Reporting alignment in the new regulatory environment

Received (in revised form): 25th April, 2008

Bryan Joseph*
is a partner in the Actuarial & Insurance Management Solutions practice of PricewaterhouseCoopers LLP in the UK, specialising in property and casualty insurance. Bryan has over 25 years' experience in the insurance industry, including the establishment, structuring and purchase and sale of insurance and reinsurance programmes. Bryan has also worked with commercial companies and reinsurers on the design and capital requirements to support their overseas business, including with rating agencies and regulators on capital management and solvency. Bryan is a Fellow of the Institute of Actuaries, Fellow of the Society of Actuaries in Ireland and Member of the American Academy of Actuaries.

Richard Barfield
is a director in PricewaterhouseCoopers' UK Risk Advisory practice. He has broad-ranging consulting experience from over 15 years at the company, including secondments to major financial institutions as finance director. Richard's recent engagements include leading teams advising clients on risk appetite formulation, asset and liability management, stress-testing design, capital allocation and performance management, as well as delivering board-level coaching, training and workshops. He also led the design and delivery of training in the Supervisory Review and Evaluation Process of Pillar 2 of Basel II to the UK Financial Services Authority and other international banking supervisors.

Frank Lyhne Hansen
is a senior manager in PricewaterhouseCoopers' Danish Enterprise Risk Management team and an external associate professor at the Copenhagen Business School's Department of Finance. He conducts reinsurance optimisation, audit support and pricing for insurance companies, and has worked with most Danish banks on their Basel II projects. This work has included validation of models, compliance and documentation, and development of credit and market risk models. He also helps insurance companies with their capital management and Solvency II projects. In addition, Frank has been an adviser for a number of Danish insurance companies and banks regarding strategic decisions in connection with risk-adjusted performance measures.

*Actuarial & Insurance Management Solutions, PricewaterhouseCoopers LLP, 1 Embankment Place, London WC2N 6RH, UK
Tel: +44 (0)20 7213 2008; E-mail: bryan.rp.joseph@uk.pwc.com

Abstract In many banks and insurers, risk management, capital management and finance often exist as functionally-separate entities, with distinct tools, languages and reporting lines. This status quo is a by-product of differing functional objectives and the divergent reporting and regulatory requirements that institutions face. Regulatory requirements and reporting, however, are converging around a model that emphasises economic reality and is closer than ever before to the internal metrics many companies use to manage themselves. This evolution has some way to run, but it should be welcomed. This paper outlines the drivers and agents of change to the way businesses report, discusses the benefits that institutions can obtain from the changes, the practical steps they can take for implementation and also highlights some of the likely challenges.

Keywords: *reporting, Solvency II, risk management, ERM, management information, embedding, risk appetite*

INTRODUCTION

Historically, the different corporate functions within companies have tended to have their own metrics and reporting conventions, which often presented the same underlying story in very different ways and often produced slightly different results. This lack of a common language has been an obstacle to agreement among stakeholders and a burden for companies themselves, which have to use a variety of — often clumsy — tools and techniques to communicate a single economic reality.

The situation is beginning to change, in part as a result of growth in the number of combined financial services regulatory bodies such as the Financial Services Authority (FSA) in the UK and BaFin in Germany. In recent years, largely spurred by new regulatory requirements such as Basel II[1] and Solvency II,[2] banks and insurers have developed better internal metrics, especially for complex items like loan portfolio risk and insurance liabilities. These metrics were initially used to enable better decision making by company management, but they are and will be increasingly reported to external stakeholders. There are also signs of convergence and harmonisation — accounting standard setters are allowing institutions to use their internal reporting for external purposes within the International Financial Reporting Standard (IFRS)[3] regime. Increasingly, the consensus is that financial reporting should present the company to the outside world 'through the eyes of management', and there is a growing acceptance that internal risk measures are now sufficiently useful and mature to be included in reporting regimes.

