Canadian Insurers, IFRS II and Solvency II

Canadian Reinsurance Conference

April 7, 2011

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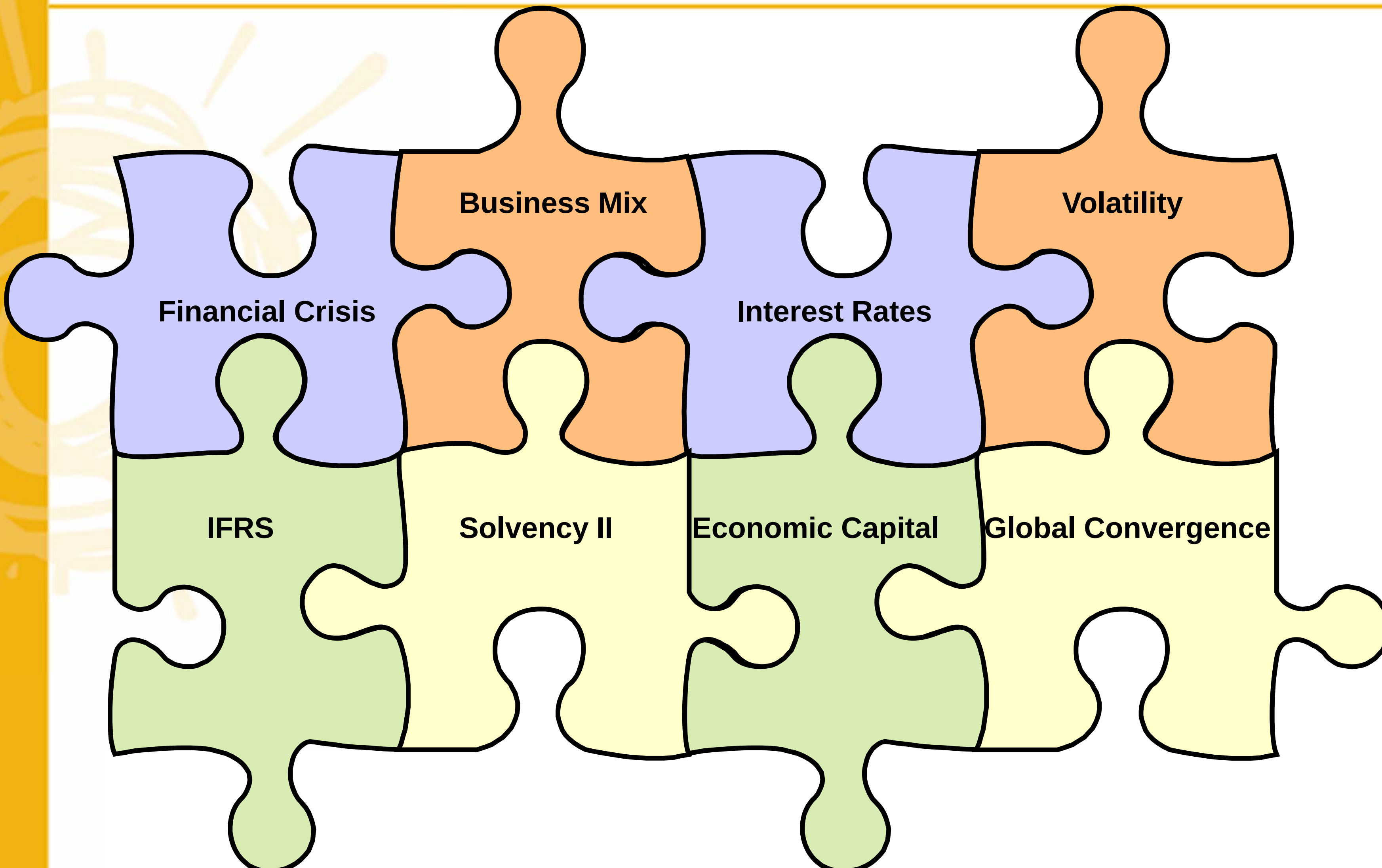
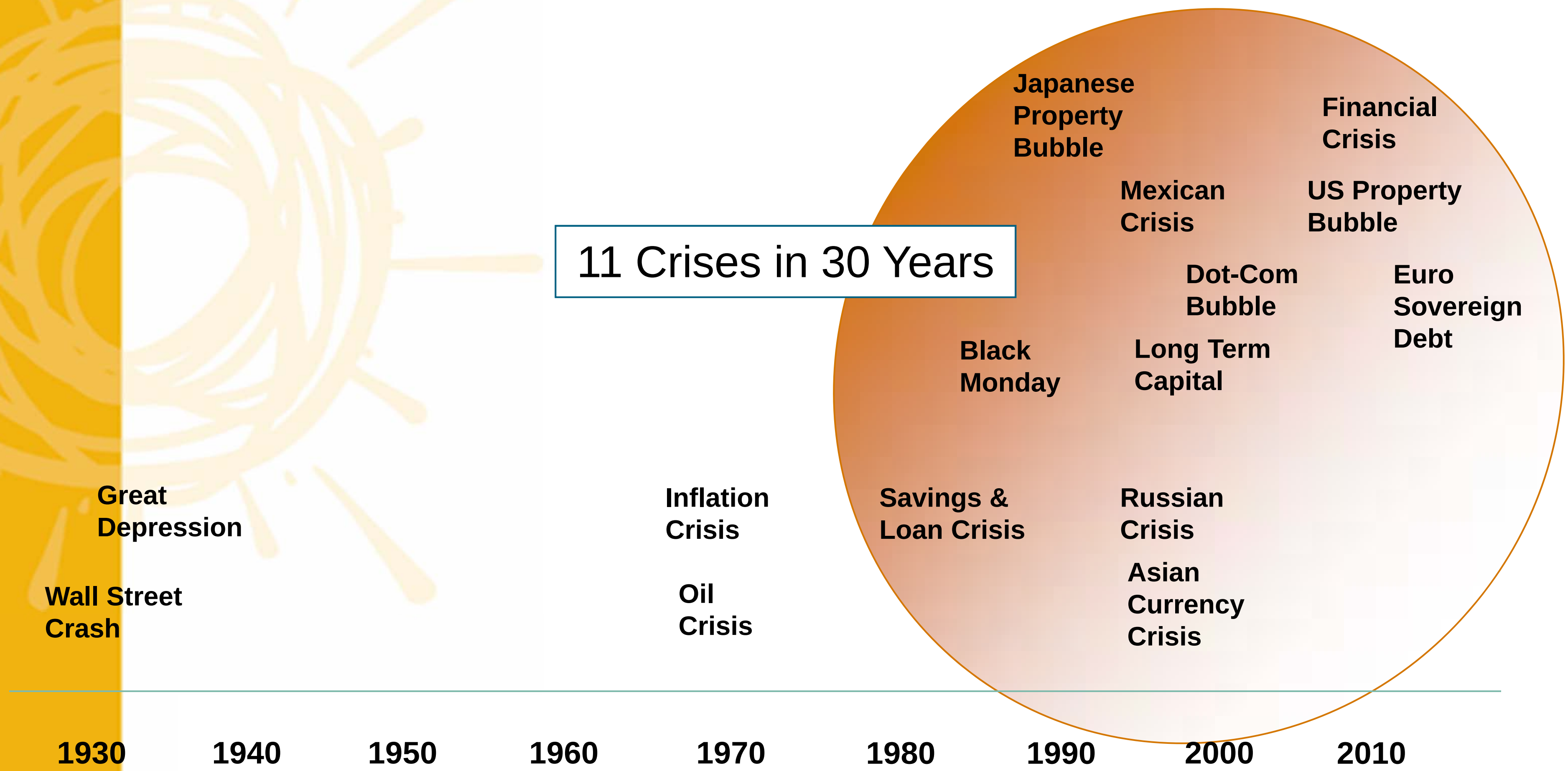
Life's brighter under the sun

