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Summary of Discussion Sessions at the Seminar

by Stefan Schuermann, Senior Insurance Analyst, Credit Agricole Cheuvreux

- The third International Insurance and Finance Seminar was of high quality in terms of panel speakers and attendance.
- The highlights included the FSA regulatory announcements of group discount recognition and ISPV creation.
- Another highlight was the US insurance industry (GNAIE) statement of influence on non-life valuation, presented by the CFO of AIG.
- Greater flexibility for rating agencies with regard to hybrid debt makes capital restructuring an important topic.
- Solvency II is an ongoing discussion, with the question of what level of ruin to allow in the future framework a key issue.
- Value creation in the insurance industry has been modest in the last few years, though the outlook is better, with improved risk and capital management.
- US GAAP and IFRS convergence: roadmap by IASB and FASB started, but mutual recognition might be a more pragmatic solution in the foreseeable future.
- Presentation slides will be available on www.genevaassociation.org, or <http://ga.e-doc.info>

Already the third seminar

The third Geneva Association Insurance and Finance Seminar has built on the success of the previous events in 2004 (hosted by Prudential) and 2005 (hosted by Aviva), and this time was hosted by Lloyds of London. The roughly 120 announced participants gained a valuable insight into the continued accelerating pace of change and fundamental issues of the global insurance industry. **Professor Gerry Dickinson, Vice Secretary General and Head of Insurance and Finance at The Geneva Association, and Patrick Liedtke, Secretary General of The Geneva Association**, chose seven of the most interesting interactive themes resulting in active discussions in the plenum. Being the "Finance" pillar of The Geneva Association, nine CFOs of international insurance companies presented their point of view on insurance topics, which contributed to the remarkable level of this third Insurance and Finance Seminar. The seven themes were:

Seven themes discussed

1. capital restructuring in insurance groups;
2. capital efficiency, reinsurance and risk securitisation: new structures and the changing regulatory scene;
3. progress on Solvency II and the search for global standards;
4. IASB and FASB convergence: agenda and challenges;
5. creating and managing economic value in insurance companies;
6. phase II of the new IFRS in insurance: is a solution emerging?, and
7. current challenges in the investment of insurance company funds.

This short summary reflects the author's view

Please be aware that this summary reflects our own view of the proceedings and not that of The Geneva Association. **Our brief conclusions, marked with an arrow (→) are added from the point of view of a financial analyst.**

Luke Savage, Director of Finance, Risk Management and Operations at Lloyd's of London, graciously allowed the two-day seminar to take place in the traditional "Old Library" and honoured the event with his presence during the discussions.

Capital restructuring: an important issue

1) **Dr Rolf Ulrich, CFO of Ergo Group**, Munich Re, introduced the panel on the subject of "**Capital Restructuring in Insurance Groups**". He introduced three speakers on the subject with three different viewpoints: first an investment banker, second a speaker from medium-sized London insurer and finally a speaker from a rating agency.

Insurers are the future banks

Shazia Azim, head of Capital Advisory and Structure at RBS asserted that "insurers are the future banks". She explained her view about how hybrid instruments can improve rating agency treatments, as they can be accounted for as "equity" and can also be partially used as acquisition financing. A lot of hybrid debt has recently been issued by the insurance industry, mostly by big European groups. In the end, equity remains the most attractive form of capital, but hybrid capital has advantages such as not being dilutive, being tax-deductible and rating-enhancing. She also presented the benefits of securitisation, which can lower the cost of capital, decrease credit risk or increase asset velocity. Overall, she believed the insurance industry was at a stage comparable to that of the banks 15-20 years ago, and that insurers could be the banks of the future by starting to work their risks out of their balance sheets.

Comment from Stefan Schuermann (Cheuvreux)

→ *Insurance companies are certainly going this way (reinsurers more so than primary insurers), but a core competence of insurance companies should and will remain to "pool" risks on their balance sheets.*

Hybrids to help enhance RoC

Richard Hextall, Finance Director at Amlin, explained its stakeholder map, where optimising ROE and the rating are key issues. In order to maximise shareholder value, he sees: 1) operating leverage, 2) M&A and 3) capital management. His capital levers were separated in two categories, first reinsurance, cat bonds, side-cars and similar and second the use of senior and hybrid debt. As an example, he showed that when applying an optimal use of hybrid debt WACC could decrease from standalone 8.19% to 7.83% and EPS improve from GBP13.3p to GBP14.8p. He stressed that spreads in the hybrid market currently were attractive, resulting in 2006 volumes being higher than 2005 levels. He also believes that hybrid debt should go along the insurance cycle, with varying rates to trigger lower exposure and also varying debt gearing ratios.