Strictly speaking, the reporting of risk measures alongside financial statements is not new — for example, big banks have long been providing a snapshot of their market risk exposure by disclosing value-at-risk figures, while insurers are required to use regulatory reserving factors for their insurance liabilities. But (in the case of insurers) the regulatory risk weightings have been criticised as being opaque, arbitrary and almost invariably too conservative.

More generally, the use of differing measurements in financial reporting has often led to (or been caused by) risk and capital management functions operating independently from finance. However, a minority of leading organisations have been able to align risk, finance and capital management more successfully than others.

For the majority, the new accounting and reporting standards are helping to close that gap. The changes needed for compliance will gradually bring financial and regulatory reporting more in line with internal risk reporting. For stakeholders as a group, developing this kind of common language would help to streamline the management of institutions and give the basis for a more aligned analysis of problems and opportunities.

The benefits for banks and insurers are arguably more immediate: at the heart of these changes in the reporting landscape is a closer alignment of risk and finance, two functions which have traditionally been viewed as separate. While these distinctions have been valuable in providing different perspectives, benefits can be gained through the closer alignment of corporate functions like risk management, capital management and finance. Management will be able to make better-informed decisions in pace with business dynamics, costs can be reduced through the consolidation and streamlining of processes, and communication with external stakeholders will be both simpler and more effective.

EVOLUTION IN FINANCIAL REPORTING

A series of developments in market reporting in recent years have combined to create a platform for the alignment of risk and finance. Some of the key changes are described below:

- In 2004, the bulk of the revised Basel II framework was agreed and published, establishing for the first time the now familiar three Pillar approach.
  - The bulk of the Framework focuses on Pillar 1, which describes the rules by which banks should assess their regulatory capital requirements for credit, operational and market risk. For advanced institutions, these methods rely on internal models and bank-specific default and loss data.
  - Pillar 2 is non-prescriptive and describes the principles that banks should follow in assessing how much capital they should hold against all risk types (not just those covered by Pillar 1) given their strategy, the economic context in which they operate and the results of stress-testing capital plans. Pillar 2 requires firms to describe how they manage risk and capital together in a dynamic way. It also describes the principles by which a supervisor should assess a bank's internal capital assessment and, if required, the supervisory remedies to be applied.
  - Pillar 3 deals with market discipline and describes how firms should disclose externally the detail of their Pillar 1 capital calculations with the most detailed disclosures relating to the credit risk capital assessment.
- The use of embedded value as a supplementary reporting metric has also grown in recent years, particularly in Europe and Asia. In May 2004, the European Insurance CFO Forum published its European Embedded Value (EEV) Principles, with additional guidance following in October 2005.[4] The CFO Forum initiative sought to provide greater consistency and comparability in embedded value reporting. By 2006, it was clear that the principles were drawn too widely to provide such consistency. In particular, the principles did not mandate a single approach to risk in the EEV framework. Despite the array of methodologies permitted under EEV, there is now a clear trend in the industry towards a current market-consistent approach known as market-consistent embedded value (MCEV). The underlying philosophy of the approach is that all projected cash flows are valued in line with the price of similar cash flows traded on the open market. There is also a further trend to embed MCEV as a metric in company risk infrastructure capable of identifying, assessing, quantifying and monitoring risks. Such a metric would then inform decision-making processes primarily covering pricing (and how this drives value) and overall capital allocation. In June 2008, the CFO Forum published its MCEV Principles that formalised its market-consistent valuation framework. The next phase of embedded value development has the potential to influence the shape of IFRS Phase II and

Solvency II. Ultimately, there is the possibility that all three measures could converge, eliminating the need for supplementary embedded value reporting.

