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Study of Insurance Economics

Études et Dossiers

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Layout & Distribution: Valéria Kozakova

Financial Challenges in Insurance

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The CIO Network – A New Geneva Association Initiative

Aim:

- To exchange experiences on key issues facing global insurance asset management and to establish a more effective dialogue with government policymakers, regulators, rating agencies and other external stakeholders.

Target Group:

- Chief Investment Officers and top insurance asset managers from the largest international insurance and bancassurance groups as represented in The Geneva Association.

Mission:

- The CION strives to create more knowledge and better understanding about issues that confront the role and function of asset management and the formulation and implementation of investment strategies.
- It serves as a platform for the interchange of information, expertise and best practice approaches. Issues of common concern are identified (without the objective to develop a single policy position) and to influence external stakeholders through the provision of credible research and high-level meetings and seminars.
- In addition, there is the intention of informing government policy-makers and wider public opinion of the key role that institutional investors linked to the insurance sector play within a modern economy.



The CIO Network – A New Geneva Association Initiative

The CION follows a topic-orientated approach through its activities.

Possible topics fall into three different groups:

- Topics that address high-level technical and organisational issues in insurance asset management. This would include: different styles of effectively running an asset management operation; measuring the contribution and value to the parent group; and how to deal with internal constraints arising from wider corporate policies within the group, such as ALM, capital management and internal performance measurement and reporting.
- Topics that entail an exchange of views with external organisations whose policies impact on the asset management efficiency and decision-making. This would include identifying and assessing the impact of regulatory authorities, rating agencies, accounting standards setters, and tax authorities, and through balanced discussion with these organisations find ways of reducing these external constraints, where they are costly or unnecessary;
- Topics that deal with the wider economic role of the asset management sector. This would include assessing its influence of the sector on the structure and development of capital markets in advanced and emerging countries, on innovative ways for financing for the private and public sectors, and on global economic growth and stability.



A Lot of Things Change as Financial Intermediaries Evolve



Insurance and Finance 2007 - Topics

- Insurance Linked Securities:
 - investor and market perspectives
 - legal and rating agency perspectives
- Solvency 2:
 - current challenges
 - 2nd generation of international risk-based solvency systems
- IFRS: latest developments and call for comments
- Asset liability management:
 - Key strategies and risks
 - issues in outsourcing policy
- Financial statement presentation for insurance companies



IFRS-phase 2

- Projects has long timeline, which demands patience and perseverance
- IFRS comment period for discussion paper recently closed
=> over 130 comments received!
- Work will now start on the Exposure Draft



What is happening...

- IFRS comment letters show a range of views
- This reflects the global nature of IFRS and the different insurance accounting practices around the world
- Consensus at this stage is patchy
- The SEC's recent commitment to IFRS shows the progress made on convergence
- Challenge: IFRS phase 2 needs to fit in with existing IASB standards and develop in line with other projects, like revenue recognition
=> more coordination would be helpful



PWC Analysis – high level snapshot of industry responses

	GNAIE	CFO	Japan LIA	Canada L&H	ACLI
Supportive of the three building blocks?	No (non-life) and partial yes (life)	Yes, with important changes	Yes, with reservations	Yes, with exceptions	Yes (life), with important changes
Supportive of market consistent assumptions?	No	Financial only	Financial only	Yes, but not discount rates	Financial only – except for discount rates
Calibration of the margin & day 1 profit	Calibrate to premium (b)	No calibration, but defer initial profit (d)	Calibrate explicitly to premium (a)	Day 1 profit (c)	Calibrate explicitly to premium (a)
Cash flow definition?	All cash flows	All cash flows	All cash flows	All cash flows	All cash flows
Single model?	No	Yes	Yes (but they are life association)	Yes (but they are life association)	No
Presentation approach?	Premiums in P&L	Undecided – esp. for non-life	Premiums in P&L	Premiums in P&L	Undecided

PWC Analysis – high level snapshot of standard setters

	UK	US (AICPA)	Canada	Australia	S.Africa
Supportive of the three building blocks?	Yes, with important changes	Yes, subject to below	Yes	Yes, with important changes	Yes with important changes
Supportive of market consistent assumptions?	Financial only	Yes, where available	Yes	Financial only	Financial only
Calibration of the margin & day 1 profit	Calibration to premium (b)	Calibrate to premium (b)	Day 1 profit	Day 1 profit	Day 1 profit
Cash flow definition?	All cash flows	No comment – OK?	All cash flows	All cash flows	Commercial substance
Single measurement model?	Yes	Yes	Yes	Yes	Yes
Presentation approach?	Premiums in P&L	Await FS presentation project	Premiums in P&L	Premiums in P&L	Tending to P&L (non-life) and margin (life)

The I-2 minefields...

