropriate assumptions for future inflation should be built into the cash-flow projections	✓
Separate calculations of best estimate and risk margin are not required, where future cash-flows associated with obligations can be replicated using instruments for which market value is observable	✗
Cash flows are discounted at risk-free rate applicable for relevant maturity at the valuation date	✓

Technical provisions

How do IFRS phase II and Solvency II line up?

QIS 4 guidance – risk margins	Phase II
A cost-of-capital methodology should be used in the determination of the risk margin.	✓
Calculation of technical provisions is based on their current exit value which means that the cost of providing capital is assessed starting from the valuation day of the best estimate	✓
Renewals and future business should be considered only to the extent that they have been included in the current best estimate of liabilities	✓
The Cost-of-Capital rate is 6%	?

Technical provisions

How do IFRS phase II and Solvency II line up?

QIS 4 guidance – unbundling	Phase II
Differentiate between “hedgeable” and “non-hedgeable” obligations	x
If within a contract an option, guarantee or other part of the contract can be completely separated and as such be perfectly hedged on a deep, liquid and transparent market the separate benefit is classified as a hedgeable component and is valued as a hedgeable (re)insurance obligation	x
Where there is an unsure distinction between hedgeable and non-hedgeable cash-flows, or where market-consistent values cannot be derived, the non-hedgeable approach should be followed (separate calculations of best estimate and risk margin)	x

Fundamentals

- IFRS permits or requires the use of fair values for virtually all financial assets
- It also permits it for certain other assets (such as investment property)

QIS 4

CATEGORY	QIS 4 BASIS
Financial assets	IAS 39 fair values
Goodwill and intangible assets	Nil
Property, plant and equipment	IAS 16 revaluation basis
Investment property	IAS 40 fair values
Subsidiaries, associates and joint ventures	Where IAS 39 fair value is used in the accounting this is acceptable for QIS 4
Non-current assets held for sale or discontinued operations	IFRS 5, to the extent that fair value and not the carrying amount is used
Deferred and current tax assets	The treatment under IAS 12 is an acceptable proxy for valuation on an economic value basis
Cash and cash equivalents	Treatment under IAS 7 and IAS 39 is acceptable