Comment from S. S:

→ *Hybrid debt clearly can be used to enhance return on capital and even earnings per share, especially in times of low interest rates and spreads.*

Level of capital and nature of debt matter for Moody's

Simon Harris, Managing Director at Moody's highlighted why it is important to work on "capital structure". Drivers for this were highlighted to be Solvency II, increasing shareholder return expectations and a higher rating agency leverage tolerance, among others. He saw two main challenges: 1) the level of capital and mix of debt/equity and 2) the nature of debt. In Moody's rating approach, "capital adequacy" accounts for 10-15% of the total rating view. E.g. for Aaa capital to total assets has to be above 12%, and for Baa between 4% and 6%. "Capital leverage" can account for 20% of the total rating view and a new category will be "capital fungibility" (regulation, tax, etc).

Comment from S. S:

→ *Overall, Moody's rating model is enhanced (as are its competitors') due to fundamental changes in assessing solvability of the insurance industry. Unlike others, Moody's model appears more transparent and includes less of a change to date.*

Q&A included the role of reinsurance as a form of capital, with availability and pricing being an issue. Collateralisation (US barrier), the participation of hedge funds in hybrid debt and the slow pace of securitisation market development were also discussed.

Securitisation for more efficient capital management

2) **Shayne Deighton, Group Financial Management Director at Aviva plc**, introduced the panel on the subject of "**Capital Efficiency, Reinsurance and Risk Securitisation, New Structures and the Changing Regulatory Scene**". His introductory remarks pointed to the industry still needing capital (regulatory, M&A and other purposes) and also to securitisation not being a commodity product yet, but a tool enabling companies to "show" diversification benefits.

FSA proposals for improving UK insurance market regulation

Julian Adams, Head of Wholesale Insurance Department at the FSA, UK, used this platform to announce major changes in the regulatory treatment of the insurance industry. Two issues, supervision of groups and risk transfer to capital markets were a main focus. There were two ways of viewing this: either as a single economic entity, or as a collection of legal entities. A discussion paper by the FSA proposes greater freedom to allocate capital resources between different subsidiaries within the EU and also discusses the responsibility of supervisors of groups. The paper proposed holding no more than the minimum capital requirement (MCR) at local level, while retaining any excess capital at group level (SCR and Solvency II at group level). Mr Adams saw the main issues to be addressed in this respect as: using capital to support a local unit in extreme circumstances; capital flows being impacted by tax, legal restrictions or by a closed fund; transferability in case of insolvency (guarantee fund); and the insurance/capital market relationship (e.g. new capital in reinsurance industry, including side-cars). Further issues to be addressed by the UK regulator are the Reinsurance Directive especially with regard to special purpose vehicles, where the FSA creates the ISPV (Insurance Special Purpose Vehicle), recognising the relatively lower level of risk associated with SPV transactions compared with traditional reinsurance companies. Finally, he outlined simplified procedures for setting up a new insurance company in the UK, where the process will in the future take 4-10 weeks vs 16 weeks today.

Comment from S. S:

→ *The UK regulator made a clear statement in going ahead with pragmatic solutions with regard to new developments such as group supervision or the ISPV, which will clearly impact discussions on regulation over the coming months in Europe. The measures taken are aimed at maintaining or improving the attractiveness of the UK (London) insurance market, which appears to be successful. He said that the policy of the FSA was to encourage dialogue with the insurance industry to find solutions to new problems in order to increase the efficiency of the sector, which in turn will benefit insurance consumers.*

