



SOCIETY OF ACTUARIES

**Market-Consistent Embedded Value Seminar  
December 2008**

**Session 4: Rating Agency Perspective of Evolving  
Reporting Standards**  
[Jeffrey A Mohrenweiser](#)



## Rating Agency Perspective of Evolving Reporting Standards

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SOA / Watson Wyatt MCEV Seminar  
Philadelphia, PA  
December 4, 2008

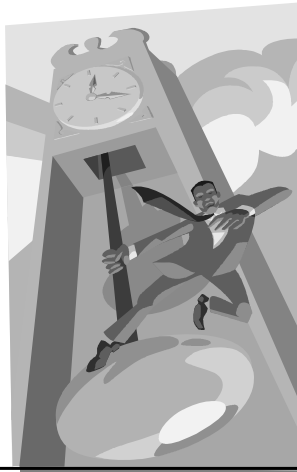
Market-Consistent Embedded Value  
December 4-5, 2008 | Philadelphia, Pa.



### For Every Action, There Is A Reaction

Circa 2000

Regulatory  
Formulaic  
Approach



Circa 2005

Internal  
Capital  
Models

Is it a matter of "IF" or a matter of "WHEN"?



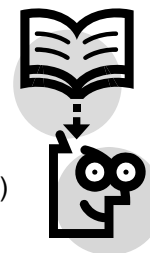
## Reporting Standards – Defining Characteristics

- Principle based
  - ✓ In theory, more responsive to changing economic and product environments
- Forward-looking
  - ✓ Impact of new business
  - ✓ Total balance sheet
- Stochastic in nature
  - ✓ Tail impacts
  - ✓ Asymmetric volatility risks
  - ✓ Shock events
- Leverage internal practices
  - ✓ Enterprise risk management - holistic
  - ✓ Internal models



## The Positives

- A better risk reporting tool
  - ✓ Corrects inherent flaws of prior capital regimes (too formulaic, too simplistic)
  - ✓ Realistic calculations of cost of guarantees
- Towards improved risk disclosure
  - ✓ Analysis of Movement
  - ✓ Standardized Sensitivity Tests
- Alignment of Solvency II and IFRS initiatives (in Europe)
  - ✓ Statements of principles
  - ✓ US receptive to IFRS, Principle Based Assessments



FITCH SPECIAL REPORTS: EEV: Valuable but Needs to Bed Down (February 2007)  
EEV 2006 – On the Road to Value (September 2007)



## Reporting Standards – Practical considerations

- Calibration
  - ✓ Shareholder returns v. Policyholder protection
- Capital fungibility
  - ✓ Lead regulator
- Complexity
  - ✓ Diversification v. Leverage



- Lots of lessons learned (and to be learned) from current financial crisis
- Is there knowledge arbitrage?



## The Negatives

- Everyone needs to do it
  - ✓ Regardless of size - Large, Medium and Small Companies
  - ✓ Through Thick and Thin
- Is the World ready for capital volatility?
  - ✓ Current crisis is requiring large capital calls
  - ✓ Some companies are big enough to fail
- Is this a Classroom exercise?
  - ✓ Theory versus real-world?
  - ✓ Possible delays in Solvency II / "Mark to Model"
- The Devil is in the Details
  - ✓ Is there real consistency?
- Basic fundamental exposure data is still a Mystery
  - ✓ Off balance sheet exposures – CDOs
  - ✓ "Non-core" business risks





## Everyone Needs To Do It – is there consensus?

Financial Times article – November 18, 2008

While the goal was to make financial reporting more easily comparable, there were increasing doubts this would be achieved.