Liabilities

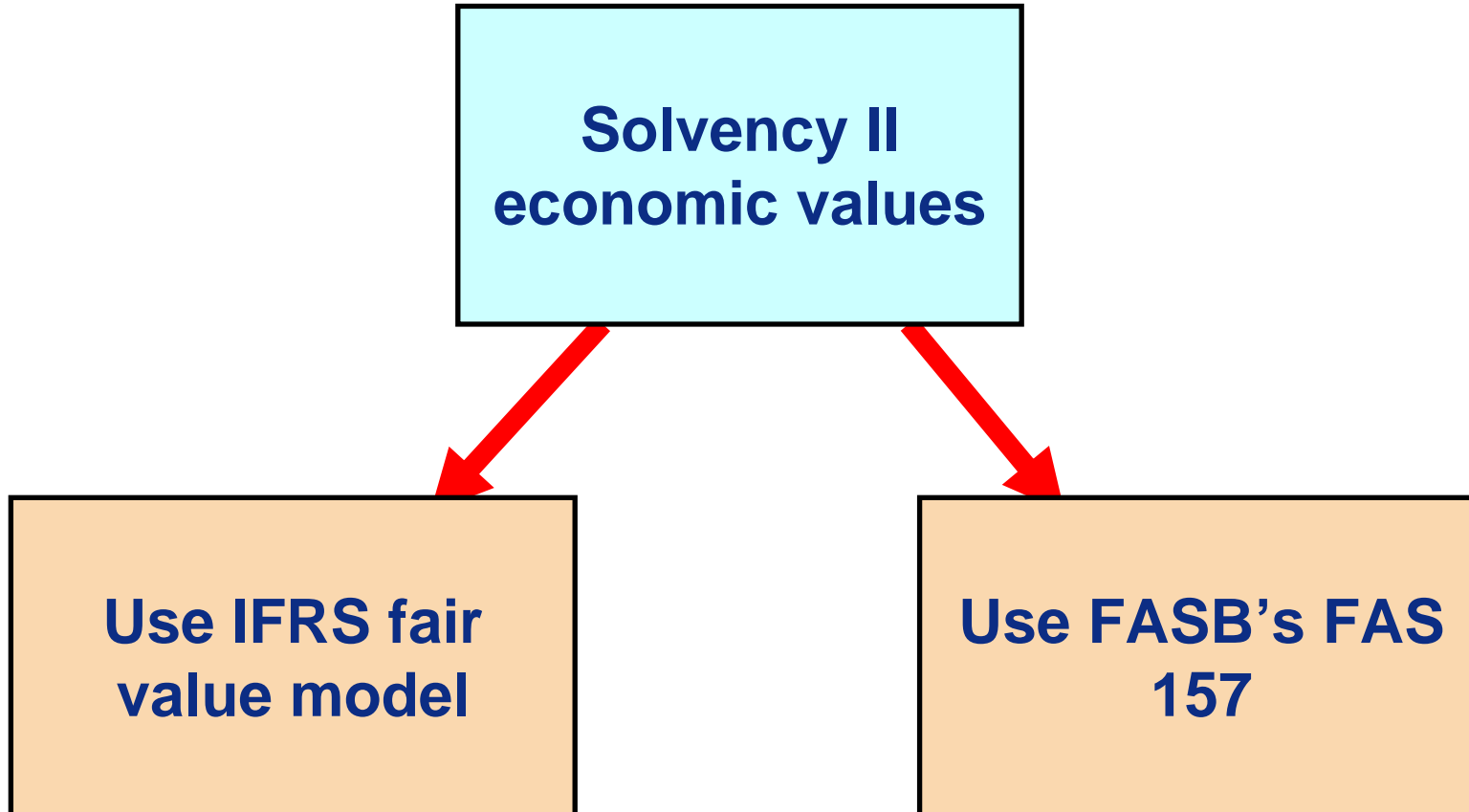
Fundamentals

- **IFRS permits or requires the use of fair values for some financial liabilities**
- **It uses current values for some other liabilities (for example, defined benefit pension plans)**

QIS 4

CATEGORY	QIS 4 BASIS
Provisions	The value under IAS 37 is an acceptable proxy
Borrowings	If the borrowings are held at fair value through profit or loss, the treatment under IAS 39 is acceptable
Other financial liabilities (e.g. payables)	Fair value in accordance with the guidance provided in IAS 39 with no adjustment, where applicable, for own credit standing
Deferred and current tax liabilities	The treatment under IAS 12 is an acceptable proxy for valuation on an economic value basis
Employee benefits	IAS 19 is an acceptable proxy

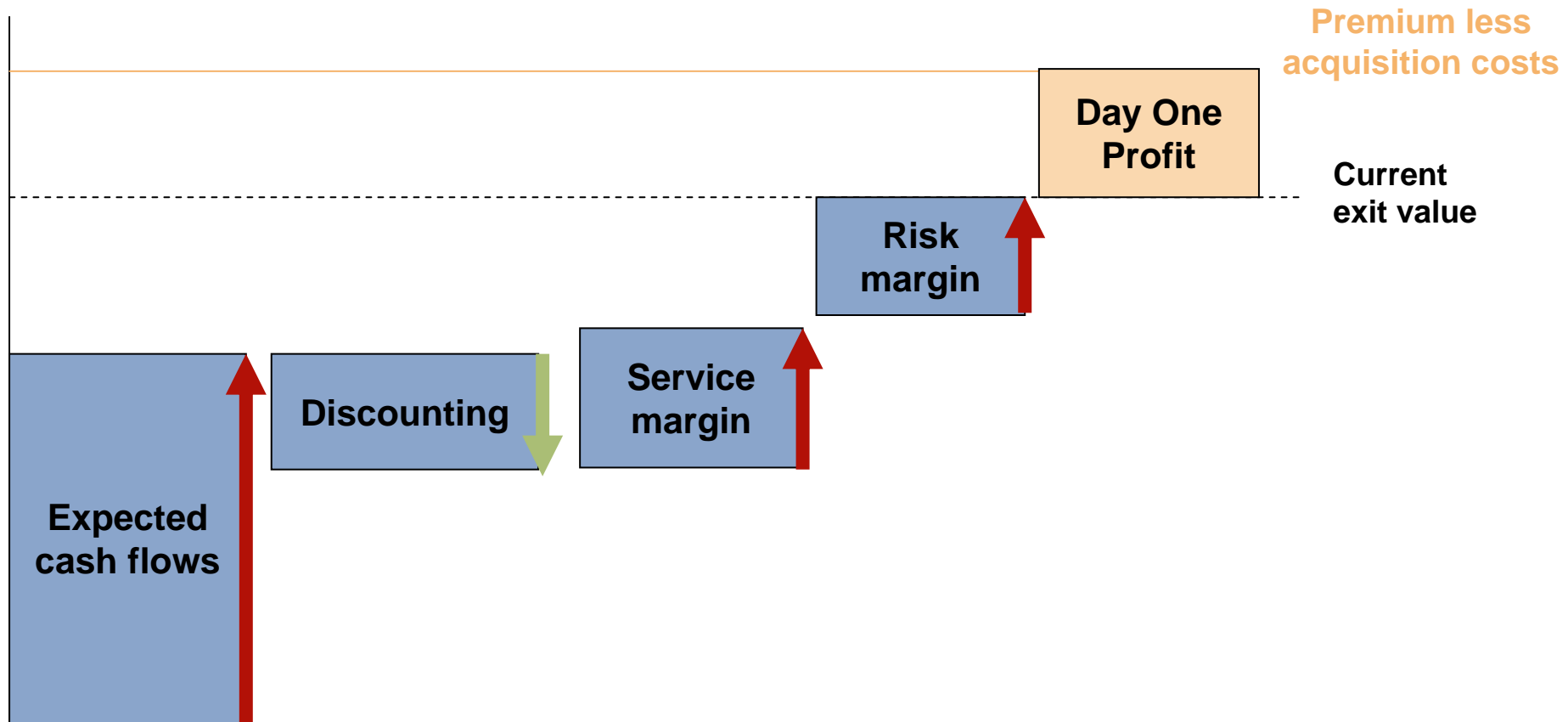
What if you do not use fair values in the financial statements?