Securitisation as a new way of raising capital

Alarik van Doorn, Managing Director and Head of Structured Credit at Dresdner Kleinwort introduced his colleague **Ed Collinge** who presented the investment bank view on capital efficiency. Securitisation was explained to be nothing other than a pooling of assets and the selling of future cash flows generated by these assets to investors, as started by banks in the 1970s with mortgage-backed securities or credit card loans later on. In order to successfully structure a securitisation deal, stable cash flows and a low volatility of these are key success factors. He mentioned Friends Provident's embedded value securitisation and AXA's personal motor book securitisation as interesting examples. In a simplified example he showed that IRR pre-securitisation of 12% can jump to 44%, however with a floor on the upside. To conclude, he saw securitisation as a new way of raising capital. The future of the industry was to transfer low volatile risks to the market, with the role of insurers being to source and administer business with increasing ROEs.

Comment from S. S: → *Another investment bank stating that securitisation is the future. It is in their interest, but also in that of the insurance industry. We now only need investors to understand and buy such products; the pipeline appears ready.*

The ISPV: a great new tool

Patrick Devine, Partner at Reynolds Porter Chamberlain, Solicitors, spent some time explaining the ISPV (insurance special purpose vehicle), an FSA created user-friendly SPV, created in regard to the implementation of the Reinsurance Directive. He gave details on the technicality of this vehicle and explained how the ISPV would be supervised through the ICA (individual capital assessment). An ISPV would assume (re-)insurance risks and fully fund exposure to them through debt issuance or similar financing mechanisms (not further specified). Also, it subordinates investors' rights to repayment to the ISPV's reinsurance obligations. In terms of solvency, the ISPV would only have to have assets above liabilities, which represents a straightforward and pragmatic solution. In terms of investment rules, the "prudent person" approach was applied. Overall, he saw this setup as a relative advantage compared with other European countries, where ISPV regimes have been delayed.

Comment from S. S: → *The UK offers a great tool to transfer risk from one's own balance sheet into an ISPV, which is pragmatically regulated and low-cost. An ISPV can result in a reduction in a company's regulatory reserving and capital requirements by claiming credit for the risks transferred. A great tool!*

Q&A dealt with issues such as the FSA's white paper for simplification, the treatment of company regulation not being a matter for the EU (where legal and conceptual problems remain an issue) or the attractiveness of the London market to risk transfer companies. Another question raised the ability of the FSA to give credit for a) reinsurance and b) contingent loans, securitisation and similar arrangements, where ISPVs could be included.

Lloyds position strong: processes to improve

The pre-lunch speaker was **Richard Ward, Chief Executive of Lloyds's** of London since April 2006, when Nick Prettejohn left for Prudential. His speech focused on the needs for Lloyd's in the future. He first explained Lloyd's strong position today: GBP2bn of capital in the central fund, underwriting profits +20% at H1 2006 and an "A" financial strength rating. He stressed that the brand was unique and worldwide 74 licences allowed it to deploy its valuable human capital. He saw the major external challenges as contract certainty (where big efforts have been achieved so far), the commission structure and competition. Internal challenges were the inefficiency of processes, with claims having to be processed electronically in future.

Solvency II: European or Global?

3) "**Progress on Solvency II and the Search for Global Standards**" was presented by **Philip Broadley, Group Finance Director of Prudential plc**. He introduced the three speakers from the regulatory, insurance and rating agency world.

IAIS paper to structure regulation

Rob Curtis, Chairman, Solvency Committee, International Association of Insurance Supervisors and FSA, UK, presented the IAIS (International Association of Insurance Supervisors) structure paper for the assessment of insurer solvency, which is expected to set the future framework for local regulators. The 15 structure elements include, among others: 1) the power of a regulator, 3) what risks have to be looked at, 4) a total balance sheet approach, 5) a market consistent valuation (the most controversial point in the paper), 7) the uncertainty of insurance liabilities being expressed in a "risk margin", 10) ALM mis-match to cost capital, 14) a solvency control level and intervention level, to cite a few principles. For 2007, IAIS will work on guidance for judgment on internal models, standards for risk management, capital resources and the valuation of liabilities. The target remains convergence of standards across countries.