Risk margins:

The way the risk margins work will be key to how the model looks overall

Profit at inception:

Very controversial, tension between accounting and value creation

Portfolio definition:

The tentative definition of a portfolio is narrow, which affects risk margin

Participating contracts:

Model for deciding the split between liability and equity is difficult to pin down

Policyholder behaviour:

Reflecting policyholder choices is difficult in principle, but generally handled in practice

Own credit risk:

Financial instruments include this but insurance is about paying claims



The Financial Firm of the Future?




Or Maybe Not?



Solvency 2


2001	Nov 2003	Oct 2005	March 2006	May 2006	July 2007	Nov 2007	End 2008	2009?	2012?
Sharma Report	CEOPS set-up	QIS1 launch	QIS1 results	QIS2 results	Solvency 2 Draft Directive published by European Commission	QIS3 results	QIS4 results	Solvency 2 Directive finalized	Implementation of Solvency 2 across Europe

- The good news:
 - Good cooperation between regulators, supervisors and the industry in Europe
 - Solvency 2 aspires to be a modern, risk-based, economically well-grounded Solvency framework
 - Solvency 2 intends to take into account the evolution of the Industry (existence of multinational groups) and of its risk management (sophisticated modeling of risks)
- Solvency II proposed Framework Directive is passing through the parliamentary process
- Solvency 2 needs to accommodate a standard framework and company specific risk modelling, which is dynamic either as risks emerge or as analysis and experience develops
- Has overlap with IFRS and it is not always clear which project sets the scene for the other



The S-2 minefields...

- Standard formula**
Standard formula should not be used as a benchmark for internal models
- Minimum capital**
Minimum Capital Requirements to take into account all risk mitigation techniques
- Investment principles**
Based on company's assessment of its risk profile, with minimum restrictions on asset management
- Reinsurance**
The nature of reinsurance to be recognised appropriately
- Third countries**
Include provision to encourage equivalence between Solvency II and third country regimes



Possible Impact of Solvency II on the European and global competition.



- Is Solvency II likely to change the competitive landscape in Europe and more globally?
 - Geographic levels: National, European, Global.
 - Cross-sectoral level: Banking... and others (Pensions)
 - Structure of undertakings: large groups vs. SMEs, local vs. pan-European, monoliners ...

**COMPETITION IS BASIC, AND WILL GENERATE POSITIVE EFFECTS...
ALTHOUGH SOME RISKS WILL HAVE TO BE LOOKED AFTER.**

Possible Impact of Solvency II on the European and global competition.



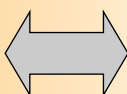
- Will Solvency II be beneficial to the Economy and Consumers?
 - Move towards a risk oriented system.
 - Alignment of the design of the system with the economic reality underlying.
 - Focus on Governance (including explicit responsibilities).
 - Need to enhance risk management and controls.
 - Increase of transparency and disclosure.
 - Objectives of supervision (protection of policyholders, but also financial stability and fair & stable markets).

WE ARE CHANGING, AND CHANGING FOR GOOD

I-2 and S-2 – A Clash of Cultures?