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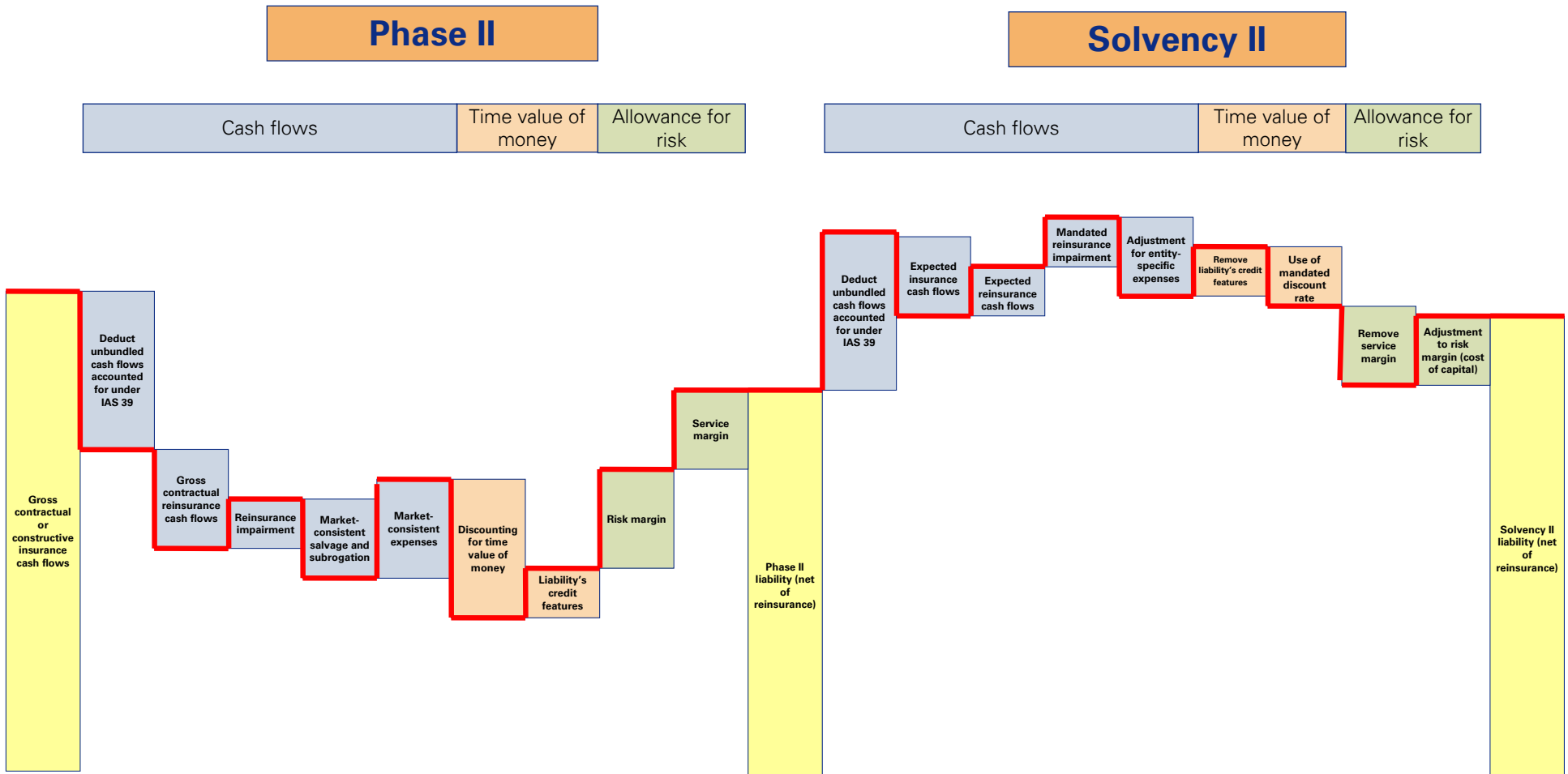
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Day One profits