Comment from S. S: → *This international supervisory body works on the standardisation of worldwide insurance regulation, which is certainly most welcome. It also is very active in training local regulators and giving input on important issues in the insurance industry, such as ALM, or disclosure requirements among its members in 180 jurisdictions.*

S II not just capital, but change in behaviour

Sue Kean, Director of Risk and Capital Integration at Aviva, pointed out that Solvency II was not just about capital, but a change in behaviour. She outlined that Solvency II should bring incentives for risk management, and EU harmonisation in terms of fair capital requirement. She stressed the consensus in Europe (especially in the CFO Forum) for an economic approach, with the details to achieve this being the challenge. Key elements of Solvency II were coherence, assets and liabilities on an economic base and a two tier MCR (minimum capital requirement) / SCR (solvency capital requirement) regulatory approach. She also reiterated the importance of diversification benefits, outlined by the CFO Forum in 2005, of between 35% and 60%. Here the challenge for regulation is the legal entity view. She concluded that Solvency II would result in a fairer allocation of capital to risks and greater transparency, which should positively impact the industry's valuation. Being complex, Solvency II was a "two-step-forwards", "one-step-back" process.

Comment from S. S: → *We share the view of a slow and painful process in regard to implementing the top down principles agreed upon, with the QIS 2 impact study results showing some way to go; the lack of data and adequate resources are further contributory factors. But Solvency II allows industry players to better recognise the risks in their balance sheets and better price them in the future.*

Solvency II: what level of ruin?

Rob Jones, Managing Director of Insurance (Europe) at Standard and Poor's presented Solvency II as a "revolution". He saw this new framework as a more intelligent and risk-sensitive supervision, but also saw a risk that too many member state "options" might be included. He raised the key political question of the level of ruin to be allowed in the future Solvency II framework. He had a question mark over pillar 3, transparency, where opinions between regulators (low) and the EU commission (high) diverge. Some markets such as the UK, Switzerland, Denmark or the Netherlands are ready for Solvency II, others like Germany, Italy, Spain and France are less so. He saw the general capital requirement increasing, with diversification being a big advantage in pricing risks. Surprisingly, he believes some local and mutual players have not yet "woken up". In S&P's new model, to be commented on by the industry by 14 February 2007, eight rating categories exist, with capital adequacy now being more important and the treatment of "risks" changing.

Comment from S. S: → *We believe the question of the level of failure in the industry is the most important one to be addressed, bearing in mind how the industry was sailing through the KRW storms with much more standing than expected by markets and rating agencies. With the risk of politicians taking too cautious a decision on this issue, we believe it would be wrong to further increase capital requirements for the insurance industry.*

Q&A addressed issues such as the measuring framework of 1 year, the 99.5% confidence level, and the challenge of addressing diversification in the light of a global and local or legal entity view. The question of how the industry's behaviour has already changed in the Solvency II process was more discipline to be recognised so far in the P&C cycle. Mutual or smaller companies were not expected to be at a disadvantage in the Solvency II process, except for the hybrid capital issue. There was also a discussion over whether the industry will need more or less capital going forward.

IASB US GAAP to converge by 2009?

4) The last session of the day was opened by **Patrick O'Sullivan, CFO of ZFS**, introducing the subject of "**IASB and FASB Convergence: Agenda and Challenges**". He suggested insurance was one of the most difficult topics to handle also because the industry has been unable to come up with sensible cash flow statements. As IFRS does not easily allow a thorough understanding of the industry, a framework such as embedded value has emerged, though this too is still not a global measure (at least not for the US).

Rather mutual recognition than convergence

Denis Duverne, Member of the Management Board in charge of Finance, Control & Strategy at AXA, outlined his view in support of mutual recognition rather than convergence of US GAAP and IFRS in the foreseeable future. The convergence roadmap started, this should allow AXA to file only under IFRS after 2009, if everything goes to plan. US GAAP and IFRS were notionally similar but different in terms of detail (e.g. accounting for financial instruments, pension benefits). The convergence makes sense in theory, but IFRS weaknesses are not clarified by the accounting bodies. The main differences were the legal view (US GAAP) compared with the economic view (IFRS) in discretionary participations; the exit value for liability measurement not being equal to the US GAAP treatment; and investment performance measurement. Mr Duverne elaborated on the "signal to noise ratio", based on Professor Gerry Dickinson' definition of artificial volatility created by full fair value financial reporting, in view of the long-term nature of the insurance business. Overall, he saw 2009 as a challenge for convergence achievement and proposed another more pragmatic solution: mutual recognition.