- The arrival of IFRS 7, which came into effect for 2007 financial statements, introduces new requirements to publish information about risk management and sensitivity to market and other risks — including insurance variables and changes in the claims environment. This will result in the disclosure of more internal risk management metrics, such as economic capital. This is not an entirely new development — economic capital metrics are already fairly common in investor presentations and are also used in some annual reports — but IFRS 7 is the first standard to require the inclusion of such risk metrics in financial statements and, as such, will expose economic capital to the scrutiny of auditors for the first time.
- In May 2007, the International Accounting Standards Board (IASB) published a discussion paper setting out proposals for Phase II[5] of its insurance project. These proposals for a new standard include a current market-consistent approach to the measurement of insurance contracts. There is early scope for convergence between existing accounting regimes here: the US Financial Accounting Standards Board has also published its IASB discussion paper[6] as part of deliberations on its own insurance contract standard, which could develop along similar lines to the new IFRS approach. The Securities and Exchange Commission has given further impetus to prospects for harmonisation by seeking comments on whether US firms should be allowed to report under IFRS.
- In July 2007, the European Commission published its draft framework directive for Solvency II, a new system of prudential regulation for insurers. Under Solvency II, insurance assets and liabilities will be measured in line with economic principles. Capital requirements in the new framework will be based directly on risk-based measures — as they are in Basel II, the equivalent set of rules for banks. Again, there are encouraging signs of convergence here — the Solvency II framework is designed to be conceptually in line with the proposed new IFRS standard on insurance contracts.

VALUING INSURANCE LIABILITIES

The valuation of insurance liabilities is one of the clearest illustrations of the sea-change in measurement and reporting. Current proposals will make it far more economically sound. As shown in Figure 1, the IFRS phase II and Solvency II liability valuation will be based on three basic building blocks: a best estimate liability, a risk margin and profit. As a result, many elements of the construction of insurance contract liabilities will pass from the risk and capital management department(s) to finance.[7] Or, to put it another way, the finance department and the risk function will be able to use the same valuation practices.

CLOSING THE GAP BETWEEN RISK AND FINANCE

Building internal risk assessments into an institution's external reporting creates an opportunity to draw risk and capital management into the finance department. Doing so will make it far easier to analyse potential strategic

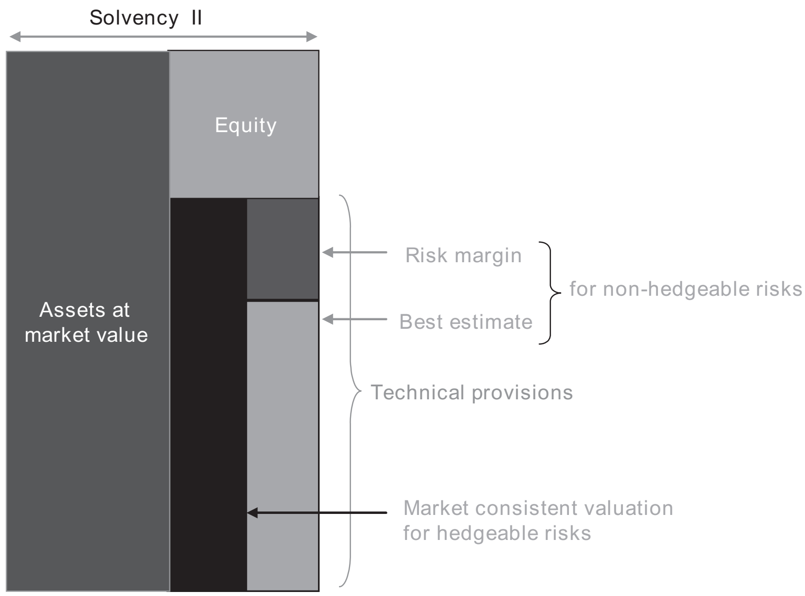

Figure 1: Evolution in the valuation of insurance liabilities

decisions from a range of perspectives which would only previously have existed in separate pockets of the organisation. For example, the risk/reward analysis of strategic initiatives could be looked at in terms of internal capital requirements, regulatory capital requirements and IFRS.

Not only will it become simpler to provide collaborative analysis across departments, it will also be far more important to do so. In terms of forecasting, for example, institutions will be able to produce more coherent strategic plans or probabilistically assess whether the current year's results will fall in line with expectations. Sensitivity analysis will be more powerful: institutions will be better placed to judge the impact of volatility in actuarial estimates, modelling assumptions and the financial markets. The dynamic between past performance and financial results will also be something that an integrated risk and finance team is better equipped to assess.