Commenting on upcoming L&G's board decision regarding early adoption of MCEV, Andrew Palmer, finance director at Legal & General, said

***“Some of the things we had presumed MCEV was going to deliver, such as greater consistency, are probably not being borne out”***



## Is the World ready for Capital Volatility?

***“MCEV will be volatile if investment markets are volatile”***

– CFO Forum, MCEV Principles Launch (London, June 4, 2008)

Financial Times article – November 18, 2008

Andrew Crean, Citigroup analyst, calculated:

- Aviva's estimated UK new business profit in 2008 would **fall by two-thirds**
- Prudential embedded at June 30 value will **fall by 18 percent**

Another observer said there are implications for balance sheets if life insurers fully marked the assets backing annuities to market values. The hit to new business profits was ***“just the tip of the iceberg”***



## Is this a Classroom Exercise?

AIG uses the excess of the “market value” of assets over the “market consistent value” of the liabilities as the basis for measuring available economic capital to ensure consistency between the measurement of required and available economic capital.<sup>2</sup>

However, given (i) the lack of liquidity and severe risk aversion in the credit markets - brought about by the U.S. housing recession and subsequent economic slowdown - and their effect on the fair valuation of credit and credit related products, (ii) the increased volatility in the commodity and equity markets and (iii) fears of global recession and/or stagflation, **AIG believes it is very difficult to develop a stable measure of excess capital at the present time.** These markets have the ability to materially affect available capital measured from a regulatory, rating agency and economic basis.

<sup>2</sup> This follows the general principles recommended by the CRO Forum in its July 2008 paper titled “Market Value of Liabilities for Insurance Firms - Implementing elements for Solvency II” available on [www.croforum.org](http://www.croforum.org).

SOURCE: AIG Website – Investors Section: “Economic Capital - August 2008 Update”



## IMPACT ON CREDIT RATINGS



## Where are we? The Road ahead is foggy



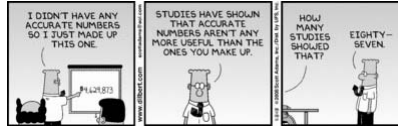
## US Life Insurance Industry

- Negative Outlook – September 29, 2008
  - ✓ Implies more downgrades than upgrades
  - ✓ Does NOT indicate volume of activity
- Current Financial Turmoil
  - ✓ Next logical sector
  - ✓ Though starting at a stronger capital point
- Leveraged Investments
  - ✓ RMBS, CDO
- Equity Exposures to Variable Annuity Guarantees
- Liquidity Risk
  - ✓ Institutional funding products, Securities Lending, Commercial Paper, Large debt maturities, Annuities
  - ✓ Potential “credit cliff” if confidence erodes



## Lessons Learned From Credit/Market Crisis, So Far...

- High leverage is bad, regardless of perceived risk
- Complexity often “trumps” diversification
- Areas of rapid growth yesterday are usually the areas of trouble today (i.e. subprime, CDS)
- Supposedly remote “tail” risks occur more often than expected
- Financial flexibility is a myth when most needed
- Rating triggers – both explicit and implicit – can create “credit cliffs”
- Illiquidity can “kill” overnight
- Lack of transparency is bad
- **Enterprise Risk Management and economic capital modeling did not seem to help for some**

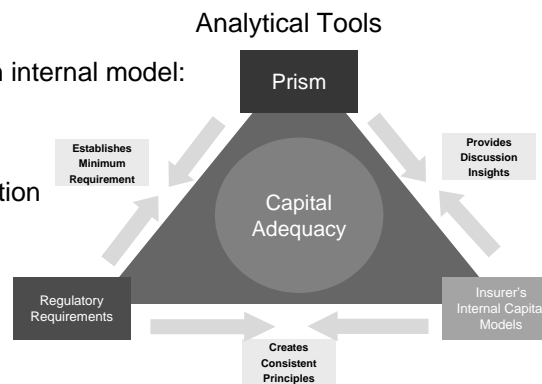


## The relationship of regulatory, internal models and Prism

*“No single valuation framework will perfectly answer all interesting questions”*  
– CFO Forum, MCEV Principles Launch (London, June 4, 2008)

Dynamic weighting based on internal model:

1. Degree of transparency
2. Track record
3. Level of model sophistication
4. Testing and controls
5. Results interpretation



FITCH CRITERIA REPORT: Assessment of Insurers' In-House Economic Capital Models (September 2006)



## Do Today's Challenges Warrant Deterministic Scenarios?

1. How to model tail events when you are in the tail?
  - ✓ "Bad luck" tends to correlate
2. Speed kills – not enough time to run sophisticated models
  - ✓ Markets are fast – re-parameterization is slow
3. Management needs to understand and act
  - ✓ ERM + EC = Competitive Advantage (or Survival)

However, don't throw the baby out with the bathwater



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