Sun Life Financial

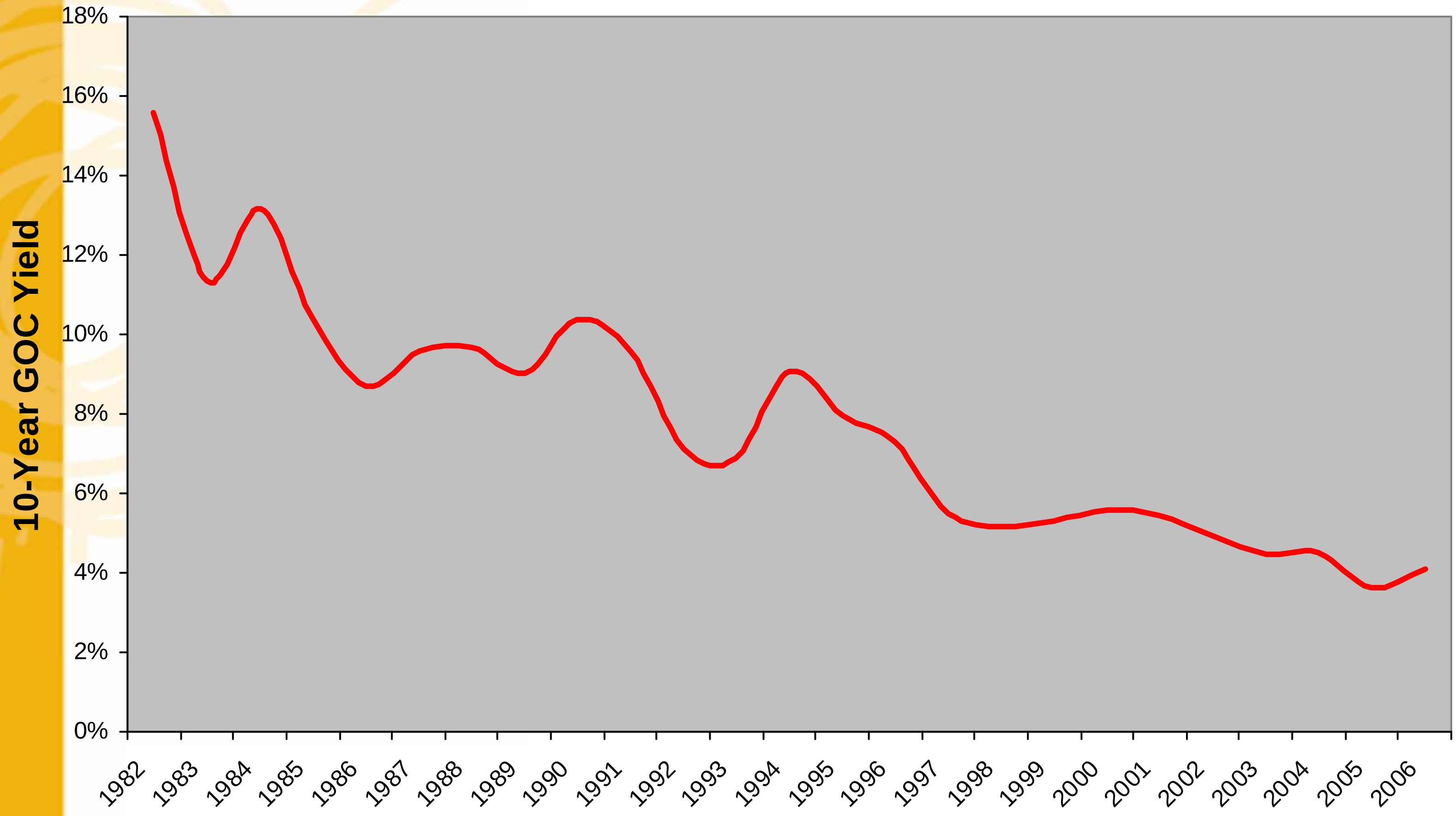
Context is Broader Than Solvency II and IFRS…