The production of these figures and analyses will have many common inputs and parameters, as shown in Figure 2.

THE BENEFITS OF ALIGNMENT

Silos are a persistent feature of the organisational structure in many financial institutions. They create inefficiency and inertia, and often prevent companies from bringing their most appropriate skill sets to bear on any given problem. Within single functions, the banking industry in particular has made some progress in breaking down these barriers — for example, by integrating into a single structure once-separate departments like market risk, credit risk, operational risk (and, in some cases, audit and compliance departments). But at banks and insurers alike, the finance department often remains functionally separate from risk and capital management, despite the fact that all three have overlapping responsibilities. The new emphasis on economic reporting helps emphasise and

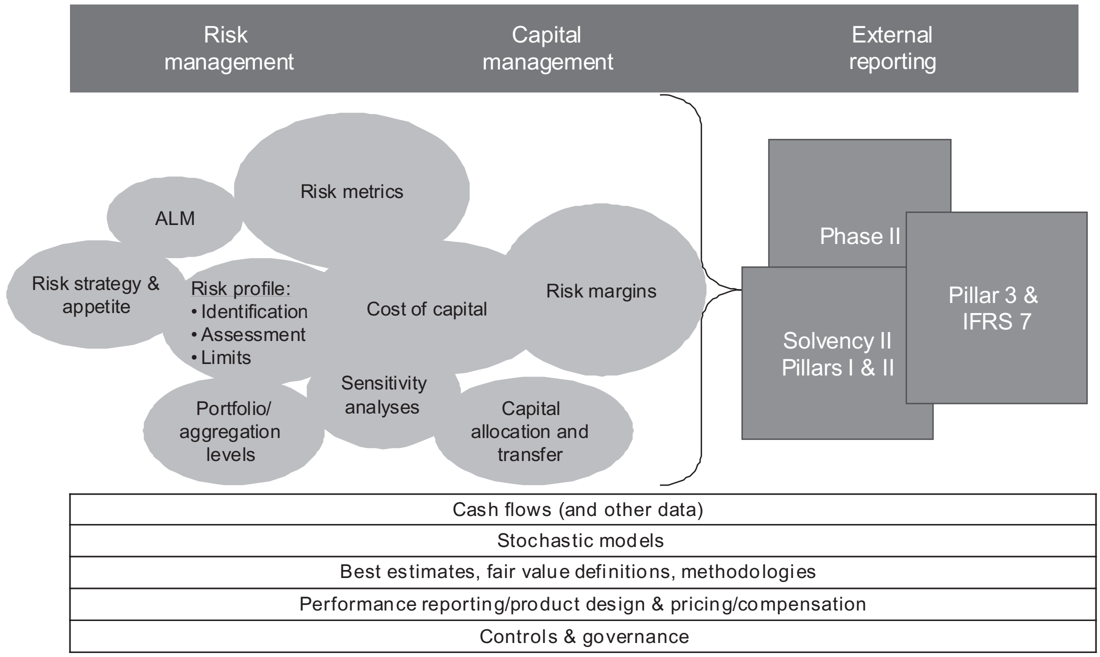

Figure 2: Inputs to external reporting processes

reinforce this common ground, and institutions stand to benefit substantially if they can achieve closer alignment between risk management, capital management and finance.

One version of the truth

All too often, analysts have to decipher conflicting information produced by differing metrics — for example, when a product may have a positive impact in terms of risk-adjusted return on capital, but a negative impact in terms of the return on equity reported under IFRS. While there are always good and justifiable reasons for this, senior executives should not need a detailed understanding of the nuances of two different metrics in order to reconcile the stories each is telling. In a perfect world, internal models that use sophisticated and economically sound parameters and assumptions would be in line with externally reported results and objectives.

Better alignment of finance with risk and capital management can improve the understanding of what drives key performance indicators throughout the organisation and will increase the ability of the finance and risk departments to add value in the strategic planning process.