- Solvency II based on ‘market consistent’ valuation
- Currently active projects:
 - IFRS phase 2
 - Solvency 2
- All risk models are stochastic or scenario based
- Holistic, aggregate view



- Statutory accounting based on book value methodology
- Currently active projects:
 - Principles Based Reserves
 - Principles Based Capital
- Only interest/equity risk models are stochastic
- Product level view



I-2 and S-2 – An issue of perceptions

- Lots of stereotyping of insurance and reinsurance going on
- General lack of understanding in some quarters and many concerns about transparency, complexity and performance
- IFRS phase 2 and Solvency 2 are an opportunity to address this
- All stakeholders will benefit from a high quality outcome of the projects



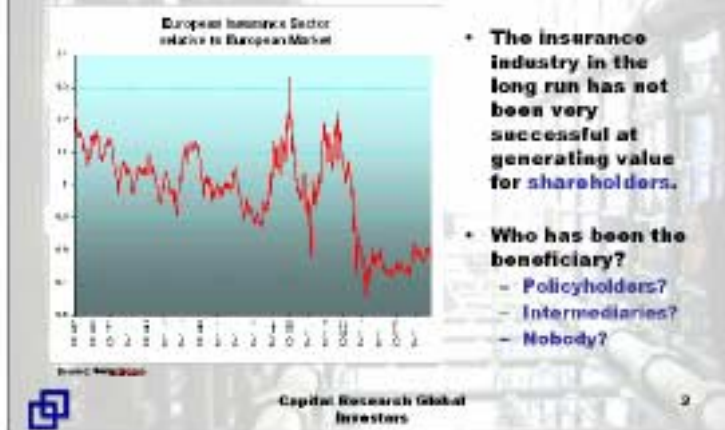
Insurance and Finance - a special view from an investor