Comment from S. S:

→ *The proposal of mutual recognition of IFRS and US GAAP is certainly a better and also realistic solution, but might not be implemented by the accounting standards boards, where pragmatic solutions do not always predominate. Stock market regulators such as the SEC or the European CESR can play an important role here and in our view would have an interest in testing such a solution.*

Insurance accounting: from ugly duckling to leading voice?

Ian Dilks, Global Head of Insurance Group, PWC, added a consultant's view of the subject of accounting convergence. He stressed that convergence was a process rather than an objective and that half the world today would use US GAAP whereas one-third in terms of market capitalisation would use IFRS. He explained the interdependence on capital markets and accounting standard-setting boards. He also outlined that coherent and consistent application of IFRS (meaning acceptable, not identical application) was a prerequisite for reconciliation elimination in the US. PWC sees three levels of standards for measuring companies: Tier 1 Global GAAP, Tier 2 industry-based standards (embedded value or EEV, which is preferred by 55% of UK equity analysts as a primary valuation tool) and Tier 3 company-specific information. He closed the presentation by highlighting Phase II of IFRS covering most of the "convergence" topics, which are revenue recognition (fair value measurement), liability and equity classification (participating contracts issue), consolidation for considering the issue of control in a "fiduciary capacity" (unit-linked: pure asset management) and accounting for policyholders to potentially influence the issue of pension accounting. IFRS phase II was seen to be a tool for shaping or helping to resolve the convergence discussion.

Comment from S. S:

→ *Whereas the insurance industry woke up late to the need to take part in the future accounting framework discussions when IFRS Phase I was launched, it now seems likely that detailed discussions to resolve insurance issues will help address matters such as pension liabilities for other industry sectors. Full convergence of IFRS and US GAAP was still a long way off and mutual recognition was the most practical way ahead for the next decade, at least.*

Market adjusts for accounting differences

Stefan Schürmann, Senior Insurance Analyst at Crédit Agricole Cheuvreux, added his views on the subject of convergence from an investor/analyst angle. He said that the IASB/FASB convergence roadmap took six years to mature from "exploring the possibility of reconciliation elimination" in 2000. When looking at real reconciled figures reported by AXA, AEGON, ING and Prudential plc, the main finding for 2004/5 was that average net income for both years was not different between IFRS and US GAAP, but shareholder funds were on average 18% higher under US GAAP than under IFRS. Interestingly, the current market valuations of the six biggest insurers in both accounting frameworks shows a valuation difference in terms of price to book value of 16%, which suggests that the market does adapt to different measuring frameworks. However, when looking at company-by-company reconciliations for a specific year, net income fluctuated by between -24% and +59% and book value by between 7% and 38%, suggesting there is some room for improvement in terms of convergence, but more important a greater need for IFRS "internal" consistency adjustments before convergence to US GAAP. The real figure analysis suggests a need for convergence in issues such as pensions, own real estate valuation, hedge accounting, tax treatment and purchase accounting. When looking at the convergence roadmap, some of these issues will be addressed (at least in exposure drafts) by mid-2007. A closing question was who needed convergence more, FASB or IASB, with international pressure mounting on US GAAP, as more and more countries adhere to IFRS. Nevertheless, US GAAP with more rules-based principles and a broad literature, might maintain a greater influence over future accounting discussions.

Q&A touched on the topic of European embedded value, how investors use accounting in their valuation, and the fact that accounting for insurers is still different from other industries, especially on the issue of cash flows, which is to be considered in the Phase II discussions. The cost of regulation and IFRS developments were also discussed.

Economic value creation

5) **Max Taylor, Deputy Chairman of Aon Ltd and former Chairman of Lloyd's of London**, introduced the subject of "**Creating and Managing Economic Value in Insurance Companies**", with speakers from the industry, consultants and investors.