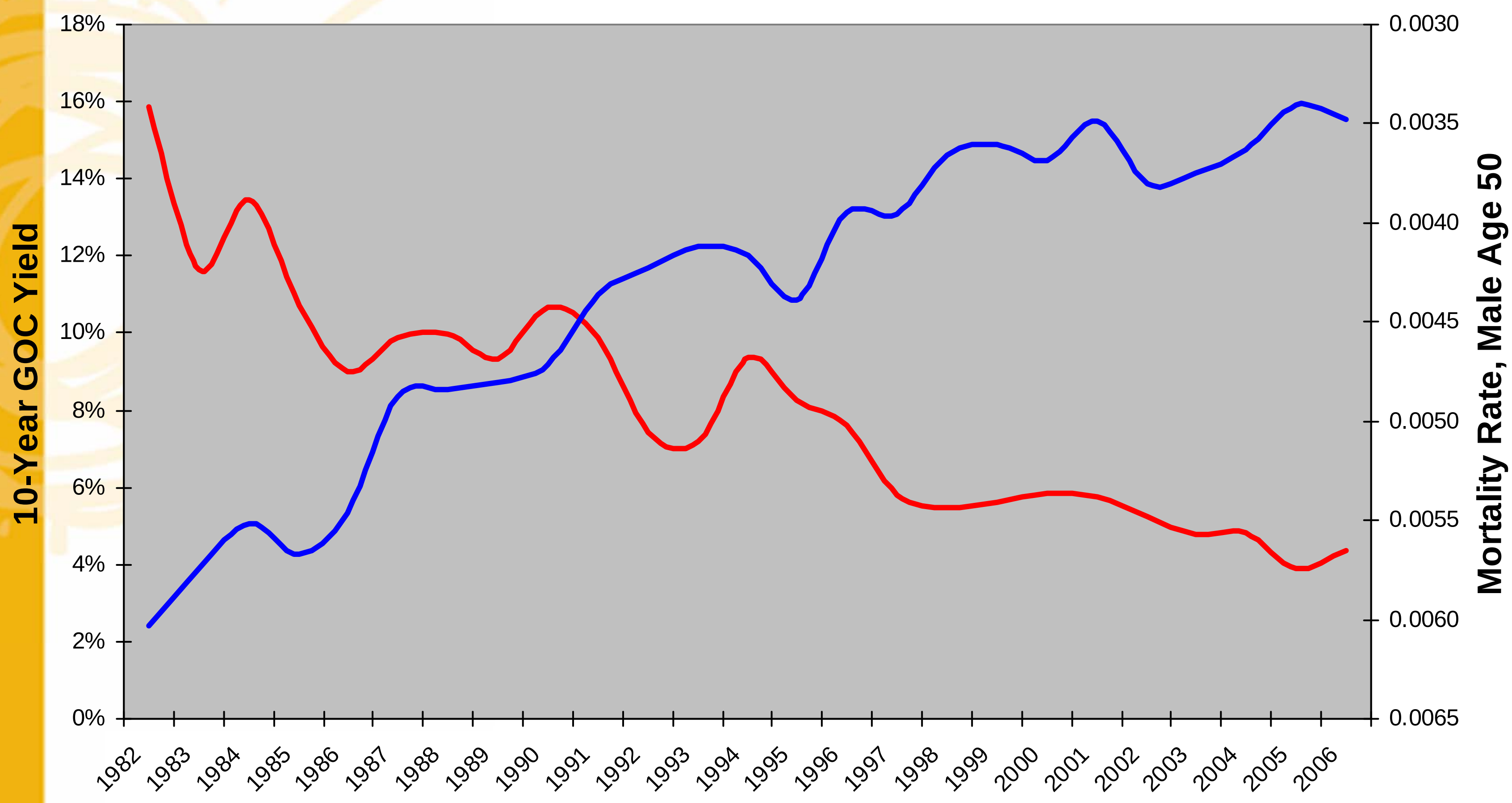
The Next Financial Crisis: When, Not If