Source: KPMG

Reconciling Phase II to Solvency II

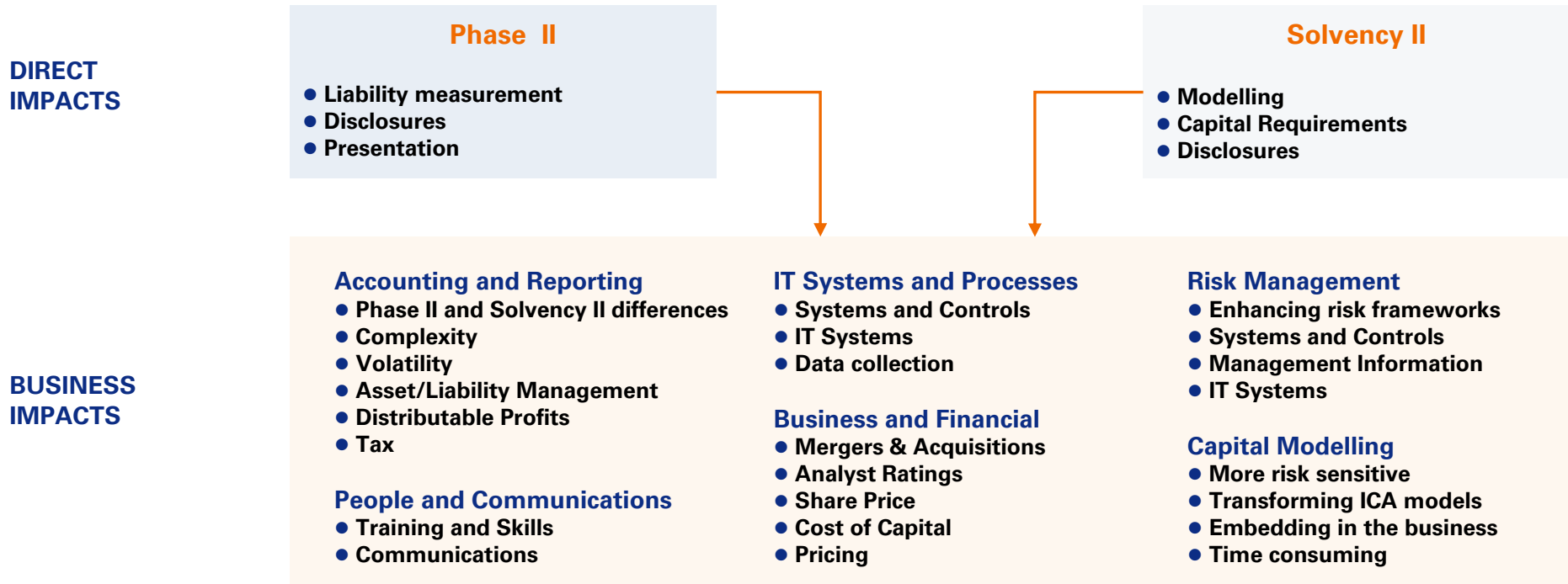


Source: KPMG

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The importance of an integrated approach



