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The Geneva Association - General Secretariat - 53, route de Malagnou - CH-1208 Geneva
Tel.: +41-22-707 66 00 - Fax: +41-22-736 75 36 - secretariat@genevaassociation.org - www.genevaassociation.org

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Layout & Distribution: Valéria Kozakova

How Well Have we Used our Time Since the Previous Crisis?

Denis Duverne

The European insurance industry has learnt the lessons from the 2001-03 market crisis...

- Support for a risk-based solvency regime leading to solvency II
- Support for a value-based financial reporting
 - EEV
 - MCEV
 - Elaborated principles for IFRS phase II
- Improved risk management frameworks and practices
 - *“As the implementation of Solvency II gets closer, industry awareness of the need to build holistic risk-management systems is increasing. This has already taken place at the more sophisticated insurers. [...] One very positive aspect of the focus on risk management across Europe is the improvements we see in the overall development of a positive risk management culture.”* S&P – March 2008
 - Europe at the forefront of this transformation: 40% more insurers with “strong” or “excellent” ERM in Europe than in the US, according to S&P (March 2008)

> **More convergence in financial reporting, even if some skepticism remains**

...but financial markets have failed to recognize this progress

- Material underperformance of the European insurance industry since mid 2007
- Extreme level of fear on the insurance sector triggered and fueled by
 - Failure of AIG
 - Failure of US monoline insurers
 - Recapitalization of several bankinsurers
- The accounting mismatch has been worse than ever envisaged...

Perf. since July 1st, 2007

Euro Stoxx 50	Stoxx Insurance
-47%	-57%

An AXA example: credit spread widening in 1H08

ca. €1bn negative impact in AXA's P&L due to "fair value" accounting		ca. €1bn positive impact from the market value of AXA's financial debt, <u>not</u> accounted for in IFRS
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- ...which, mixed with current regulatory regimes, accelerated pro-cyclical reactions

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18 months into an unprecedented turmoil, what should be the reaction of the European insurance industry?

An economic risk-based approach is more than ever justified for solvency assessment

- No one can argue that Solvency I is better than Solvency II, as
 - Solvency II is less pro-cyclical, notably as asset charges decline when value of assets decline,
 - Solvency II takes into account interactions between assets and liabilities,
 - Solvency II gives credit to diversification, the benefits of which are proven “live” by this crisis (P&C vs. Life & Savings, US vs. rest of the world...)

- Late mover advantage of the insurance industry: validation of internal models will have the benefits of the banking experience

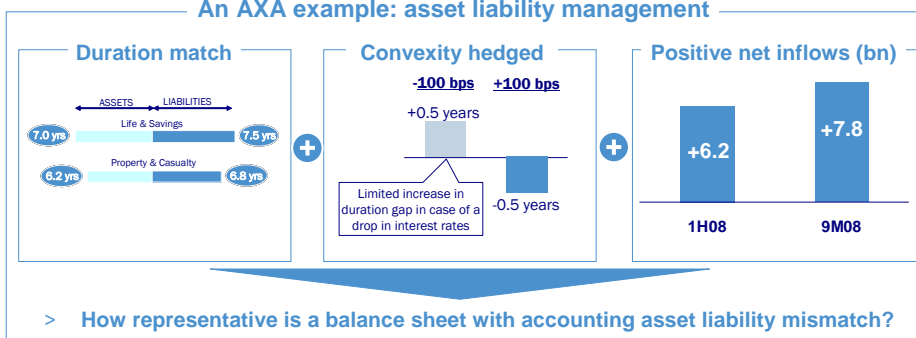
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Accounting framework should also be improved on the way to IFRS phase 2

- IFRS Phase 1 should be improved on a few striking items
 - Impact of Illiquidity premium on asset valuations
 - Ability to reclassify some AFS P&L assets in loans and receivables
- The industry should welcome IFRS phase 2 which will solve the asset liability mismatch issue

An AXA example: asset liability management



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MCEV is still in its infancy, but will be a further improvement for the insurance industry...

- From a market standpoint, insurance companies continue to suffer from the black box syndrome
 - Transition to EEV did not bring the eagerly expected comparability across the insurance industry
 - From a business standpoint, adoption of MCEV will lead to more rational pricing, hence more disciplined competition
- > **MCEV is a positive move, but it's a complex subject: its introduction will require a lot of pedagogy within our companies and within our stakeholders**

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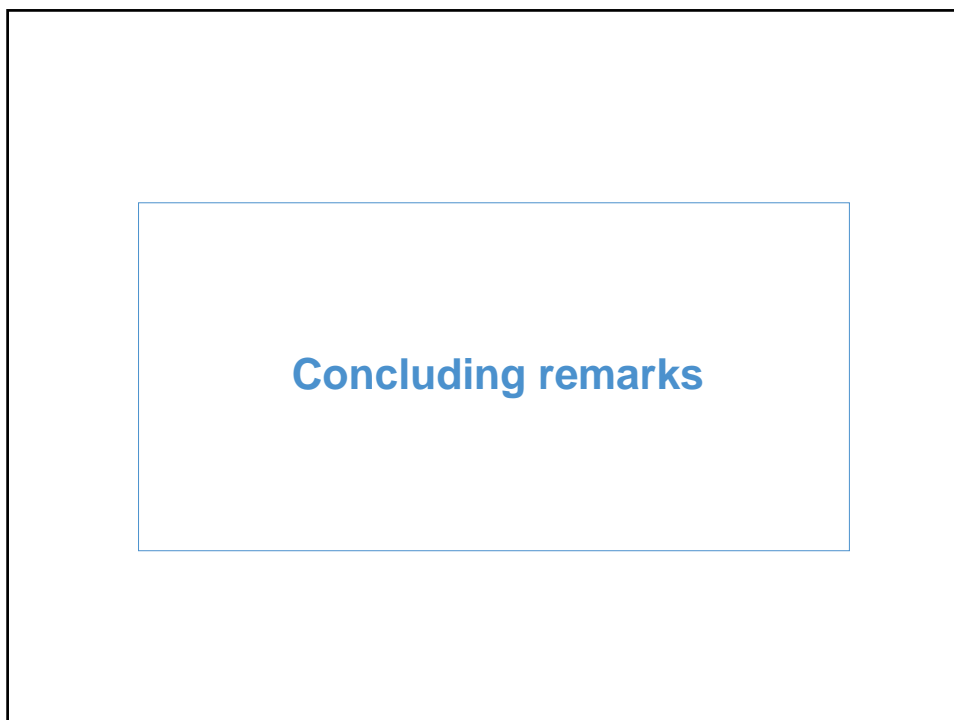
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...provided implementation issues are well managed by the industry

- Some areas of concern have been identified by the CFO Forum's MCEV Working Group, including:
 - Application of market consistency in current markets
 - Use of observed implied volatilities
 - Use of swap curve as the reference rate
 - Treatment of spread based products, notably raising questions on the appropriateness of the liquidity premium
 - Allowance for the cost of residual non hedgeable risk (between 0.4% to 6% across the industry)
- > **Consistency across the industry is a challenge but it is in our best interest to achieve it**

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Concluding remarks

Lesson learnt!

- Despite isolated cases, this unprecedented crisis shows the progress of the insurance industry in terms of risk management
- These progresses have been fostered by development of internal models, rating agencies approaches and Solvency II discussions

Don't throw out the baby with the bath water!

- The crisis should not lead to a return to a Solvency I world
- Solvency II, IFRS phase 2 and MCEV are more than ever needed by the insurance industry and should be welcomed by all stakeholders
- Being at the forefront of this transformation is a unique opportunity for the European insurance industry

But the devil is in the details!

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