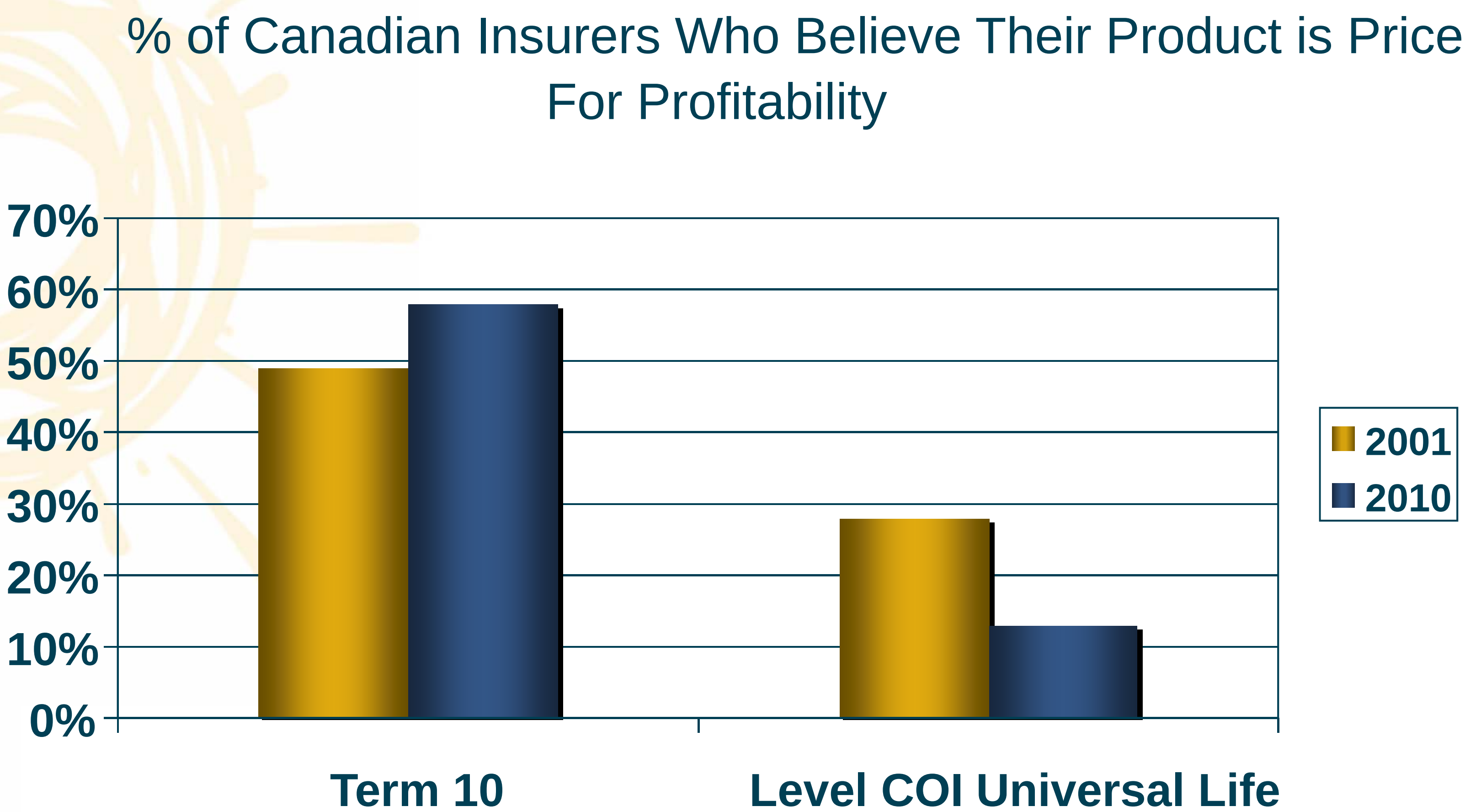
Lower Interest Rates Have Challenged Insurers



