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IFRS and Solvency II

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Major Background Issues

- EU has decided that the accounting system underpinning Solvency II should be based on IFRS's ('IAS compliant') but adjusted where necessary to reflect the prudential concerns of regulation and supervision. This general support for the IFRS regime now extends internationally through IAIS.
- The new IFRS4 and IAS39 are requiring changes to current regulatory reporting in some countries to ensure that existing prudential systems are unaffected until Solvency II is finally agreed, These adjustments to IFRS reporting requirements are being achieved through 'prudential filters'.
- Slow progress on Phase II of the IASB' Insurance Contracts project has meant that CEIOPS work on Solvency II seems to be now moving ahead of the IASB work. The Groupe Consultatif and Chief Risk Officers Forum (initiated by the Geneva Association) are making a constructive contribution to the development of a workable Solvency II.
- It is likely that CEIOPS work on Solvency II will influence the IFRS work on the measurement of insurance liabilities going forward, as the IASB needs to find a solution.

- If Solvency II is likely to adopt an entity approach and cover all policyholder liabilities of insurance companies. This will differ from the IFRS regime where there will continue to be split between insurance contracts and investment contracts (part of other financial instruments under IAS39).
- Unlikely to be any major changes to the current mixed measurement system for financial assets (IAS39) until after the final IFRS for insurance comes in 2008/9. Solvency II is likely to have a standardised valuation framework for all financial assets, probably on a market/fair value basis, but some national regulatory authorities are likely to make adjustments to this, especially to minimize short term market value movements.
- IASB likely to retain the strict 'tainting rules' for bonds to encourage insurance companies to move towards a 'available-for-sale' valuation at fair value. How far insurance companies decide to move toward the available-for-sale in their financial reporting will vary between companies.

- If Solvency II is on market/fair value basis, this could drive insurance company reporting towards a more fair value approach in their balance sheets (but not in the Income Statements (Profit and Loss Accounts).
- IFRS 4 already prohibits equalisation and catastrophe provisions from being recognised as liabilities, defining them as equity capital. This will continue to pose in a number of EU states where regulation continues to allow or requires them to be set up. For credit insurance there is general EU requirement for equalisation provisions under the Prudential Directive.
- Under IFRS, equalisation and catastrophe provisions (where they exist) will be renamed 'reserves' and earmarked as part of equity capital. Under Solvency II if redefined as 'reserves' would count towards Tier 1 capital for solvency purposes. But it is likely that in many countries they will be gradually merged into the new prudential margins.

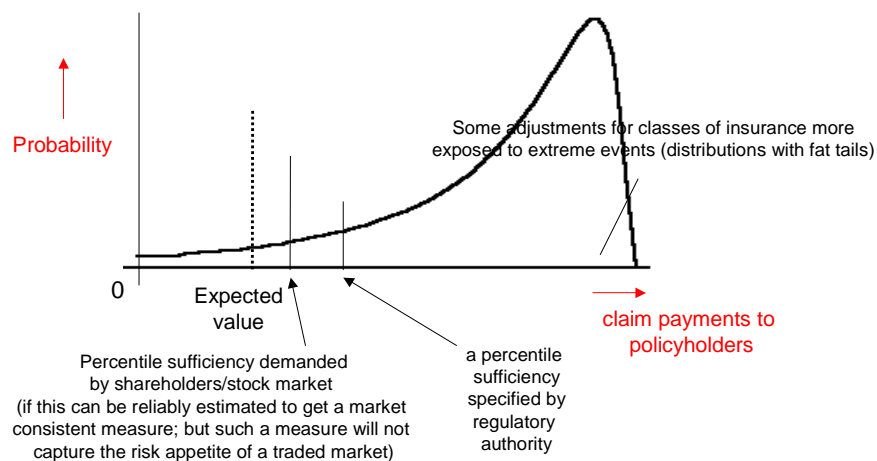
- The IASB is now recognising that embedded guarantees and options in life insurance contracts, from policyholder surrenders etc, should be valued taking policyholder behaviour into account. Regulatory authorities are likely take a more conservative view on surrenders and hence value these embedded guarantees and options higher than for IFRS reporting.
- In countries where the financial statements are the basis for assessing tax, there will need to be changes to the tax system to prevent insurance companies being penalised by the removal of these provisions.

The Central Challenge is Valuing Liabilities

- The central challenge for Solvency II is to decide what standardized approach should be used to value policyholder liabilities in non-life insurance and in life insurance and what prudent margins should be included in these valuations.
- A parallel challenge still faces IASB in current Phase 2 of their Insurance Project. While IASB is against prudential margins, it would like to include risk margins into insurance liability measurements and to discount liabilities. But problem that they face any risk margin in fair value framework must include the riskiness of insurance liabilities and the current risk preferences (appetite) in a relevant traded market.
- CEIOPS and IASB have indicated that if that there is a current preference for discount insurance liabilities (even non-life liabilities) at risk free rates and to also have prudential margins (Solvency II) and risk margins (IFRS). The logical alternative to this is no prudential margins/risk margins, with no discounting in non-life insurance and conservative discounting in life insurance.

- The two likely approaches in Solvency II for determining the prudential margins above the best estimate of the future claim payments to policyholders are:
 - To specify a percentile level of sufficiency above the best estimate (expected value) on the future claims distributions for different classes of non-life and life insurance. This would be an extension of the current Australian regulatory (APRA) model which uses a 75% sufficiency level for non-life insurance only.
 - To calculate the present value of cost of maintaining capital over the run-off period of the claims liabilities, with this level of capital support set at some specified value-at risk probability level.
- It is more likely that the percentile level of sufficiency will be the general measure as it is a tested model (Australia) and can be clearly defined in legislation. But in some EU countries, insurance companies may be able to allowed to use a capital maintenance cost approach, if they show it is sufficiently prudent.

Sufficiency percentile approach to measure the prudential margin ('margin for adverse deviations') for different classes of insurance



This assumes that the distributions are well defined and can be measured. Combining distributions for different classes of insurance would be complex, unless one assumes for simplicity that they are lognormal.

