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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

GAAP with Adjustments (GAAP+)

Moving towards ICS 1.0

Presentation for Stakeholder Meeting in La Jolla, USA
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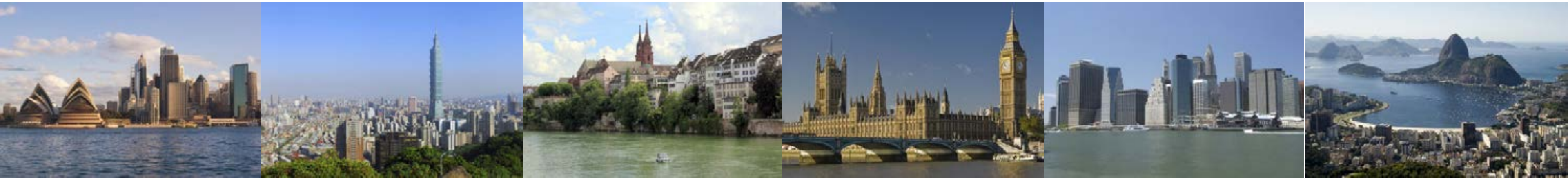

GAAP WITH ADJUSTMENTS

GAAP with Adjustments ("GAAP+") Principles

- Adjust only the most material items on the balance sheet, i.e., insurance-related liabilities and invested assets; the proportionality principle applies.
- To the extent possible, base adjustment on amounts, processes and/or systems subject to audit.
- Insurance assets and liabilities should be treated consistently to minimize non-economic volatility; may require some alignment between valuation of certain liabilities and assets (e.g., for AOCI).
- Insurance liabilities and reinsurance assets should be as reported on the audited GAAP financial statements and adjusted to approximate the current estimate.
- Invested assets should be as reported in the balance sheet of the audited GAAP financial statements, which for different portions of the portfolio could be at amortized cost or market value.
- All adjustments in the ICS Capital Resources section of the field test specifications would apply to GAAP+ just as for MAV; no other adjustments for capital resources would be unique to GAAP+ (with possible exception of MOCE pending further analysis).

Key Objectives of 2016 Field Testing Data Analysis

Broadly, the aspiration is for GAAP+ and MAV to eventually be comparable

Key objectives in 2016 field testing of GAAP+ include:

1) to determine that GAAP+ is developed so as to result in an appropriate capital ratio in its own right; and

2) to assess the comparability of outcomes between GAAP+ and MAV, which was done in two key respects:

    a. The impact of valuation on capital resources, i.e., the numerator of the ICS ratio. With respect to GAAP+, this was the primary focus of Phase I of the 2016 field testing, which is largely complete; and

    b. The impact on capital requirements, i.e., the denominator of the ICS ratio. With respect to GAAP+, this is the primary focus of Phase 2 of the 2016 field testing, for which some analysis continues

Outcomes from 2016 Field Testing Data Analysis

- 2016 marked the second year of field testing for GAAP+

- Generally, results were largely comparable to the prior year, showing that, with some exceptions/outliers among volunteer IAIGs, the principal difference in the impact of valuation on capital resources between GAAP Plus and MAV is related to:

  - The different discounting methodologies used for the two valuation bases and, to a lesser extent;

    - Differences in the definition of contract boundaries; and
    - For non-life, different understandings of Unearned Premiums

- The differences in discounting can be material as measured relative to insurance liabilities of the volunteer IAIGs, and to its corresponding impact on capital resources.

General Observations and Follow Up

Generally, there are three life valuation approaches being followed under GAAP+ where discount rates for GAAP+ liabilities are usually either:

- taken directly from market sources or published curves (e.g. EU, China);
- based on asset returns and long-term assumptions used for gross premium valuation (e.g. US, Canada)
- a hybrid of the above two approaches where asset returns are combined with some market parameters (e.g. Japan, Korea)

Consider options for greater alignment where appropriate

Firms in some jurisdictions (e.g. EU, Japan) use more than one GAAP+ approach where they have overseas subsidiaries. Sometimes MAV is used for these subsidiaries in the GAAP+ balance sheet.

Need to address in future specifications how GAAP+ should apply for firms reporting consolidated figures using multiple GAAPs

A number of firms did not report GAAP+, or else provided numbers that were identical or very close to either MAV or jurisdictional GAAP.