Operating efficiency, capital management growth/innovation

Mel Carvill, Head of Strategy, Finance and Risk Management at Generali started with a company internal view, with the key definition of value measurement being the delta of economic equity between two points in time (= RoEV). He gave an example of cost of equity being 9% and the target return on embedded value being 15%, where Generali stood at 12% in 2005. Generali believes in local entrepreneurship, by aligning interest, the use of risk metrics, capital optimisation and ERM as value creator. He gave examples of 10% new business value creating 30bp of RoEV or a EUR2bn shift from equity to hybrid debt creating 1% of RoEV. He also explained that the EUR10bn of value in-force was a big drag on value creation, with the solution being to bring this off-balance sheet through tools such as securitisation. Three factors to improve value creation were cited: operational improvements, capital leverage (share buybacks, hybrid debt) and growth & innovation. The main challenges in the case of Generali were: decentralisation, global/local view, full integration of risk management, regulation and minority equity interests. He closed his presentation on value creation highlighting the importance of risk-adjusted metrics, efficiency improvements, the alignment of interests, business opportunities and capital management.

Comment from S. S:

→ *Generali steers its value creation on the embedded value framework, defining a delta of economic capital in the "economic balance sheet" as the RoEV. Decentralisation favours local innovation, but it is a challenge to control it groupwide.*

From "defence" to "offence"

Anthony Stevens, Managing Director (Europe) at Mercer Oliver Wyman, showed some historic figures on the financial services industry, with market cap doubling over the last 3-4 years and growth being 1% above GDP p.a., suggesting that financial services add 1.25x the value of the average market. Going forward, a recent CEO survey expects on average 5-14% market value growth. The Sharpe ratio over the last five years shows only a 0.1% median with a big gap between winners and losers, suggesting that big financial services groups create less value than the market average. Whereas the insurance sector today offers a 20% discount to the banking sector, 20 years ago the sector traded at a 20% premium to banks. The future should allow the unbundling of liabilities, the adoption of strategic balance sheet management, increased focus on asset management and thus a move into "offensive mode" from the "defensive mode" of the past. Product innovation such as variable annuities will allow the industry to regain momentum, with a mix of risk taking and optimised action on capital to bring the industry back into a more positive light.

Comment from S. S:

→ *Leading consultants always give a good reflection of what is being discussed at top management level. Believing this, the industry is working on its risk taking and profitability in order to become stronger, which will also be perceived by the public.*

Reporting risk! Back to basics

Maurizio Lualdi, Senior Investment Advisor (Insurance), The Capital Group, outlined his most interesting view on the insurance industry's value creation. Over the last 20 years, the European insurance sector has underperformed the market, especially its US peers. He sees a major difference between the two markets, as the US has no "dispute" on the measuring framework. His message was that the insurance sector accounts for only 5% of the world's market capitalisation and rather than going into further EEV developments, the sector should go back to basics. The end user, a non-specialised fund manager, normally does not understand an EV framework. For the insurance sector, he sees two major black boxes: reserves in non-life and profitability for life. Another issue was the treatment of risk, where the banks use a VaR approach that is well accepted among investors. VaR can be given in detail in the notes of the accounts and helps to keep the financial statements more understandable and comparable. Overall, current discussions on the measuring framework for insurers include a substantial reporting risk, which banks do not have. In the end, what investors want is cash generation, defined as cash earnings minus the increase in required capital, which should result in the maximum affordable dividend payment.

Comment from S. S:

→ *Maurizio made a clear statement for keeping it simple and coming back to a view that insurance has in the end to be compared with other sectors, from an investor's point of view. Otherwise investors will be less inclined to buy the shares of insurance companies. This should give food for thought for all the committees involved in the current discussions on the future measuring framework for the insurance industry!*

Q&A discussed the differences between insurers and asset managers or banks, capital leverage and the impact of diversification with regard to the risk-adjusted return on capital. One participant was convinced that the market does understand insurance, at least much better than five years ago, a view not broadly shared by the panel. Another question addressed the issue of how to measure life profit margin: would accounting or the EV framework move first to a more useful solution?

