



Economic Balance Sheet

As part of the Bermuda Monetary Authority's (BMA) final push to gain Solvency II equivalence, it has released guidance to the market for the implementation of Bermuda's Economic Balance Sheet (EBS) framework.

The assessment of required and available capital against an economic view of net assets underpins many of the regulatory changes that have taken place globally in recent years. In the absence of any significant strides by the IASB or FASB to move accounting standards in this direction, regulators have had no choice but to design their own balance sheet framework that they believe best represents this economic view.

The BMA has continued to take a practical approach to this topic; however, there are many fundamental differences between an economic valuation of assets and liabilities and the approach prescribed in existing accounting standards. This paper outlines the thought processes that companies should go through to identify, assess and solve these

differences. It also highlights the governance implications inherent in producing and being measured on a (for now) unaudited balance sheet.

Similarities to Solvency II

In publishing its EBS framework, the BMA has not deviated significantly from most of the principles contained within the Solvency II guidelines. Indeed, companies are given the option of using Solvency II principles (subject to pre-approval by the BMA) if this is a more efficient approach, for example for those who are already part of a European-supervised group. The benefit for Bermuda companies is that the trial runs and progress made in much of Europe over the last few years means that there are lots of lessons

already learned and problems already solved. Given the relatively short implementation timetable in Bermuda, it will be important to make the most of these experiences.

Key aspects of the guidance

The underlying premise of an EBS is that both assets and liabilities are valued using market or fair values. While for most insurance companies this won't represent too much of a change on the asset side of the balance sheet, very few liabilities are currently fair valued under prevailing accounting principles. In particular, the fair valuing of liabilities arising from insurance contracts can pose significant challenges, even to those companies where relevant data sets are already available. This is especially true when looking beyond reserves for loss events to those liabilities created by legally enforceable contracts where loss events have not yet occurred.



Issues faced in the UK

In implementing similar principles in the UK, companies experienced a number of issues, including:

1. The reporting process was not sufficiently automated or embedded;
2. A variety of reserve data problems, such as homogeneous risk grouping;
3. Finance and actuarial teams were not sufficiently coordinated;
4. Documentation and rationale for treatment of binary (or significant loss) events;
5. Trial runs were found to be the only way to accurately set up systems and processes;
6. Numerous errors in reconciling back to audited data sets;
7. Inefficiencies created from a lack of consistency;
8. Accurately modeling the effect of non-proportional reinsurance;
9. Determining materiality for individual modeling decisions; and
10. Forecasting expenses and benchmarking as a % of technical provisions.

Who will it impact?

Although financial reporting teams will now be required to prepare and review a much wider suite of adjustments to audited GAAP balances, the creation of a substantially different way of looking at the balance sheet will impact individuals and teams far beyond financial reporting. For example:

- **Reserving actuaries** - establishing best estimate reserve cash flows will likely differ from the current GAAP or statutory approach, requiring different sets of assumptions;
- **Capital modelling actuaries** - establishing risk margins may require additional analysis to that currently performed for internal capital purposes;
- **Underwriting teams** - capturing additional data fields for bound business may be necessary, together with increased balance sheet reliance on pricing or initial expected loss ratios;
- **System support teams** - re-configuring systems and reports could be required to capture and analyse the additional data points, or even to create an additional set of books and records;
- **Tax specialist** - calculating the deferred tax assets and liabilities arising from an alternative accounting measurement basis;
- **Internal audit and control owners** - establishing new process elements, with appropriate control activities, to support the reliability of the new reporting basis; and
- **Board or committee** - understanding the principles involved, the approach taken by management and the extent of independent validation, prior to approving the balance sheet.

In addition, each company's Approved Actuary will be required to sign their opinion on the economic value of the technical provisions, in contrast to the current opinion on the sufficiency of reserves. This not only broadens the scope of the opinion, it substantially narrows the range that the actuary should be comfortable opining on.

When will it impact me?

If you are a Class 4 or 3B entity, you should be preparing to file a 2015 year-end EBS on a best efforts basis, ahead of a January 1, 2016 implementation date. Life business written by dual licensees with a Class 4 or 3B license will also be captured by this implementation date.

If you are a Class 3A entity, then you have a further year to comply.

If you are a Class E, D or C entity (other than those dual licensees above), you should also be preparing to file a 2015 year-end EBS on a best-efforts basis.

Implementation will be on January 1, 2016, with the exception of technical provisions, which will continue on a best-efforts basis for the 2016 and 2017 year-end filings, while the BMA conducts quantitative impact assessments. Implementation for technical provisions is expected to be January 1, 2018.

What should I consider first?