More relevant and reliable financial communications

External stakeholders are taking an increased interest in risk management. The most prominent example of this for many insurance industry executives is the plan by two leading rating agencies — Standard & Poor's[8] and Fitch Ratings[9] — to incorporate a specific assessment of enterprise risk management and a quantitative analysis of economic capital and allocation into the ratings process.

While external stakeholders like rating

agencies and investors often complain that financial statements are opaque and lack relevance, they do provide information that the markets consider reliable and comparable. As has been seen, information provided outside of the financial statements is often considered less reliable and can be discounted by the market — as reflected in a quote from a European analyst in a recent survey by PricewaterhouseCoopers: 'All too often, embedded value is subject to management bias, reflecting what it desires from the future performance of the company rather than being objective. Such assumptions should therefore be discounted from share valuations.'[10]

The hope is that by bringing visible risk assessments into financial statements, institutions will be closer to producing comprehensive financial information that is relevant, reliable and comparable. Such information — if it can be achieved — will better serve the interests of investors, rating agencies, regulators and customers. Furthermore, it will also increase the market's confidence in the financial statements of many insurers and of the insurance sector, thus reducing the cost of capital, which is generally thought to be more expensive than that of comparable industries. Not only will external reporting benefit, a natural by-product will be additional discipline in the processes surrounding risk management reporting and internal reporting in general — see the additional discussion of 'systems, processes and data' and 'controls and governance' below.

Operational synergies

Alignment of the different departments will, at worst, streamline certain activities and, at best, eliminate duplicative processes. Candidates for analysis would be data management and modelling. The use of common data and modelling assumptions could not only save time and effort but, just as importantly, decrease 'unexplained amounts' when reconciling the different analyses.

Less focus on compliance, more focus on value

Nearly all finance departments today are expected to justify their existence by adding value to the organisation. The biggest challenge lies in finding a way to increase this value and demonstrate it clearly. As IFRS, Basel II and Solvency II use more risk metrics derived from internal models, activities which are often perceived as being merely compliance-related will come to be seen as more valuable — a positive step forward.

PRACTICAL ALIGNMENT

New regulations and reporting standards highlight previously obscured commonalities between risk, capital and finance, creating a platform for the closer alignment of these functions — but they do not proscribe that alignment. The decision to pursue closer alignment is a matter of choice for individual institutions. As discussed, the benefits to be gained from closer alignment of these functions go beyond compliance and offer real opportunities for value creation.

To assess how well an organisation is placed, a few sample diagnostic questions should be asked. Organisations may wish to consider, for example, whether risk professionals are involved in reviews of business performance; whether the company has a way of linking risk information and other financial information together to provide a consistent basis for the efficient management of capital; whether risk measures are embedded in enterprise-level processes like strategic planning and resource allocation; and whether lower IFRS earnings are used as a measure of the risk department's effectiveness.

Some of this may feel like jumping the gun as many aspects of Solvency II and IFRS Phase II are still at the consultative stage and there is a reasonable argument to be made for suspending any significant work until the picture is clearer. In fact, although the rules are still in gestation, there is nonetheless plenty of work which could helpfully be done now. Both Solvency II and IFRS Phase II have a clear direction and a momentum which is too strong to be reversed.

Some lessons can be learned from the banking industry's experience with Basel II. For example, Pillar 2 of the rules has been a catalyst that stimulated firms to consider how they manage risk and capital and to integrate risk management much more strongly in key business processes such as strategy formulation, planning, budgeting and forecasting. However, with the benefit of hindsight, many banks would have addressed these issues much earlier in the Basel implementation process. The experience of Basel II has shown that it is imperative to make the business case for change at an early stage in the process. This is a matter for the CEO and the executive team to address — it is not something that should be left to technical specialists.

The main working assumption for an insurer to adopt is that insurance liabilities under both IFRS Phase II and Solvency II will be based on future cash flows, using current assumptions with transparency around best estimates and risk margins. If that is accepted as a starting point, the convergence of risk and capital seems inevitable — and a number of actions can be taken now to align the departments.

