

# Coming up with the numbers

## Countdown to Solvency II

Preparing a Solvency II  
balance sheet and  
managing the impact on  
market communications

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*The Solvency II balance sheet will differ markedly from both current and future IFRS, creating significant technical, logistical and market communications challenges for European insurers.*

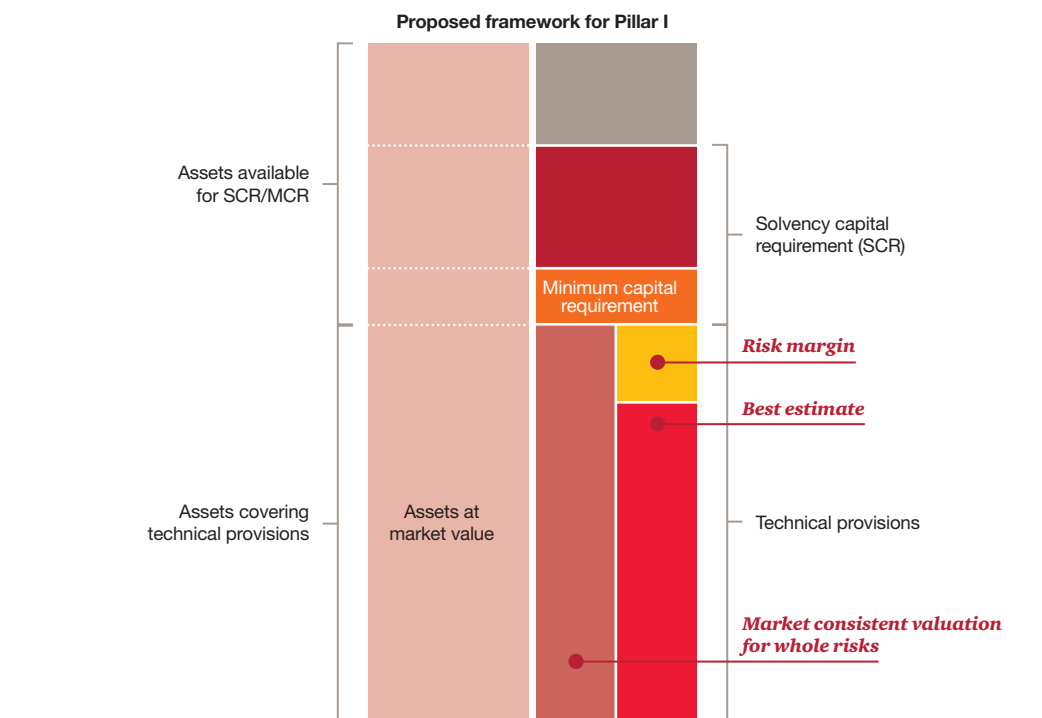
'We should not underestimate how big a task it will be to construct this balance sheet according to the new requirements. It is also worth noting that because of the importance of getting the balance sheet right, you can also expect the FSA to be focusing our attention in this area,' said Ken Hogg, Insurance Sector Director of the UK Financial Services Authority (FSA).<sup>1</sup>

The importance of the Solvency II balance sheet and the focus of supervisors stem from the fact that the technical provisions and risk margin are the principal building blocks of the capital requirements (see Figure 1). The 'total

balance sheet approach' ushered in by the directive, in which the eligible capital is the difference between the market-consistent valuation of assets and liabilities, will be a new departure for many insurers.

Supervisors will not just be examining the figures, but also whether the methodologies and assumptions used to produce them are valid. Insurers therefore need to be able to explain and justify their valuation techniques. Among the other areas of scrutiny will be whether the technical provisions are consistent with the internal model evaluations and vice-versa.

<sup>1</sup> Speech by Ken Hogg, Insurance Sector Director of the UK FSA, to the FSA Insurance Day Conference, 18.05.2010

**Figure 1: The Solvency II balance sheet**

Source: Committee of European Insurance and Occupational Pensions Supervisors

### **IFRS: Synergies and differences**

Insurers will also need to consider the implications of the new numbers for their performance management and how they are judged by analysts, investors and rating agencies.

There are some conceptual similarities between the Solvency II balance sheet and current IFRS, particularly on the asset side (the Solvency II implementation measures include guidance on how to go from one to the other). The market-consistent valuation of liabilities in the planned new IFRS for insurance contracts (see [www.pwc.com/insurance](http://www.pwc.com/insurance) for more information) would bring the two bases closer, opening up valuable synergies in data management and model development. However, fundamental differences will remain, and therefore preparing the Solvency II balance sheet will require far

more work than a simple conversion from IFRS (our paper 'Getting to grips with the shake-up' outlines the differences and potential synergies between the two frameworks).

