ICIR International Center for Insurance Regulation

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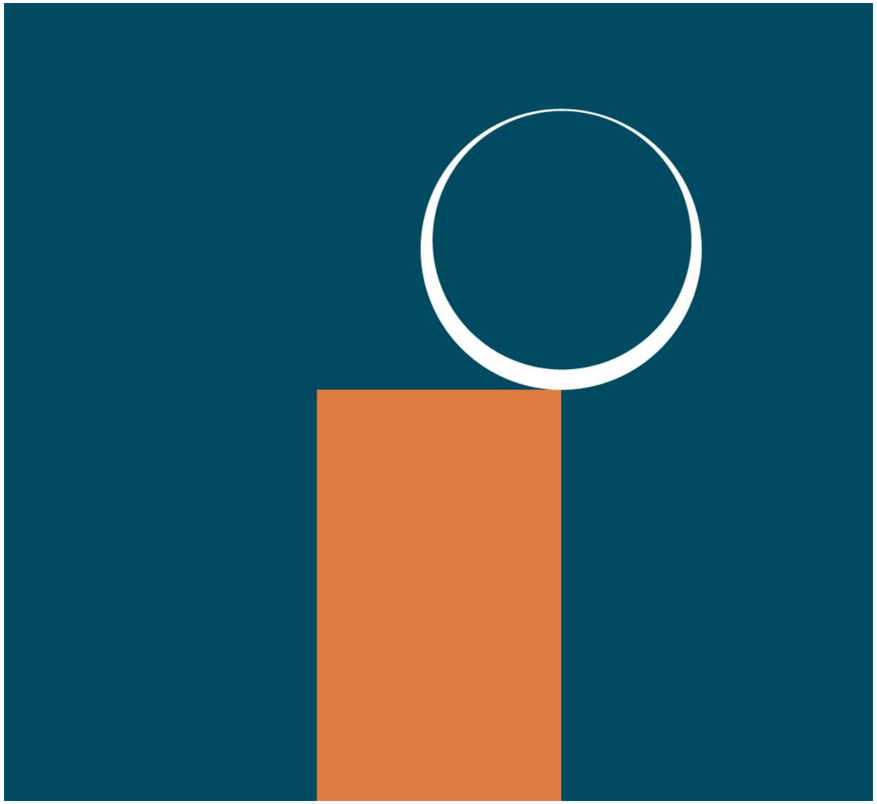
Valuation: “True and Fair View” under Pressure?

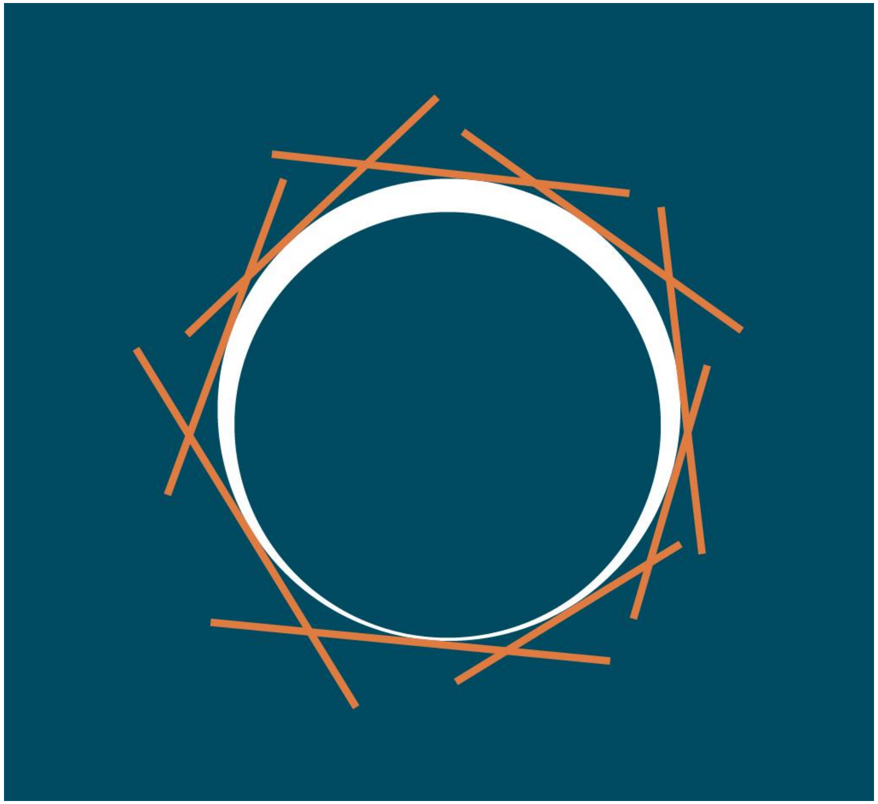
9 September 2015
Conference on
Global Insurance Supervision