Systems, processes and data

As discussed above, the new metrics required by IFRS and Solvency II will become part of the audited financial statements, but many existing cash-flow projection models have evolved in an unaudited environment. This issue will likely be most acute for institutions that have grown through acquisitions, building up an agglomeration of models that use different standards and are subject to different control regimes. Even if some of these metrics already appear within the audited financial statements as a footnote disclosure, that is a world away from being rigorously audited as part of the accounts and included in the determination of net income. Organisations can already start preparing for greater audit scrutiny of these models.

Reconciliations

One of the big questions that institutions will face is how to tackle the different reporting levels that are likely to exist in different regimes — for example, IFRS segmentation may be different from that required under Solvency II. Such differences will impact data capture. Again, this is something that can be tackled ahead of time.

Controls and governance

Many institutions have already decided that now is the time to improve the controls and governance surrounding their cash-flow projection systems — for example, by seeking to use (better controlled) common data across risk, capital management and finance departments. Once these different departments produce and analyse common reporting measures, the need for cooperation will grow even further. For example, modelling assumptions and estimates, as well as the accompanying analyses, will need to be approved by a wider group of representatives from senior management who use the information for different purposes. As institutions move forward with alignment — including Solvency II and Phase II implementation projects — the composition of the oversight bodies will be an important decision.

While such improvements are effectively voluntary at this point, this issue will ultimately be 'forced' by the abovementioned audit requirement as well as by pressure from the rating agencies who are keen to encourage consistent and clear reporting and risk management. Internal audit will clearly play an integral role in preparing for these challenges, but that department will be challenged to possess or acquire the skill sets necessary to understand these areas, which are inherently more complex than those they normally review.

Internal reporting lines

Some institutions require risk, capital and finance departments to report to different senior executives. This may not be conducive to closer alignment of the underlying departments and could create obstacles in the implementation of Solvency II and IFRS Phase II. Organisations may wish to consider whether some rationalisation of these reporting lines is desirable.

Yet, as reporting lines blur, management will need to be mindful to ensure there is adequate segregation of duties and oversight. For example, the independence of risk management's review of treasury operations could possibly be compromised if both functions become part of the same department or report to the same person.

People/communication

There must be an environment that fosters communication and cooperation across the different departments, but measuring something this vague is not easy. One way to appreciate it is to consider the extent to which skill sets and understanding are shared across those departments — so, for example, how many of the company's regulatory professionals can discuss IFRS standards? How many of its accounting professionals understand risk terms and concepts? How many of the risk team are familiar with accounting requirements? Establishing a rotation programme may help foster a shared understanding among the different teams.

Training

Many of the key concepts in risk management are foreign to finance executives and vice versa. Additional training for both finance professionals and senior executives can help to embed these metrics throughout the organisation.

THE CHALLENGES OF ALIGNMENT

Of course, it is one thing to preach the virtues of more closely-aligned risk, capital and finance functions, and another to actually achieve it in practice. The challenges are formidable as illustrated in Figure 3. Each of the different reporting bases serves different audiences and there is only so much alignment that is possible given their different contexts.

Despite the obstacles, the liquidity scarcity that started in mid-2007 has shown clearly that risk and financial reporting in both banks and insurers need to be better aligned. This needs to happen at the front-end when risks are taken on, as well as at the back-end when reporting results to the markets and regulators.

A related lesson has been that the IFRS principle of marking to market becomes very difficult to apply when markets become illiquid. A key reminder for financial institutions is that it is essential to have rigorous and responsive processes in place for the reported valuation of assets and to ensure that the valuation conclusions are well documented. Another key lesson has been the importance of monitoring, reporting and managing risks, such as liquidity, that cannot be mitigated by capital.

Beyond these specific issues, there are also more overarching challenges that organisations will face. Large multinationals will almost always have to tackle cultural and language barriers, for example. More significantly, while regulators and standard-setters in different jurisdictions are showing encouraging signs of an appetite for convergence, it remains the case that subtle differences in the wording and interpretation of existing rules can produce significant practical divergence, as Table 1 illustrates.