Solvency II looks at the entity as a whole, and therefore, there is not the distinction between insurance and investment contracts that there is in IFRS. Other crucial differences include the absence of goodwill and other intangible assets in Solvency II, as the directive is primarily interested in funds that can be used to support solvency. The coming changes to financial instrument accounting (IFRS 9) are going

to create even more of a headache. In particular, assets on the Solvency II balance sheet will continue to be marked to market, while under IFRS many may be held at cost. This may make the Solvency II numbers a lot more volatile than IFRS.

The extent of the divergence will make it difficult to reconcile and control the two balance sheets. Insurers need to allow enough time to go through each item on the balance sheet to identify differences and, where possible, work out ways to bring them into line. The results of the latest quantitative impact study (QIS5) can help to identify

aspects of the balance sheet that are going to invite attention from analysts. Where reconciliation is not feasible, insurers need to come up with a good explanation as to why the numbers differ or they could find themselves facing some awkward questions from analysts and rating agencies.

### **Technical issues**

Risks that can be hedged (sometimes referred to as 'whole risks') will be measured on a market-consistent basis. Those that cannot be hedged will require a 'best estimate' of future liabilities. Such evaluations have always been difficult. The techniques used are essentially judgement calls, based on the nature of the portfolio and its risks. The back testing and documentation of judgements will therefore be critical in being able to justify the estimates to supervisors.

Solvency II will require a risk margin in addition to the best estimate of liabilities. As in the current solvency test in Switzerland, this will equate to the cost of holding the capital needed to cover the projected liabilities.

Proportionality and pragmatism will be crucial in making this work. Although the directive requires insurers to assess all possible outcomes, the effort needed to evaluate some risks may be out of proportion with their likelihood or impact. A simplified estimate may be the best approach. Similarly, there is no point in using the most sophisticated techniques when there is insufficient data to

*Undertakings must have adequate systems and controls, sufficient to give management and supervisors the confidence that their valuation estimates are appropriate and reliable.*

Source: CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Valuation of Assets and 'Other Liabilities', October 2009

## *The key drivers and uncertainties associated with the best estimate should be explored and described.*

Source: CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Actuarial and statistical methodologies to calculate the best estimate', October 2009

make them work. A simpler alternative may actually be more reliable. It might also be easier to adjust for changing circumstances, and easier for management to understand and validate the resulting calculations against expectations.

From a strategic perspective, one of the most potentially contentious elements of valuation is the discount rate and, in particular, the inclusion of an illiquidity premium. The basis for the illiquidity premium currently envisaged under Solvency II is a reference portfolio of corporate bonds in each currency, which could create a mismatch with the assets held by the company. This could in turn affect pricing, profitability and investment strategies.

### **Logistical challenge**

The underlying challenge is logistical. Insurers will eventually need to have the numbers ready for supervisory review within four weeks of quarter end. Quite a lot of the figures going to management, or being used within the Own Risk and Solvency Assessment (ORSA), may need to be produced even more quickly.

Companies should therefore look closely at what is required; including the impact on systems, and how to ensure the necessary collaboration between actuarial, risk and finance teams (see Countdown to Solvency II

article 'Up to speed with reporting'). In many cases proxy models for curve fitting or replicating portfolio techniques may be useful to accelerate timelines. QIS5 will have provided a useful indication of whether systems and processes are fit for purpose and what further work may be required.

### **Standing up to scrutiny**

Preparing the Solvency II balance sheet is a more demanding challenge than many insurers realise. Insurers need to assess the most viable measurement techniques and ensure that their methodologies stand up to scrutiny. They also need to anticipate variations between Solvency II and their financial statements, and explain to analysts the reasons for the differences.

The benefits include the development of market-consistent valuation techniques, which while different in important details can provide a useful basis for the future IFRS for insurance contracts. It will also provide more timely and reliable valuation for companies using economic bases of measurement such as market-consistent embedded value (MCEV) in their investor relations and internal management information.



**Charles Garnsworthy**

Partner PwC (UK)  
+44 (0) 207 804 4147  
charles.e.garnsworthy@uk.pwc.com



**Andreas Sanner**

Senior Manager PwC (Germany)  
+49 211 981 2129  
andreas.sanner@de.pwc.com



**Julia Schüller**

Partner PwC (Germany)  
+49 69 9585 2667  
julia.schueller@de.pwc.com

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