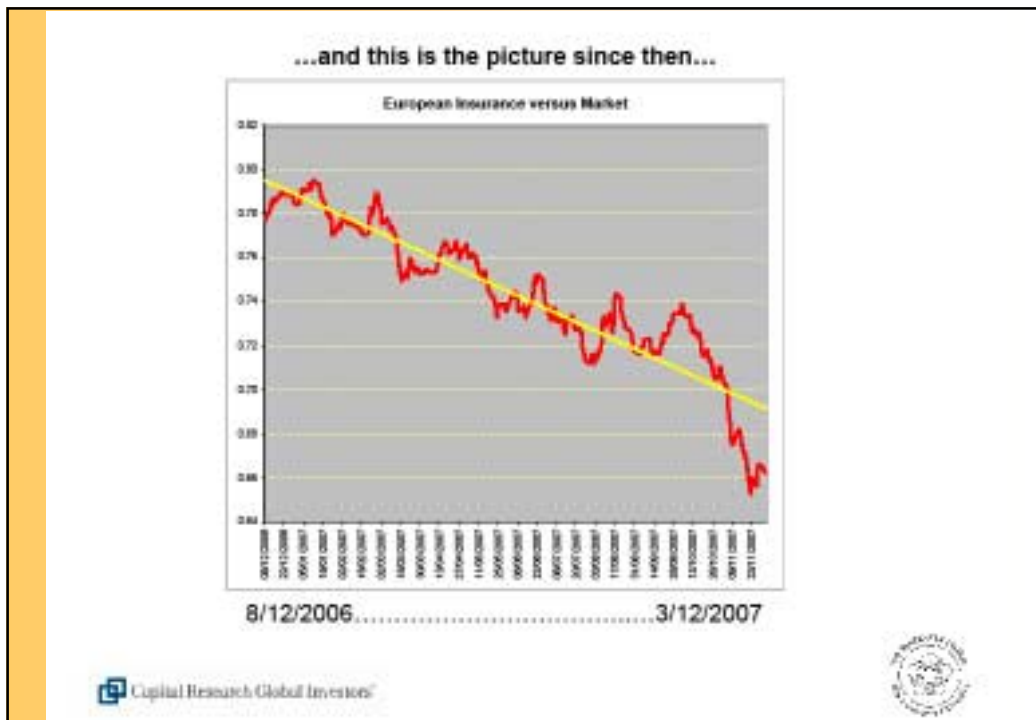
*Report from
the I&F Conference 2007*

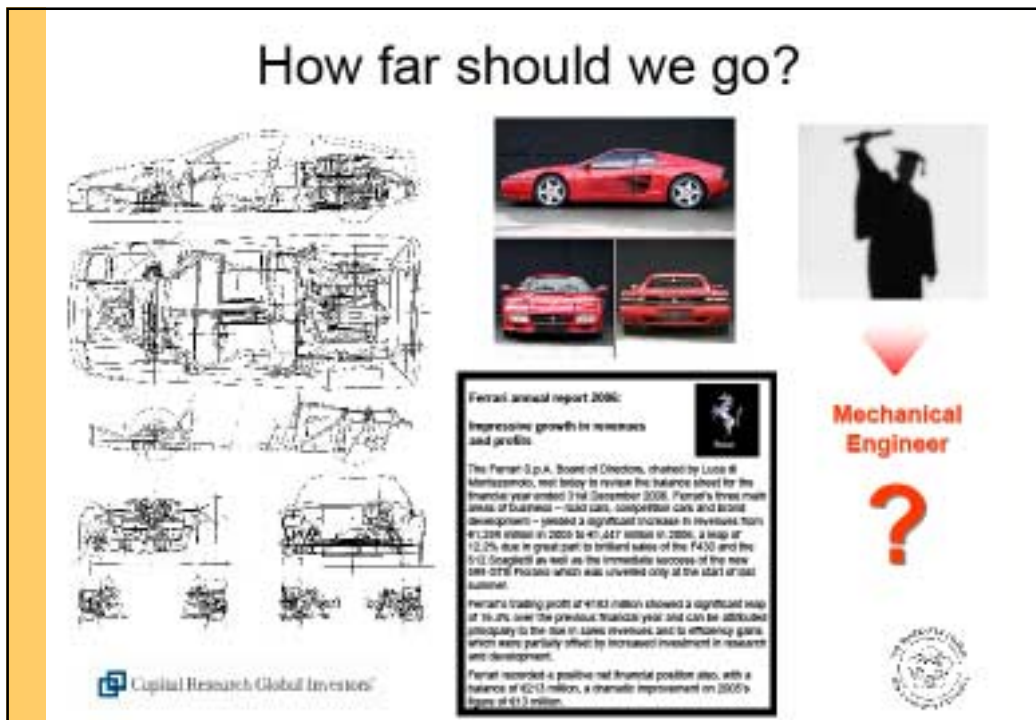
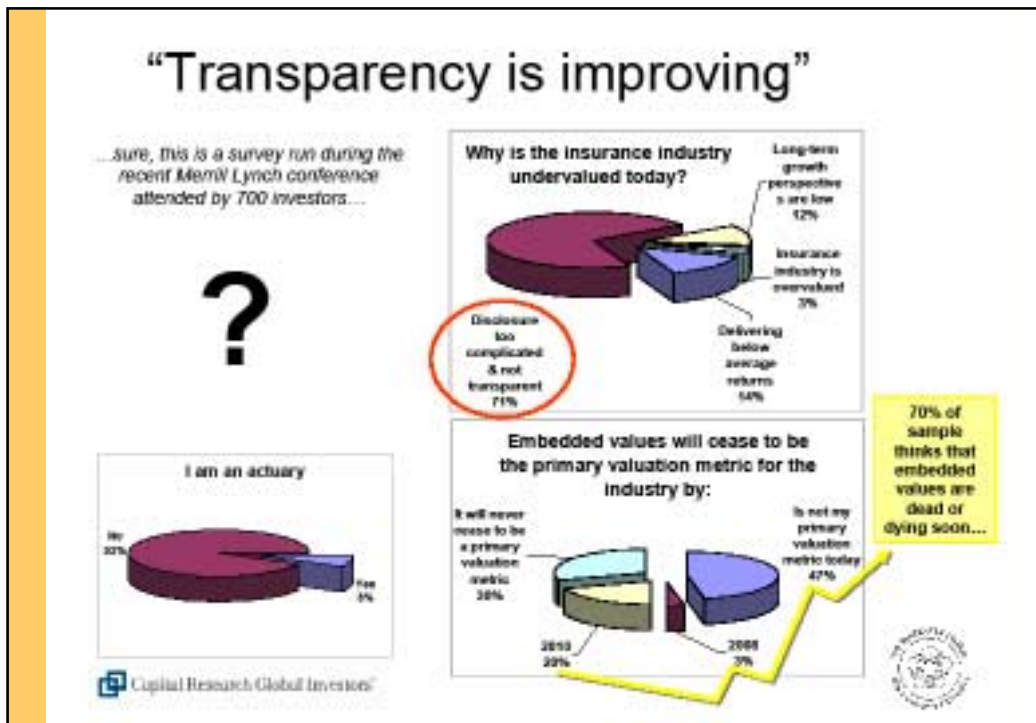


