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ERNST & YOUNG STUDY CALLS FOR MAJOR TESTING OF MARKET VALUE MARGIN CALCULATION FOR INSURANCE SOLVENCY PURPOSES

Report Urges Extensive Validation, Calibration and Consistency Testing

NEW YORK, Nov. 2 – A study by Ernst & Young recommends significant validation and testing of the market value margin (MVM) calculation being proposed in Europe for solvency purposes.

The Group of North American Insurance Enterprises (GNAIE), an insurance trade association whose members include the largest global providers of insurance and substantial multi-national corporations, sponsored the study by Ernst & Young which reviews the cost of capital method for calculation of MVM or risk margin.

The study focuses on the practical implementation for estimating MVMs for non-hedgeable insurance risks, a method that has emerged as the preferred methodology for this calculation in Europe under the pending Solvency II directive now before Parliament.

GNAIE said it is prepared to play a part in conducting further analysis to validate, calibrate and test the MVM parameters and estimates, possibly in conjunction with other interested parties.

“If the issues raised in the study are not fully considered, we have a concern that there is potential for the total capital requirements of insurers to be inadequate for the risks they assume, not provide reasonable estimates that properly distinguish between well-capitalized companies and those capitalized at minimum levels, and provide for too much variability of results between different insurers with similar risk profiles,” said GNAIE chairman, Jerry M. de St. Paer, who is Senior Vice President – Finance, American International Group.

To assist in the development of international accounting and solvency standards to ensure that they result in robust, high quality standards for insurance enterprises.

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The E & Y report observes that, “The cost of capital methodology presents a conceptually appealing and intuitive approach to determining market value margins for insurance risk. Nonetheless, we believe there are implementation challenges that suggest the need for extensive validation, calibration and consistency tests.”

These implementation challenges, in particular, include:

- Setting the parameters of the MVM calculation – the capital base and the cost of capital rate –consistently and transparently with market pricing practices (a necessary condition for producing values consistent with market prices of insurance liabilities);
- Validating the reasonable accuracy of the simplified methods and approximations proposed for practical application of the approach (e.g. impact of mortality and lapse risk, and projection of capital required in each future period of the MVM calculation);
- Calibrating the parameters to reflect market conditions at the end of the solvency time horizon after occurrence of the hypothetical ‘distress’ event, which reflect a reliable estimate of the change in the market’s assessment of the price of risk upon such an event.

Given the significant role that this method is expected to play in emerging financial reporting standards and solvency guidelines affecting all insurers globally, the E & Y study recommends that “the parties responsible for establishing these financial reporting standards and solvency guidelines work swiftly, with the help of the industry, to perform these analyses.”

De St. Paer noted that while GNAIE supports the Solvency II initiative in Europe and the development of IAIS solvency principles that recognize sophisticated capital models and risk management practices implemented by large insurers globally, the organization has specific other concerns with certain proposals as currently drafted.

“GNAIE believes that any regulatory system must ensure a level regulatory playing field for insurers across different jurisdictions,” he said. GNAIE has expressed concerns that the Solvency II group diversification benefits have been designed with EU groups in mind, driven by competitive considerations, de St. Paer said.

In addition, GNAIE questions the feasibility of a single accounting standard for solvency and financial reporting. “While the goal of a single standard may be attractive from a practical point of view, GNAIE believes that solvency needs should not drive accounting decisions – it is more important to determine the best solution for each need,” he said.

A copy of the E & Y report, *Market Value Margins for Insurance Liabilities in Financial Reporting and Solvency Applications*, is available on the GNAIE Web site, www.insuranceaccounting.org.

The goal of GNAIE is to influence international accounting standards to ensure that they result in high quality accounting and solvency standards for insurance companies and, to that end, to increase communication between insurers doing business in North America and international regulators and standard setters. GNAIE works to meet its goals through modeling of proposed accounting standards, analysis, comment, and coordination with various end users of financial reports.

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