6) **Jerry de St Paer, CFO of XL Captial Group** introduced his panel on the subject of **"Phase II of the new IFRS in Insurance: Is a Solution Emerging"?**

**Discussion paper
Phase II in Q1-07**

Peter Clark, Senior Project Manager (Insurance) at the IASB reminded us of the fact that an "insurance" standard has only existed since 2004 (IFRS4). The timetable for IFRS Phase II was as follows: discussion paper expected for Q1-07, not a complete version but including the "hot spots" and leading to an exposure draft after 18 months and a standard by late 2009, with realistic implementation by 2011. He described the three building blocks in this paper: 1) estimation of future cash flows; 2) the time value of money; and 3) operating margin. On the first point, current estimates, unbiased and probability-weighted characteristics provide guidelines. On the second issue, current discount rates have to be applied but expected returns were not important. The margin should include a service and a risk margin. Another important issue in discussion was the measuring of liabilities where "current exit value" (could be close to "fair value") should be favoured, due to more relevant and reliable information on contractual cash flows, explicit margins, consistent change in estimates and clarity on economic mis-matches (eliminating the accounting mis-match). He further described the issues of acquisition cost and policyholder participation accounting treatment, both work-in-progress. Lastly, high priority was given to the US convergence project, where the roadmap between IASB and FASB was signed in a memorandum of understanding in September 2006. On the insurance side, the US will address accounting issues such as risk transfer, financial guarantees and life settlements (policyholder participation) in the short term, to be closely watched by the IASB.

Comment from S. S:

→ *The phase II IFRS discussions are ongoing, with the discussion paper long-awaited by the industry. However, political influence, convergence with US GAAP and other sector's priorities will impact insurance accounting; we therefore expect the discussion to be long. Finally, the US view, articulated by AIG later in this summary, will have a big impact on the discussion, in our view.*

**CFO Forum an
important voice in
the Phase II process**

Nigel Masters, Chief Actuary of Global Life Business, ZFS, said that his company supported the view of the CFO Forum, which includes the use of future cash flows, discounting and a "margin", consistency and the unearned premiums approach as major principles. He explained that a market-consistent approach was not easy to achieve, due to volatility issues. On the margin, he outlined the different techniques applied by companies and questioned the definition of a "service margin". For participating plans, the current IASB proposals could result in "expected future losses". He stressed that obligations depended on economic conditions. The market-consistent approach faced major challenges, summarised as: ensuring economic models, doing 10 million calculations per policy, revisiting the treatment of foreign exchange (quarterly reporting) and – perhaps the biggest challenge – analysing change, e.g. cash flow calculations. In conclusion, he saw IFRS Phase II as a slow process but a great opportunity for the insurance industry.

Comment from S. S:

→ *The CFO Forum, through its 20 members, tries to shape the future phase II in IFRS for the insurance industry. The discussion will be long, but the solution hopefully useful. There will be no new standards until 2009, according to the IASB, with companies being given a break to digest past changes and reshuffle systems in order to be ready for future changes.*

**GNAIE against
the exit value**

Steven Bensinger, Executive Vice President and CFO of AIG, used this platform to address a clear message from the US insurance industry: they do **not** share the theoretical approach of "**exit value**", proposed for non-life liabilities valuation in the phase II project. He expressed the belief of the GNAIE (Group of North American Insurance Enterprises) that their current approach of best estimates of future benefits and expenses was more useful than a theoretical approach with no reliable market-based cash flows, where discounting and risk margins are issues to be considered. By discounting reserves, there was exposure to estimation errors, reduced comparability, possibly resulting in misleading performance indicators. He compared the solvency and accounting views, where probability-weighted liabilities represented a policyholder's view whereas best-estimate accounting was an investor's view. Overall, an exit value approach would lead to additional artificial earnings volatility and therefore higher cost of capital and also leave room for subjective judgments. He outlined that a non-life company working more efficiently than the market average would have to add an artificial "accounting premium" to its liabilities, which would not make sense. He closed with the message of "let's converge to the right standard".

Comment from S. S:

→ *This is a clear GNAIE statement against the IASB and European proposal of non-life liabilities valuation on an "exit value framework" and will heat up the discussion on this issue. We believe this discussion to be healthy and hope for a pragmatic, easy-to-understand solution for all stakeholders. The CFO Forum, GNAIE and four leading Japanese life insurers (representing many of world's leading insurance companies) presented their views to the IASB in September 2006 on what they considered should be a set of guiding principles for a solution for Phase II of the Insurance Contracts project.*

Q&A discussed the issues of discounting (not a conceptual but a practical issue), the difference in pricing for insurance and reinsurance upon inception of a contract (risk premium different for insurer than for reinsurer) and the issue of accounting treatment for volatile pricing changes. No one really knows how to calculate accurately a 'risk margin' that is market consistent. Also, AIG's CFO stated that US GAAP was currently too rules-based, going more in the direction of principles based in the future, and allowing more "judgment" by users.