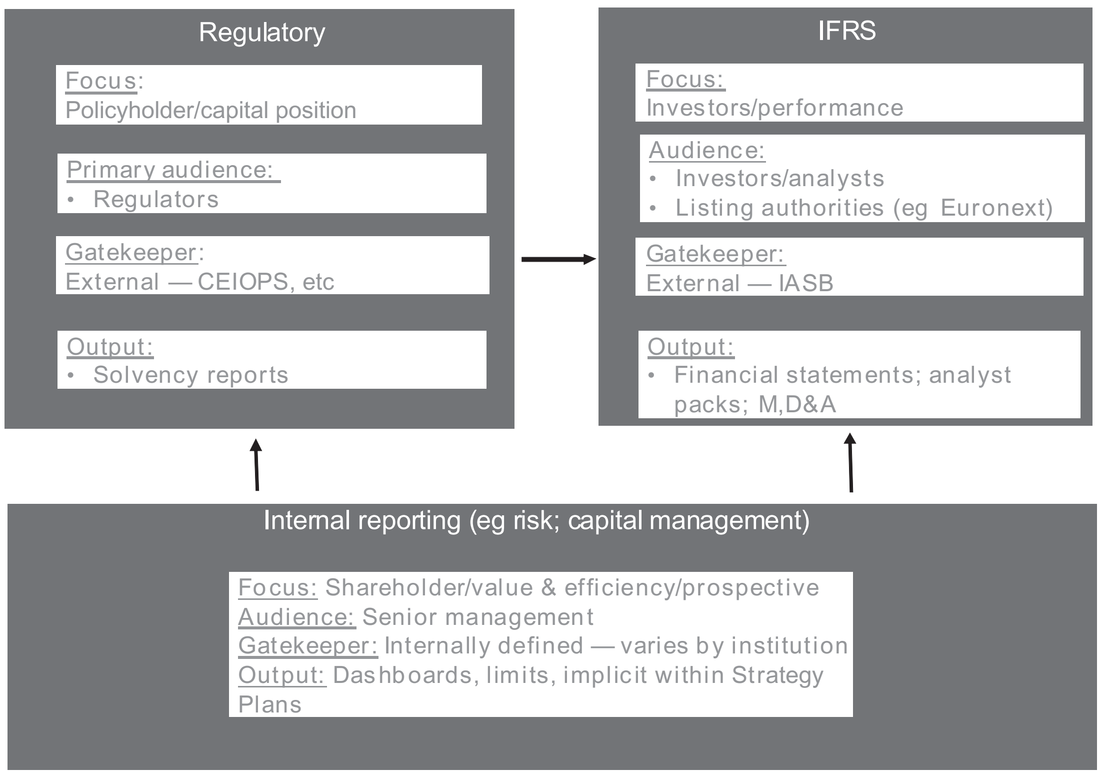

Figure 3: Stakeholders for internal and external reporting

Table 1 Comparing IFRS Phase II with Solvency II

	IFRS — Phase II	Solvency II
Scope	Not yet confirmed, but likely those that meet the IFRS 4 definition	Contracts in the insurance portfolio held by insurance companies
Cash flows	Portfolio-specific based on market observations	Entity-specific, difference in hedgeable and non-hedgeable risks
Risk margin	Not prescriptive	Cost of capital + input from supervisors Prescriptive
Future premiums	Concept of guaranteed insurability	Economic approach
Policyholder dividend	Legal or constructive obligation	Economic approach
Own credit standing	Included	Not included

Managing the overlaps between these two implementation projects will be challenging. As an example, institutions will need to identify existing information within the risk and capital management departments that can be leveraged for use in Solvency II and IFRS Phase II — should these projects run side by side or as a single process? There also needs to be a clear procedure of identification and arbitration in those instances where there is divergence between Solvency II and IFRS Phase II.