Helped Somewhat by Improving Mortality



…but Still Not Adequate



Source: Munich Re Canada Surveys

Implications for Life Insurers

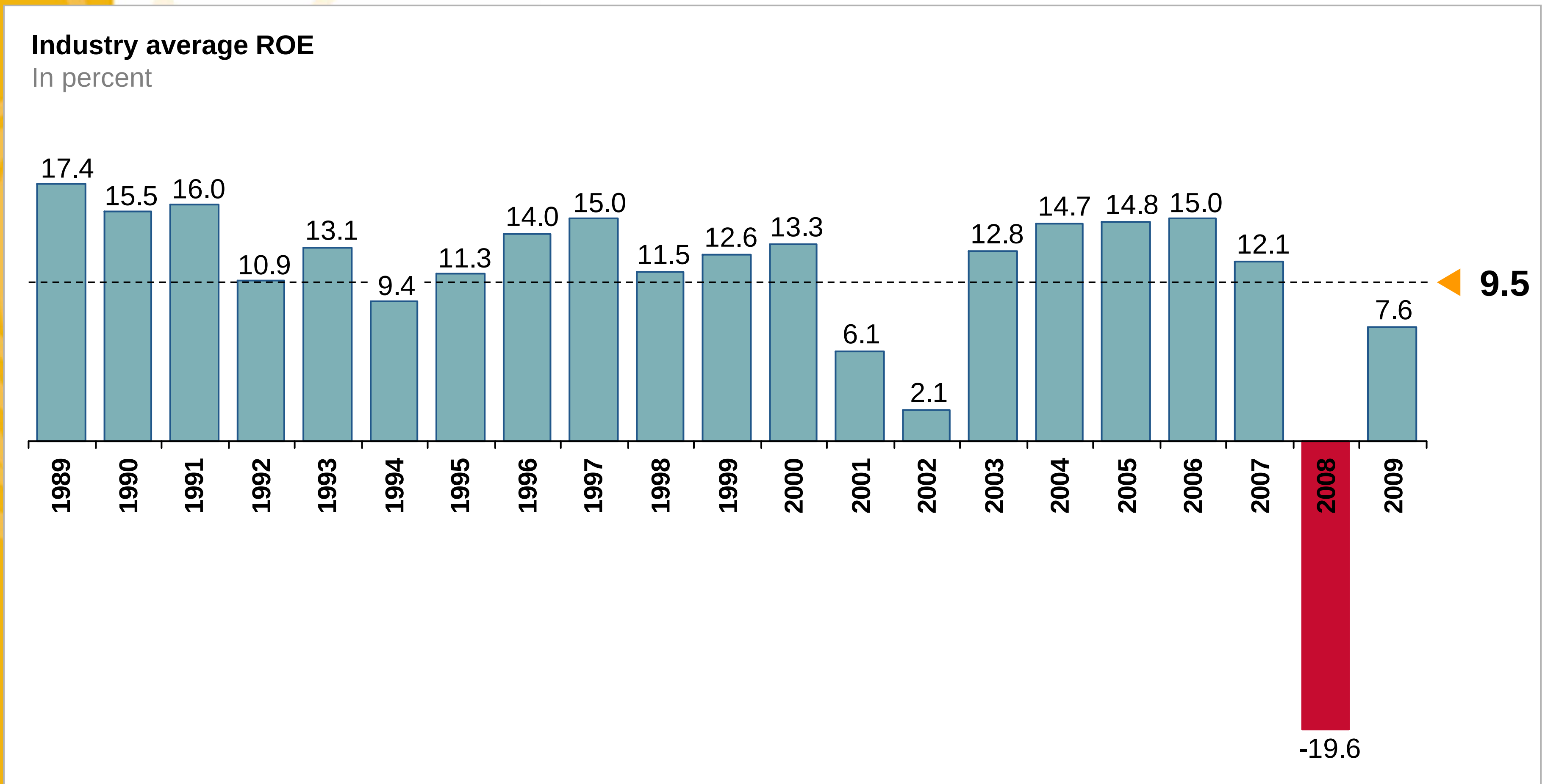
- **Long-dated promises with irrevocable pricing and optionality are challenging for life insurers**