7) **Jonathan Bloomer, Managing Director of Cerberus UK Advisors and former CEO Prudential plc** introduced the last panel on the topic of "**Current Challenges in the Investment of Insurance Company Funds**".

**Liability driven
investing**

Guido Fürer, Head of Global Asset & Risk Management at Swiss Re presented the challenges of investment management. Swiss Re uses an "economic view", as this will be reflected in accounting results over time. The economic balance sheet approach includes experience, perception and future, indicating the economic net worth as a result. The challenge in asset/liability management was changing liabilities in a liability-driven investment approach. Investment management was given benchmarks, in relation to credit risk, interest rate mis-match and more. In order to optimise the asset allocation, regulatory, tax, legal and liquidity, restrictions had to be taken into account. For Swiss Re, ALM in practice meant above all protection of capital (stress testing) and lower earnings volatility, which sounds easy but involves a lot of work. Other issues to be included in the investment management approach were Swiss Re's ROE and EPS growth targets as well as the different rating agency capital adequacy ratios.

Comment from S. S: → *Investment management is one of an insurance company's great value creators (or destroyers, in the past). We believe the market lacks a wider discussion on the specific issues of investment management in a (re-)insurance company, which evolves in a different environment compared with traditional asset management.*

Regulatory and operational constraints

Daniel Mouen-Makoua, COO of AXA Investment Managers UK, presented his view from the UK life insurance side. He defined three stages in the life cycle of a policyholder: asset accumulation, preservation and retirement. New regulation and constraints led to new investment classes such as private equity, CDOs, infrastructure investing and commodities, to cite a few. He elaborated on the regulatory and operational constraints in the UK, e.g. the FSA prudential rule, IFRS, FSA realistic policyholder expectations, tax (life funds). He elaborated on the use of equities and real estate in with-profit funds, fixed income in non-profit funds and additional use to optimise investments through structured finance or hedge funds. Portfolio optimisation could be achieved by diversification and careful choice of managers.

Comment from S. S: → *Another presentation on the specific handling of investment optimisation at insurance companies, where different constraints make an investment process a more sophisticated issue than for "traditional" asset managers.*

Alpha, beta and liability hedging

Alasdair Macdonald, Senior Investment Consultant at Watson Wyatt Worldwide, closed the day with a discussion of two issues: the risk budget and the governance budget (time). He addressed three different levers: liability hedging, alpha generation and beta diversification. Liability hedging could be achieved with a longer bond duration or cash flow hedging through swaps. The cost of a swap was defined as spread x duration x present value, which can lead to substantial costs. Alpha generation was driven by the selection of managers and the investment areas and segments to be chosen. Lastly, beta diversification can happen by choosing small cap investments often offering relative information advantages, a short-term compared with a long-term view and an optimisation of investment manager hire & fire.

Comment from S. S: → *An investment approach with ALM playing a dominant role clearly has the potential to create value more value than can be achieved by "average" investor.*

Q&A focused on a more complex investment process, alpha generation compared with a passive beta view (80% of return) and today's greater use of derivative instruments in the industry.

Keep it simple: complexity is expensive

Prof. Gerry Dickinson wound up proceedings by outlining two significant outcomes from the seminar:

- the willingness of the FSA, and indeed CEIOPS, to discuss openly with the insurance industry to find a solution to the complex issue of "the group discount" in Solvency II and to discuss new risk securitisation and capital raising possibilities that are now emerging;
- the IASB needs to listen more to views of the US insurance industry, especially in relation to non-life insurance accounting issues. Failure to do so will probably affect the IASB-FASB convergence project in the future;

Complexity is expensive, and keeping things simple should be a major priority, whenever possible, to ensure that the insurance industry remains fully competitive in the fast-changing financial services market place.