Analysis across all Volunteers is difficult given the degree to which some volunteers did not comply with the specifications

AOCI Adjustment Background

- Applicable for jurisdictions using a gross premium valuation (GPV) approach for valuing long term insurance products based on a discount rate that represents an average investment portfolio earned rate adjusted for future reinvestments, expected defaults, and investment expenses
- This GPV discount rate adjusts more slowly than MAV discount curve as interest rate movements only impact reinvestment returns
- Fixed income investments backing these products adjust to current fair value each reporting period with the change flowing through Accumulated Other Comprehensive Income (AOCI)
- AOCI is included in Capital Resources. This produces asymmetrical accounting and artificial volatility in capital resources.
- A proposed solution included in 2016 field testing specifications is to identify the portion of AOCI related to fixed income investments backing long term liabilities and exclude that portion from capital resources

Note: MAV is also pursuing a strategy to remove excess volatility in capital resources through an adjustment to liabilities via the discount curve

AOCI Adjustment Applicability

- Currently the AOCI Adjustment is only specified in 2016 Field Testing for Volunteers reporting US GAAP to address asymmetry in the valuation of assets and liabilities
- The AOCI adjustment is applied against capital resources such that assets and liabilities would both be measured on a similar basis, thus reducing artificial volatility in capital
- Based on responses from Volunteers the AOCI adjustment may also be applicable to other jurisdictions under GAAP+

	Jurisdictions	Fixed Income Assets	Liabilities	Adjustment to achieve symmetry
GAAP+ (MV based)	EU, SA, Asian	Market Value	Current/ Market Curve	No AOCI adjustment required
GAAP+ (Blend)	Japan, Canada, Asian	Market Value and Cost	Current/Book Yield+ or Market	Consider AOCI adjustment
GAAP+ (Book yield)	US, HK	Mostly Market Value	Current (GPV)/Book Yield+	Proposed AOCI adjustment to capital resources

IAIS

Future accounting – potential impacts on ICS work

	IASB	U.S. FASB
Financial Instruments	IFRS 9 (**effective 2018**) Amended IFRS 4 gives insurers option to defer implementation until 2021	Current Expected Credit Loss (CECL), **effective 2020** for PBEs.
Insurance Contracts	IFRS 17 expected release in **Q2/17**. Proposed **effective date of 2021**, with early implementation possible.	Re-exposure draft (Sept/16) for long-duration insurance contracts. **Effective date before 2021 unlikely.**

Minimal impacts for ICS 1.0, given later effective dates for new/ proposed accounting.

However, if all of these accounting standards changes move forward as proposed, there may be more significant impacts for ICS 2.0 , but the accounting changes may also provide a more direct route to a more converged ICS.

Plan towards GAAP+ and MAV comparability

The IAIS is considering the possibility of a (more) common discounting methodology for both valuation bases:

- It expects to field test a reference method discounting methodology (referred to as the “AA Plus approach”) based on a high-quality fixed-income instrument yield independent of an insurance company’s expected investment performance, accompanied by certain prudential enhancements

- Changes to accounting rules for insurance contracts, if implemented as currently proposed, could result in much greater comparability of GAAP insurance liability valuation than currently exists:

  - The IASB’s IFRS 17 would require that firms adopt a uniform and comprehensive methodology to value insurance liabilities. Many jurisdictions which are home to IAIGs would be required to adopt this standard. That said, some supplemental specifications may be required to enhance comparability for purposes of the ICS; and

  - The FASB ED, if adopted, would result in U.S. GAAP being more comparable to IFRS 17, primarily because traditional insurance liability valuation would be based on updated assumptions, and discounting would be based on a high-quality fixed income instrument yield

Going Forward

- For ICS 1.0, GAAP+ approach expected to follow 2016 field testing specifications except for certain incremental enhancements (outlined on the next slide).
- Discounting to continue to follow referenced jurisdictional GAAP rules and any adjustments specified in 2016 field testing specifications.
- The 'AA Plus' discounting approach will be field tested as a reference method to assist in the comparison of GAAP Plus to MAV and evaluate the impact of future accounting rule changes
- A balance sheet valued under a stress period scenario will also be requested.

Going Forward

- The following is a list of GAAP Plus incremental enhancements:
  - For liability Valuation/Discounting:
    - Evaluate prudential enhancements to existing jurisdictional GAAP life insurance valuation rules. Examples would include specification of a maximum ultimate long term forward rate (LTFR) and greater specification of the method used to grade to this rate.
    - For life, consider consistency in treatment of overhead expenses and how guarantees and options are measured across the jurisdictional GAAP+ examples;
    - For non-life, consider the interplay between discounting in the valuation~~,~~ and MOCE.
  - For the AOCI Adjustment:
    - Use a simplified definition similar to 2016 field testing, with the expectation that an AOCI adjustment may not be needed when accounting rule changes are enacted
    - Consider the use of a mechanism to defer realized gains similar to US RBC Interest Maintenance Reserve
  - Clarify definitions and/or specifications where suggested by Volunteers or as noted in field testing. Examples include structured settlements, guarantees and options, and embedded derivatives.