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The Impact of IAS/IFRS on the Strategies and Business Models: A Global Player View

Denis Duverne

Summary

- Context: what are the most relevant changes in Insurance Companies?
- Major impacts on the strategies and business model of a global player
- Challenges and solutions for Insurance Companies

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The Context

- As a global player, we are strongly favoring accounting convergence between the US and the rest of the world
- Convergence has to lay on solid ground and unchallenged standards
- Transition should be towards a better set of rules

What are the most relevant changes for a global player …

IFRS 2	Share based compensation
IFRS 3	Business combination
IFRS 4	Insurance contracts
IAS 19	Employee benefits
IAS 27	Scope of consolidation
IAS 32 & 39	Financial assets & Derivatives

… and the most controversial

- IAS 32 and 39 are imposing mark-to-market ("fair value") for traded assets and derivatives …
- … while during phase 1, IFRS 4 maintains an historical basis for insurance contracts …
- … therefore ignoring the fundamental economic logic of the insurance activity which is to match assets with liabilities …
- … until the adoption of a standard for phase 2 (2007 ?)

Mark-to-market does not reflect long-term investment strategy of an insurance company: it creates artificial volatility

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As a consequence IFRS could force insurance companies:

- **To sell equities for wrong reasons i.e. to avoid accounting volatility**
  - Changes in product development & pricing to improve earnings pattern
  - Transfer of risk on assets to policyholders
- **To change their assets allocation for accounting reasons**
  - Short term oriented strategy
  - More risk aversion driving asset allocation
  - Diminishing long term returns for both policyholders and shareholders
- **To reconsider current hedging strategies for accounting reasons**
  - Very limited number of strategies eligible
  - Need for extremely detailed documentation

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Having said that we have to live by the rules …

Key hurdles

- Assets and liabilities valuation mismatch
- Mutual funds and real estate companies to be consolidated
- Economic hedging strategies not eligible to hedge accounting
- Book return-driven strategies remain needed for local and tax purposes

… without changing nor compromising with the true economics of our business

- Asset allocation will not change as it has been dictated by our ALM,
  - Equity and Real Estate investments remain the best hedge against inflation risk
- Long-term liability management will remain unchanged
- Long-term value management will remain unchanged

The consequences on our day to day management will be the following…

- Investment strategies with lower turnover to be in line with duration of the liabilities
- Limited use of Mutual Funds, due to the technical burden and the cost associated with full consolidation of Mutual Fund. This is a step backward as far as investment management implementation is concerned
- To some extent, limited use of hedging programs through derivatives due to the impossibility to use hedge accounting under IAS even for protection programs

… but ALM will still be driven by sound economic objectives

1. ALM will still aim at maximizing long-term economic value under several risk constraints (Economic Capital, Regulatory constraint, Shareholders' risk aversion …), even at a price of higher earnings volatility
2. Global risk-reducing programs implemented through derivatives (caps, floors …), reflecting embedded options in Life products (minimum guarantee, surrender guarantee …) will be maintained. The resulting earnings volatility will be identified as such
3. In general, current asset allocation will remain unchanged. Management of assets and investment processes will be adjusted to allow compatible accounting treatment with long-term investment objective. For this purpose, asset allocation will be driven by a "core-satellite" approach.

Asset allocation will be driven by a « core-satellite » approach (1/2)

Core Investment portfolios

- Investment strategies resulting from yearly ALM studies whose volatility should be reflected only on the duration of the liabilities
- Management of "core" portfolios will include an investment process which fully integrates accounting specifications such as accounting targets for income, realized capital gains/ losses, impairments/ write-offs.
- These investments will generate lower long-term average turnover than investment strategies which don't have any accounting target or constraint. The turnover of these strategies will be driven in average by the duration of the liabilities. The earnings' volatility of these investments will also be much lower than the yearly volatility of the fair value of these investments.
- In general, these investment will be consolidated in $AFS_{OCI,}$ (Direct lines in AFS / mutual funds themselves fully consolidated (look-through)

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Asset allocation will be driven by a « core-satellite » approach (2/2)

Non-Core "Satellite" Investment Strategies

- Implementation of tactical asset allocation / active management including market-neutral strategies, "alpha" strategies, cash funds, hedge funds
- The investment strategies have pure investment return objectives. The investment process implemented for this block doesn't include accounting constraints, and therefore the earnings' volatility equals the volatility of the fair value variations of these investments.
- These investments have an expected return and an expected volatility which are both monitored closely.
- Investments mainly through mutual funds consolidated in $AFS_{P\&L}$ or direct holdings classified as Held for Trading

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Key performance indicators will remain unchanged

- **Underlying and Adjusted Earnings**
  - AXA will preserve for Phase I the Underlying and Adjusted Earnings concepts, with IFRS related volatility in the Net Income
- **New Business Contribution / Embedded Value**
- **Life margin analysis**
- **Cash flow**
- **Cost income ratio**
- **Combined ratio**
- **AUM, net inflows**

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Major operational impacts identified for Phase I

- **Changes on IT systems**
  - Investment reporting systems
  - General ledger if local applications
  - Consolidation tools
- **Change on processes**
  - Consequences of the limited use of investment funds
  - Investment managers to integrate accounting constraints related to hedge strategies
  - Increasing requirements of data from French entities (local GAAP, US GAAP, IFRS)
- **Cost of the project**

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Challenges of IFRS Implementation

Understanding & Communicating Results during Phase I

- **Likely delay in acceptance of IFRS as primary forecasting/analytical basis:**
  - Asset and liability valuation inconsistencies
  - Lack of trend information (IFRS from 2004 only)
  - Parallel reporting (both IFRS and local GAAP) probable at the request of local insurance regulators
- **Advance dialogue with & education of investors, analysts and rating agencies will be important**
  - Training sessions to be provided by companies

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Phase II ???

- **Too early to tell**

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