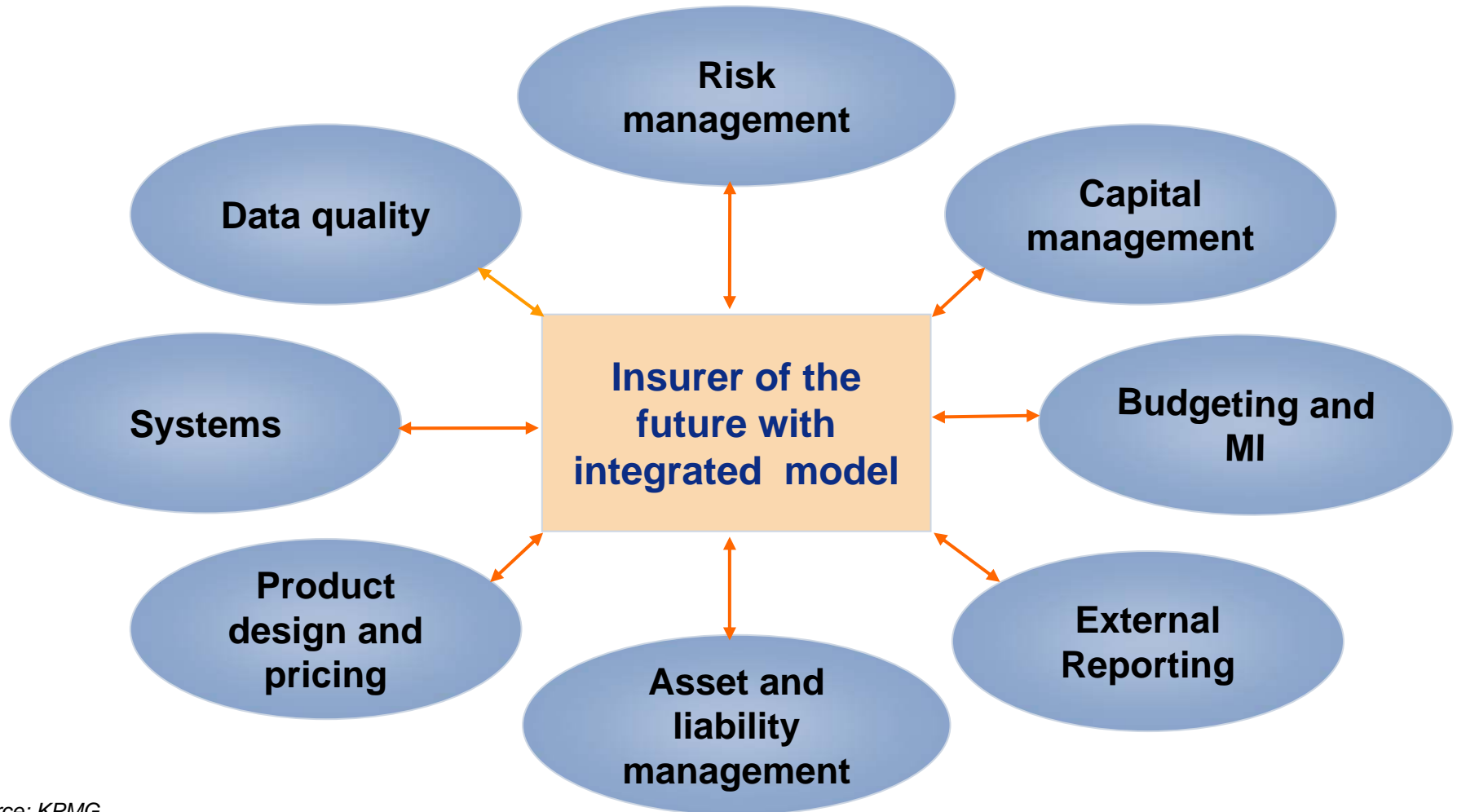
Key issues

- Solvency II may come into operation before a final IFRS Phase II Standard is finalised
- Solvency II and IFRS II requirements overlap in many areas and may conflict

Possible solution

- A flexible and co-ordinated approach to Phase II and Solvency II is required
- A 'Multi-release' strategy with mitigation activities to minimise the risk of re-work

Business Impacts



Source: KPMG

Solvency II



Phase II





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