There is no doubt that the new reporting regimes will produce some thorny dilemmas. As a practical example, 57 per cent of life companies and 40 per cent of non-life companies anticipate increasing the use of derivatives for hedging purposes as a result of the introduction of Solvency II.[11] This is already a source of genuine complexity within IFRS, which gives entities a choice about how to report their derivatives use — hedge accounting involves a burdensome and restrictive set of effectiveness tests, but confers the potentially significant benefit that changes in the value of the derivative can be offset, in part or in their entirety, in earnings. Some popular hedging strategies are deemed ineffective under IFRS, however — so, if a company decides to dispense with hedge accounting, volatility in the derivative's value will be carried straight through to the income statement.

If an insurer is hedging exposures in its insurance portfolio, will it choose to apply hedge accounting or allow volatility in its derivatives to impact profits? That depends. For one thing, it still remains to be seen whether the IASB's definition of the fair value of insurance liabilities would be comparable to that used within an insurer's risk model. Early indications from the Phase II consultative process, eg the inclusion of arbitrary concepts like 'guaranteed insurability' within the IASB's insurance contract liability, make one sceptical that industry practice can be reconciled with the standard-setter's stance. As such, insurance industry derivative users may have to accept significant IFRS earnings volatility.

Ironically, the current move towards an accounting and solvency model based on fair market values can make these problems surrounding the IFRS impact more serious. In other words, today the IFRS results of insurers are often so unintuitive that the impact of proposed strategies on those results is a second-order consideration. In the future, if the IASB is successful in making the Phase II results more relevant, financial statement users may interpret volatility of IFRS results as an indication of a genuine asset-liability mismatch.

CONCLUSION

The emergence of a new reporting framework that better reflects a consistent view between finance, risk and capital will take some time. Opportunities for harmonisation of approaches between regulators and accountants, and across jurisdictions, remain just that — opportunities. There are many unknowns, and the new reporting rules will impose fresh strains on institutions' technical expertise and on their internal resources. The lessons from the banking sector need to be learned.

For too long, risk management, capital management and finance have been estranged. These differences have been exacerbated by outdated reporting requirements. Now, there is an opportunity for reconciliation, which the industry should embrace — not only will institutions' communications with their various groups of external stakeholders become easier, but they should finally be in a position to harness reporting bases that have developed in distinct functions, and bring them to bear on tomorrow's challenges.

References

1 Basel Committee on Banking Supervision (2006) 'International Convergence of Capital Measurement and Capital Standards, available at: http://www.bis.org/publ/bcbs128.pdf (accessed 27th October, 2008).
2 Commission of The European Communities (2007) 'Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of insurance and reinsurance, available at: http://eur-lex.europa.eu/LexUriServ/site/en/com/2007/com2007_0361en01.pdf (accessed 27th October, 2008).
3 International Accounting Standards Board (2008) 'IFRS Summaries', available at: http://www.iasb.org/IFRS+Summaries/Technical+Summaries+of+International+Financial+Reporting+Standards.htm (accessed 27th October, 2008).
4 CFO Forum (2008) 'MCEV Principles' available at: http://www.cfoforum.nl/eev.html (accessed 27th October, 2008).
5 International Accounting Standards Board, ref. 3 above.
6 Financial Accounting Standards Board (2008) 'Exposure documents', available at: http://72.3.243.42/draft/index.shtml#fasbiasb (accessed 27th October, 2008).
7 For example, the determination of a 'replicating portfolio' that mirrors the hedgeable risks within your insurance liabilities; and the cost of capital of the non-hedgeable risks.
8 Standard and Poors (2008) 'Enterprise Risk Management', available at: http://www2.standardandpoors.com/portal/site/sp/en/eu/page.article/2,1,5,0,1145836438677.html (accessed 27th October, 2008).
9 Fitch Ratings (2008) 'Fitch: Insurance ERM is Evolution not Revolution', available at: http://www.fitchratings.com/corporate/resource_detail.cfm?pr_id=296091&frompage=&resdet=teleconf_det (accessed 27th October, 2008).