This Morning

- **Issues of Valuation and Capital Requirements**
- **Their Effect on Insurers' Solvency Situation**



Risk



Regulation

Agenda

- “True and Fair View” in Solvency Regulation
- Pressure on “True and Fair View”: Low Interest Rate Environment
- Discuss Advantages and Disadvantages of “True and Fair View” in Solvency Balance Sheet

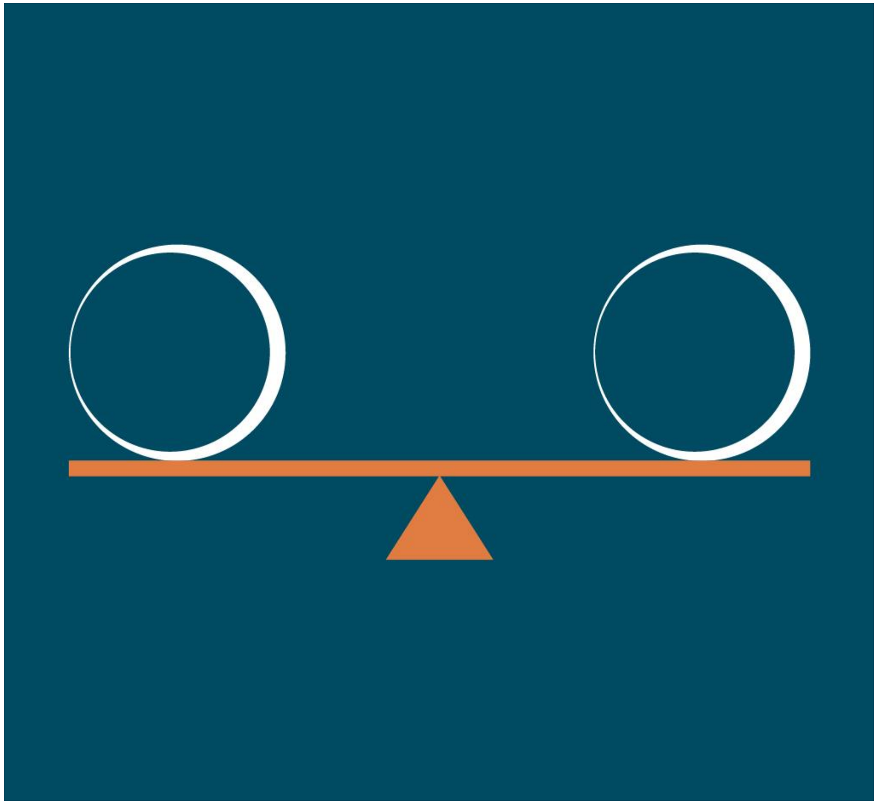
“True and Fair View” What is it?