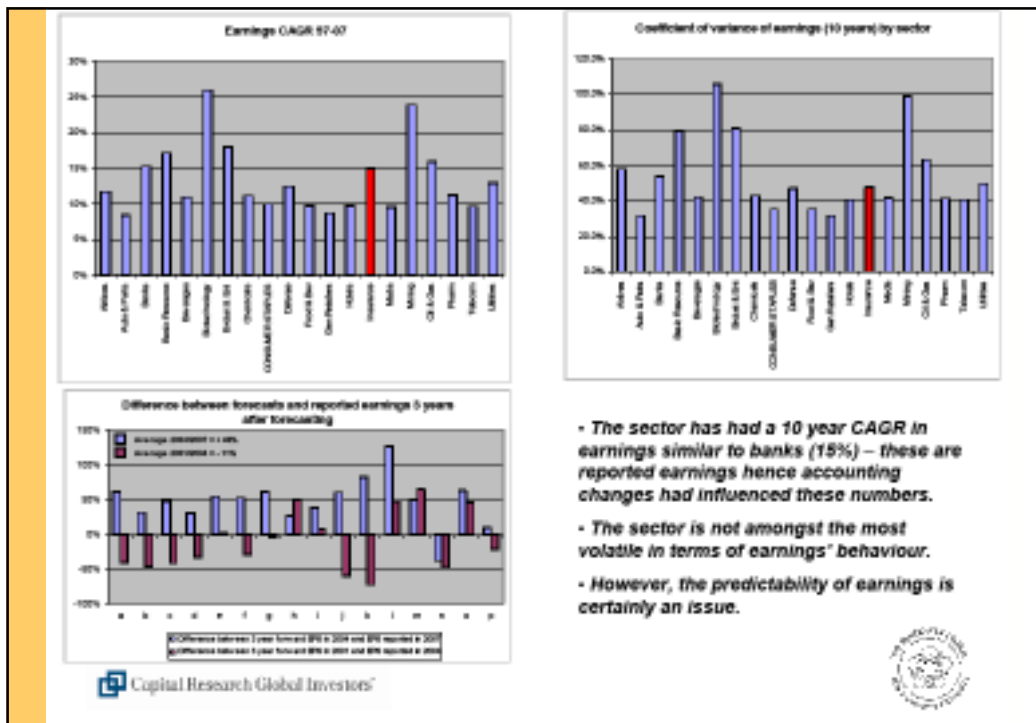
Last year we were looking at this picture...

20 Years...generating value?









How does the sector make money?

- Asset development
- Margins
- Risk underwriting

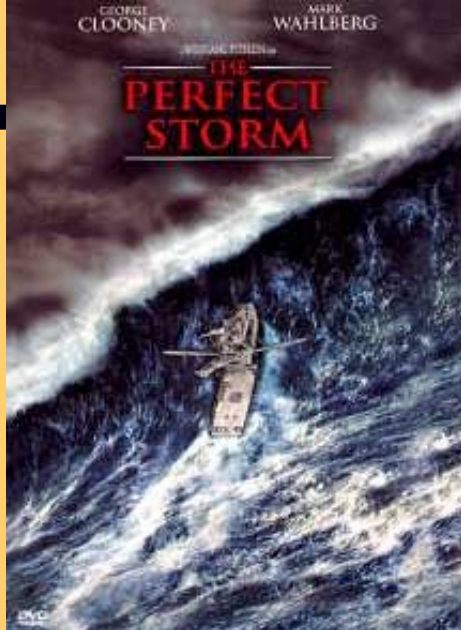

...and can we see this in our current disclosure?

Insurance (in my view) is the only sector where we can't see how companies make money...

...our sector has been distancing itself from other sectors, now we are moving towards stochastic modelling...can we get any further away?



Do we see the light?



Are we ready?