- **Insurers are responding by:**
  - Withdrawing or limiting sales of more challenging products
  - Increasing prices and/or reducing product risk
  - Retaining more mortality and morbidity risk

Implications for Life Insurers

- **Insurers are responding by (cont'd):**
  - Shifting business mix
  - Emphasizing growth in markets and segments that have better risk/return characteristics
  - Employing greater 'capital husbandry'

US Life Insurance Industry Returned Slightly More Than Cost of Capital



SOURCE: AM Best, McKinsey analysis

IFRS Phase II

CLHIA: ***"The proposed approach is in such radical disharmony with the underlying business model and with economic reality as to result in financial reports that will be neither relevant nor reliable, extremely difficult to explain and likely lack comparability."***

IASB: ***"We've recognized that this (discount) rate won't do on its own….it won't stay the way it is."***

(Sir David Tweedie, BNN Interview, Nov 24, 2010)

Pension Accounting—A Cautionary Tale

- **DB Pensions: long dated, mismatched promise**
- **New IASB proposals slated for January 1, 2013 will mean:**
  - Pension expense computed ignoring expected asset returns above discount rate
  - Excess returns will be posted to OCI
  - Companies will choose to derisk their plans for equity and interest exposure
- **Will contribute to the further demise of DB Plans**
- **Accounting *does* matter**

Impact of IFRS II on Canadian Insurers

- **Joint IASB / FASB review**
  - June 30th target date
  - Not likely to prescribe a rate or method
  - It's possible the rules will permit top-down determination reflecting asset mix

- **Hub group of North American, European and Japanese insurance companies and trade bodies**

- **Future potential alignment of US GAAP with IFRS could broaden interest in Canadian lifecos by US investors**

Solvency II

"…Solvency II is due to come into force at the start of 2013. We believe that if changes are not made to the draft implementing measures then it will damage the strength and viability of the European insurance industry…"

Letter to the editor, Financial Times, April 5, 2011 from CEA Insurers of Europe, Pan European Insurance Forum, European Insurance CFO Forum and Chief Risk Officer Forum

Impact of Solvency II on Canadian Insurers

- **For business conducted in Europe:**
  - Some products (eg annuities) will be negatively affected
  - Induced volatility in capital ratios
  - Fewer monolines, more balanced business model
  - But the devil is in the remaining detail of Pillar I requirements

- **For business conducted in Canada:**
  - Depends on what OSFI does
  - OSFI will develop a new guideline in a year to package together the key aspects of Own Risk Solvency Assessment (ORSA)

Impact of Solvency II on Canadian Insurers

- **For business conducted in the United States:**
  - European insurers will be at a disadvantage against non-EU competitors
  - Insurers will restructure business accordingly
  - Could represent a significant amount of change
  - Depends on how the U.S. responds to equivalency

Impact of Solvency II on Canadian Insurers

- **Larger insurers will have an advantage:**
  - Able to support internal capital models
  - Value of diverse business model

- **Solvency II has potential to create a more level playing field—but depends on degree of convergence by country**

- **Significant cost—and execution risk—of compliance**

Impact of Solvency II on Canadian Insurers

- **Not clear how Canadian bank-owned life insurers will manage through requirements of Basel III and Solvency II**
- **Will accounting and solvency continue to be a single system in Canada?**

Solvency II Impact on Reinsurance

- **Greater scrutiny of concentration risk**

- **Forces driving higher retention:**
  - Optimizing capital credit for mortality/longevity diversification
  - Repositioning mix of risks to increase insurance risks

- **Reinsurers may provide mortality/longevity basis risk support**

Concluding Thoughts

- Convergence across geographies in accounting and solvency is a good thing….provided the landing point makes sense
- Integrated risk management, product design/pricing and top-down capital allocation based on economic capital view is a good thing
- Who benefits from an abrupt mark-to-market of assets and liabilities each quarter, with its commensurate volatility?
- Beware the hyper-precision implicit in Solvency II