Valuation
“True and Fair View”

- Financial statements **factually correct**
- **Compliant with** applicable **reporting framework**
- **No material misstatements** stemming from material errors or omissions of transactions
- **Faithful presentation of information** in financial statements
- **Reporting without any element of bias**
- **Reflect** the **economic substance** of transactions rather than just their legal form

„True and Fair View“
Core Element of Valuation in Present and Future Solvency Regulation Worldwide

- Australia
- Bermuda
- Brazil
- Chile
- China
- European Union
- Japan
- Macedonia
- Mexico
- South Africa
- Switzerland
- United States of America
- …



“True and Fair View” in the Solvency Balance Sheet

- **Insurance contracts** like other financial contracts well described by their **cash flows**
- Risk-return characteristics can be **replicated by listed financial instruments**
- Therefore: **Market-consistent**, i.e. arbitrage-free **valuation,** a **natural way to determine** values for assets and liabilities, and, as their difference, the value of the equity capital
- **Information-efficient view on solvency situation**
- **Low degree of managerial discretion**

“True and Fair View”
in the Solvency Balance Sheet

Best achieved through Market-Consistent Valuation

“True and Fair View” Through Market-Consistent Valuation

Advantages

- **Detect financial distress** at an early stage
- **Time to react** and implement counter-measures
- **Incentive for effective risk management**

Disadvantages

- **Detect financial distress** at an early stage
- Possible **severe reaction of stakeholders** (policyholders, supervisors, investors)
- Possible **severe counter-reaction** of management (fire sales to decrease risk exposure and realize hidden reserves)

An Example for Pressure on "True and Fair View": Life Insurance in the Low Interest Rate Environment

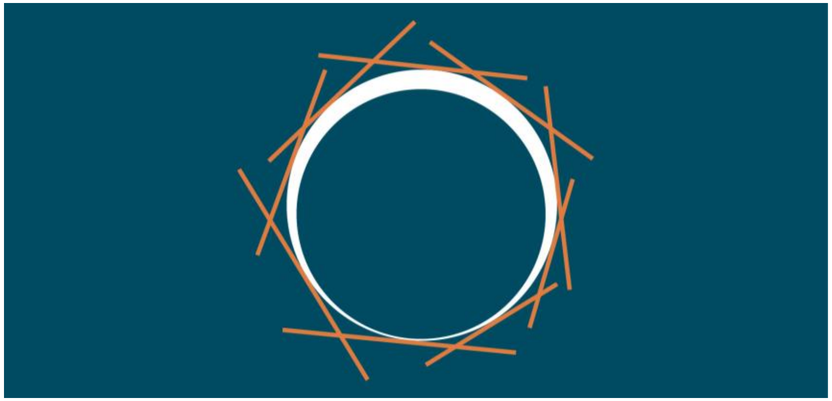
Life Insurance in the
Low Interest Rate Environment

- Especially in Europe: **endowment and life annuity contracts with high investment guarantees**
- **Guarantee period**: **often decades**

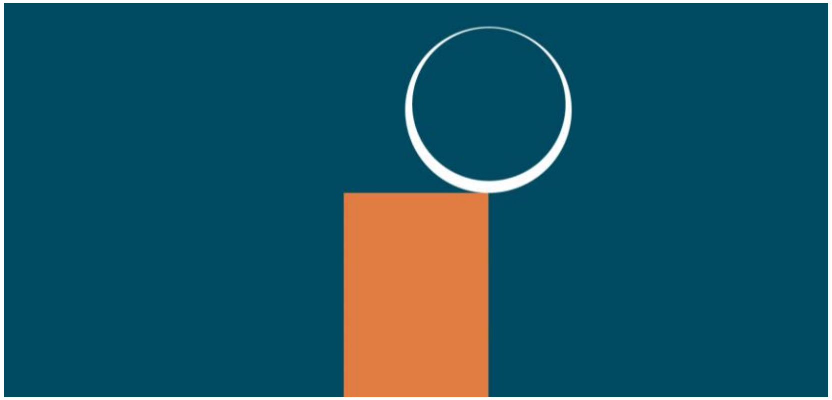
- **Investment portfolio**:
  > 90% fixed-income securities
- Duration of bonds
  < Duration of life insurance contracts

Life Insurance in the
Low Interest Rate Environment

- Preparation for Solvency II:
  Market-consistent valuation
  Assets: r ↓ → value ↑
  Liabilities: r ↓ → value ↑↑
  Equity capital: value ↓



