

Solvency Management in Life Insurance Ciudad de México

Is Fair Value the Answer ?

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Agenda

- Background
- What is fair value and how should it be measured
 - U.S. GAAP
 - Current IASB Discussion Paper
- When to apply
- When is it coming
- Possible role in solvency management

Background

- Long-term trend in accounting towards fair values
 - Especially for business combinations and derivatives
- Accelerated recently with changes made by both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) in
 - Asset disclosure
 - Measurement of invested assets
 - Trading, available for sale, amortized cost
- Both the FASB and IASB have stated that their long term goal is to have all financial assets and liabilities at fair value

Background

- U.S GAAP
 - 2001: Concept No. 7 – fair value measurement conceptual guidance
 - 2006: further elaboration in SFAS 157, *Fair Value Measurements*
 - Exit value approach
- IFRS
 - December 2006: exposed SFAS 157 as a discussion paper
 - Final conclusions uncertain now
- Both efforts provide measurement guidance
 - Not when to use fair values

What is fair value

- US GAAP

“The price that would be received for an asset or paid to transfer a liability in a transaction between marketplace participants at the measurement date.” (SFAS 157.5)

- IFRS

“The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.” (IAS 39.11)

Being reviewed with current Exposure Draft

How to measure

- Key points in definition
 - Exit price basis
 - In the principal (or most advantageous) market
 - To maximize amount received for an asset or minimize amount paid to transfer a liability
 - From perspective of a market participant
 - Focus on economic value, not entity's intent or ability to sell an asset or transfer the liability
- Thus, relevant to insurance contracts, even with no relevant and reliable exit market
- Insurance contracts primarily marked-to-model

Market

- Two types of market
 - Wholesale -- business-to-business (exit)
 - Price in hypothetical transaction to sell an asset or transfer a liability
 - Not adjusted for transaction costs
 - Retail -- business-to-consumer (entry)
- Use assumptions a market participant would use in pricing, including risk
 - Entity-specific inputs OK if not inconsistent with what market participants would use

Market participants

- Independent of the reporting entity
- Knowledgeable
- Able and willing to transact
- For a liability
 - Assumes transfer to participants of comparable nonperformance risk

Valuation technique

- Should be consistent with market, income or cost approach
 - Might use multiple methods
- Appropriate for circumstance
 - Based on reliability and subjectivity of inputs
 - Width of range
- Unit of account
 - Addressed in what is being measured

Inputs for valuation technique

- Hierarchy levels
 - Observable based on independent market data
 - Level 1
 - Quoted prices for identical asset/liability
 - Level 2
 - Other market observable inputs
 - Unobservable
 - Level 3
 - Based on best available information
 - Subject to cost-benefit constraint
- Lowest significant input
 - Determines fair value category
 - Drives level of financial statement disclosure

Level 3 disclosure

- Reconciliation of beginning and ending balances
 - Total gains and losses for the period
 - Changes in unrealized gains/losses for period
 - Transfers in and out of level 3
- Description of techniques and information used

When to apply

- Specific fair value measurement standards only address how to measure
- When to apply fair value is indicated in other standards
 - Makes many uses of fair value more consistent
- Fair value option – on a contract-by-contract basis
 - In place for IFRS
 - Coming for US GAAP
 - Potential to avoid a mixed attribute model
 - Until ultimate objective achieved

When is it coming

- Fair value already in effect
 - For many assets, including derivatives
 - Allocation of purchase price at time of business combination
- US GAAP
 - SFAS 157 for reporting years after 15 November 2007
 - FASB indicates this is not the final word and that refinements will follow
- IFRS
 - In various standards now, e.g. IAS 39
 - Uncertain when new measurement standard will be put into effect
- Future convergence
- Will accounting standard setters nirvana ever be achieved?

Some current issues

1. Choice between
 - Mixed attribute model
 - Possible measurement reliability and increased volatility
2. What is principal market
3. Risk margins
 - Calibration
 - Changes over time
4. Whether there can be a gain or loss at issue
5. Can the value of a derivative (option) be negative
6. Changes in nonperformance risk
7. Limited current guidance for insurance contracts
8. IASB insurance contracts phase 2 challenges include
 - Current proposal is expressed in terms of a current exit value
 - Is there a difference between this and fair value
 - Important feature is the measurement of risk margins to cover risks in a reliable manner in whatever measurement model used

Role in solvency management

- Better expressed in the context of overall financial management
- Underlying measurement of assets/liabilities (risk margins) is crucial in determining the desirable level of capital and its return
 - Affected by level of net risk undertaken and risk mitigation techniques available and their use
 - Determines allocation of risk coverage between liabilities and residual capital
- Fundamental in
 - Assessment of return and capital consumption
 - Performance measurement
- Relevant information needed by key stakeholders
 - Management
 - Capital markets
 - Regulators

Role in solvency management

- Management needs to
 - Determine level of target creditworthiness that optimizes the volume of business in its target market(s)
 - Hold sufficient capital to cover level of risk implied by desired creditworthiness
- Premiums and charges set at level
 - To service the cost of risk and capital carried
 - That customers are prepared to pay for the level of creditworthiness offered
- Thus, key strategic decision is the desired level of creditworthiness for the target market

Role in solvency management

Measurement of value, risk and return

- Management of new business
 - Pricing and acquisition cost needed
- Management of inforce
 - Post-issue use of product adaptability and management discretion
 - Including participating features
 - Financial risk management, including
 - ALM/ERM, Treasury management, capital need analysis
 - Investment strategy
 - Lapse risk: client relationship management
 - Operating costs in management of internal or external expense levels and their corresponding risks

Role in solvency management

- Measurement raises concerns over potential income volatility
 - Especially relating to users' perceptions
 - Fair value
 - More comprehensive use of fair values is one approach to avoid asset and liability measurement mismatch
 - Attempts to distinguish economic and accounting driven volatility
 - Key question is whether it can be done in practice
- IASB and FASB don't find volatility a problem, as they believe it reflects economic and market reality
 - Feel it an improvement on current non-comparable, opaque nature of insurance accounting
- Fundamentally, the greater the confidence in the underlying measurement of assets and liabilities, the greater the willingness to rely on capital values

Role in solvency management

- Use of relevant financial information
 - Provides a coherent framework for risk assessment
 - Internal and external use
 - Can be source of competitive advantage
 - For pricing, product management, performance management and management decisions
 - Can't afford to develop information just for regulatory compliance purposes
- Consistent overall package for use by various stakeholders