A critical first step, as with most implementations, is to ensure that the landscape of the potential changes is known and to then assign ownership at a sufficiently granular level. The changes can broadly be split into three areas:

Data sets - the capture of additional data will be critical to ensuring that the management have the ability to produce reliable valuations and can support the



areas of judgment and subjectivity. For example:

- **Original currency reserve data** – the application of risk free discount rates (which even in a low interest rate environment can vary substantially across countries) requires the underlying reserve data to be denominated in their expected payment currency, not simply all converted to US dollars.
- **Bound but not incepted contracts** – the date at which a contract becomes legally enforceable will become the recognition point for the EBS, even though the effective date and signed contracts may come substantially later.

Processes and controls - existing processes around balance sheet accounts will be insufficient to support the economic valuations. New processes will need to be established, with ownership, controls and review procedures in place, in order for management and the Board to be comfortable with the overall completeness and accuracy. For example:

- **Reserve best estimate** – removal of current levels of prudence in the GAAP reserves will require at least a reconciliation process, or potentially a separate reserving process. This should be subject to the same robustness of controls as the existing reserving process.

- **Loss-sensitive contract features** - the impact of cash flows from loss-sensitive features of these should be incorporated in the calculation of the technical provisions, including those in contracts which have been bound but not yet incepted. Management should seek comfort over how these data points have been captured and modeled, including documentation around material judgments within the process.

Validation - in the absence of external audit requirements, management should plan to obtain effective and efficient verification of the balance sheet position and the underlying procedures. The requirements for companies in the UK are a good blueprint for how comfort can be obtained and supplied to the Board to support their overall sign-off. These requirements are:

- A **'Review and Recommend' report** - this provides comfort that all significant gaps between the guidance and existing practices have been identified, together with suggestions as to how management may address those gaps or confirmation that planned activities appear appropriate.
- A **'Reasonable Assurance' report** - the criteria for this report would be established as part of the output of the 'review and recommend' report and this provides comfort that management has appropriately addressed the identified gaps in preparing its EBS.

What questions should I be asking?

The BMA's principles approach allows companies to design methodologies and apply proportionality in a manner that makes sense given their risks and materiality. However, this also raises questions as to the most efficient approach in each case. As part of the three-pronged approach discussed previously, framework owners should be asking the following types of questions:

1. [How reliable are my reserve payment patterns?](#)
2. [Could I use the approximation method for premium provisions?](#)
3. [Does the risk margin template make sense for my book of business?](#)
4. [Can I reliably estimate future expenses required for the cash flow models, including costs to manage reinsurance recoveries and investment portfolios?](#)
5. [Do I have sufficient original currency reserve data to apply materially different discount rates?](#)
6. [Are my assets and liabilities sufficiently matched to use the 'scenario-based approach' to discounting, or can I gain at least partial credit?](#)
7. [Have I captured and included all legally enforceable contracts, even if not yet effective?](#)
8. [Is my documentation sufficient to support the key judgment areas?](#)
9. [How does the confidence level for my best estimate reserves compare with peers?](#)
10. [Do I understand and am I applying my company's data quality standards?](#)

11. Will I have additional deferred tax assets that need supporting or providing for?
12. Are my intangible assets material enough to need valuation support?
13. Do I have the underlying data to be able to fair value my investments in affiliates?

If you are the company's Approved Actuary, you will need to pay particular attention to the questions underlined prior to signing off on the appropriateness of the technical provisions. This is true even if you are not responsible for the production of all elements of the economic valuation.

Is this just for the regulators?

Filing of the EBS in 2016 coincides with the BMAs introduction of public disclosure requirements. These include a number of specific disclosures on EBS valuation bases and amounts. Publication on the company's website or through other channels will increase the risks associated with an unaudited item of information.

Boards and management teams should be assessing the extent of the risks that this may expose them to, especially given the potential for the economic valuation of net assets to differ materially from the company's GAAP net assets. While the BMA can satisfy itself through direct enquiry, other potential users cannot. Third party reports, similar to those outlined above and introduced in the UK, would reduce the risk and give users greater confidence in the reliability and quality of the information, without suffering the full cost of having a second audited balance sheet.

How can KPMG help?

Our overall aim is to help companies reduce their risks and provide Boards and executive management with increased confidence regarding the reliability of information provided to the public and the regulator. An independent challenge not only increases the level of attention placed on material judgments, it ensures that the processes used to generate the information are more robust.

At KPMG, we already have extensive experience in providing 'Review and Recommend' reports on the Solvency


II EBS. The feedback on our reports is that they are well laid out, easy to follow and clearly identify any shortcomings in approach against the latest guidance, good practice and peer groups. We have done this work for both audit and non-audit clients and have tailored it for the individual needs of clients, in particular so that they do not have to pay twice for the same procedure. We would be very happy to speak to you about how we can make the process of reviewing your company's EBS approach as effective and efficient as possible.

Contact us:

For more information on how KPMG in Bermuda can help, please contact one of our EBS specialists:



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