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Market-consistent valuations and Solvency II: Implications of the recent financial crisis

Summary of the London discussion

[Institute and Faculty of Actuaries Open Forum, 16 September 2010]

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This summary relates to the following paper: Foroughi, K. Market-consistent valuations and Solvency II: Implications of the recent financial crisis. *British Actuarial Journal*, doi: 10.1017/S1357321712000025

A discussion was held following the presentation of the paper by its author, Mr. Kamran Foroughi. An earlier version of the paper was previously discussed at the International Congress of Actuaries in South Africa in March 2010, which has been updated to take account the subsequent publication of the specification for QIS 5 and the issuance of an exposure draft from the IASB on Phase II.

Introducing the author and the paper, the Chairman noted that, in the context of life assurance business, the vast majority of actuaries, prudential regulators and accounting standards setters would readily accept the view that the valuation of assets and liabilities in a balance sheet should be consistent with each other, and that to achieve this and ensure objectivity some form of market benchmark is very desirable. However, within this broad objective, there are a number of issues of interpretation over which divergent views are held. Some of these are generally material to the outcome, whilst others became so during the recent financial crisis. The more important of these include the allowance for illiquidity premia, own credit risk, the exact definition of the pre-liquidity risk-free rate of interest, the treatment of day 1 profits and the appropriate allowance for non-hedgeable risk. The paper, he noted, covers these and a number of other technical issues, and also considers the need for disclosures to supplement the presentation of market-consistent values. It also touches upon the difficult subject of procyclicality.

Mr Foroughi was then invited to the platform from where he summarised the key observations and recommendations of the paper.

The Chairman then invited comments and observations from the floor, stating that the discussion will not appear in this Journal. The two key themes coming from the discussion centred on how the disclosed information might be used and how the outcomes might be communicated. There was a desire that one should be able to move from one type of valuation to another to demonstrate that they were consistent with each other, despite giving different information. Concerns were expressed that if the Profession and industry did not speak out clearly then there was a danger that more prescriptive legislation and regulation would be brought in, which may not serve the purpose of clear communication to users.

The different viewpoints of stakeholders are well illustrated through the regulator being interested in solvency, and hence in the security of the balance sheet, whilst the investor in the equity is much more interested in the profit and loss account. For these to be compatible, it was argued that Solvency II must be on a realistic basis rather than a prudent basis. Accounting does not like the advance recognition of profits and so it will be necessary to adjust the liabilities to reflect this.

A number of technical issues were discussed including what constituted a risk-free rate (government bonds in many countries but not all), how this rate interlinked with corporate bond and swap rates and what special treatment might be appropriate when these behaved in a different manner such as during the recent financial crisis. Solvency II assumes orderly markets exist and that willing buyers and sellers can be found. However, it was pointed out that these conditions often fail in a financial crisis, raising some problematic issues. More generally, it was acknowledged that it is important to understand where risks are being allowed for at each step and what impact this may have. Extreme operational risk was highlighted as one that might be allowed for in the best estimate or added as a risk margin, depending on the various stakeholders' views.

Mr Foroughi responded by thanking the audience for the comments raised and the subsequent lively debate. Mr Foroughi noted that until Solvency II and IFRS 4 Phase II are finalised, the industry has a tremendous opportunity to shape the outcomes in a way that enable clear communication and efficient reporting processes, and engagement with the IASB and various Solvency II stakeholders is critical.