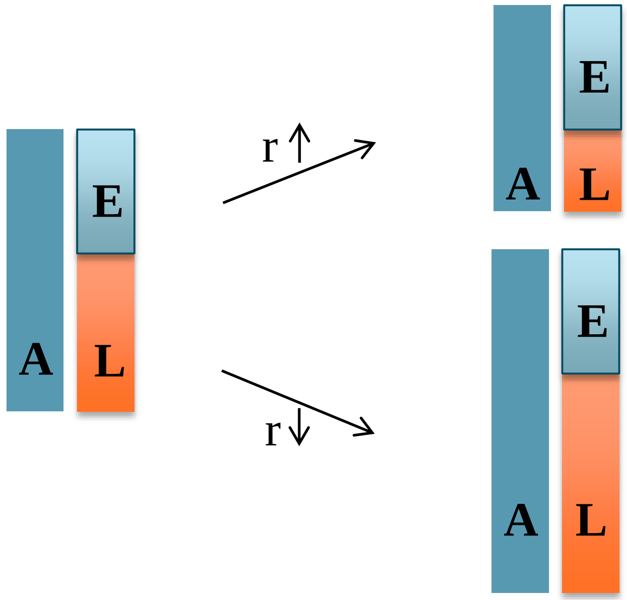
- **Insolvency risk** for a number of life insurers
- **Over-indebtedness**
  → **Illiquidity**



Life Insurance in the
Low Interest Rate Environment

Chance of True and Fair View through market-consistent valuation: **Incentive for appropriate ALM**

→ Increase duration of bonds, decrease duration of liabilities



Immunize equity capital despite volatility of asset and liability values

Life Insurance in the
Low Interest Rate Environment

Reality

- **Duration change of liabilities not feasible** at short notice
- **No sufficient supply of bonds**
  with Time-to-Maturity > 20 years
- Often **not possible to close duration gap**
  between assets and liabilities

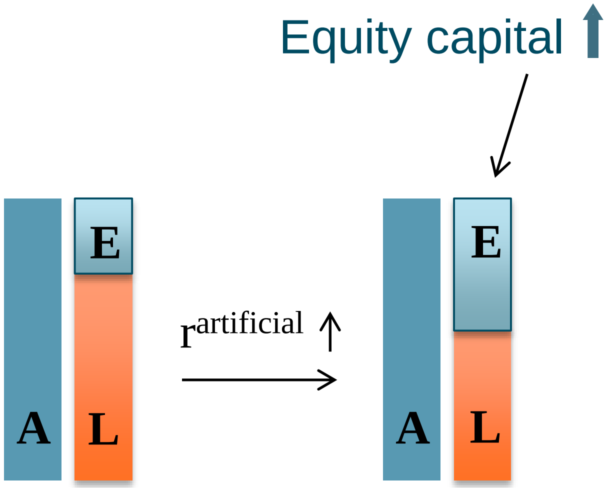
Life Insurance in the
Low Interest Rate Environment

Consequences

- Postpone introduction of Solvency II

- **“True and Fair View” in Solvency Balance Sheet** under pressure:

  Higher and less volatile interest rates for discounting liabilities (“ultimate forward rate”, “transitional measures”, “volatility adjustment”)



Deviation from "True and Fair View"

Advantages and Disadvantages

Deviation from “True and Fair View”
Advantages

Deviation from “True and Fair View” can

- … **avoid surrender waves** with immediate liquidity problems
- … **avoid fire sales**
- … can be an **effective remedy against panic reactions**
- … can be **advantageous in retrospect**

Deviation from “True and Fair View”
Disadvantages

- **Wrong incentives for risk management**:
  Optimize distorted balance sheet solvency vs. optimize real-world solvency
  → Inefficient allocation of funds and risks
- **Loss of time** to implement “real-world” risk management
- **Increased equity capital value** through deviation from fair value:
  No real capital buffer, but more or less **“hot air”**
- **“Stickiness”** of implemented deviations from “Fair View”,
  once the triggering crisis is over

→ **Sustained distortion of “True and Fair View”**

Thank You for Your Attention!