March 25, 2010

I made the following remarks to express concerns relative to the International Financial Reporting Standards (IFRS) potential use as a base for solvency assessment during a meeting of the NAIC’s Solvency Modernization Initiative task force on Thursday March 25, 2010.

Good morning,

My Name is Jeffrey L. Johnson. I am a Fellow of the Society of Actuaries and a Member of the American Academy of Actuaries. I am also an Assistant Vice President and Actuary at John Hancock.

Let me begin by thanking the NAIC for providing me with this opportunity to talk about the IFRS’ potential future implications on capital.

During my time today I will:
- Briefly provide some background for my remarks
- Summarize the key IFRS issue and potential implications

Manulife Financial Corporation is the Canadian parent of John Hancock. Manulife has acquired experience with the practical and potential implications of implementing this new accounting standard while preparing, along with other Canadian companies, to adopt IFRS by 2011. Today Canadian GAAP (CGAAP) financial statements form the basis of capital requirements in Canada. Additional solvency factors are applied to CGAAP financials to arrive at a measure of solvency. The objectives of financial reporting are not compromised despite use of CGAAP statements for capital purposes. The solvency framework in Canada works because it rests upon a sound accounting system which is not overly conservative.

Other capital frameworks internationally, expect to use IFRS financial statements as the base.

Manulife’s US Operations, John Hancock, are also subject to capital requirements using the NAIC RBC formula. The FASB is expected to release an exposure draft in June of this year regarding its joint project with the International Accounting Standards Board (IASB) to develop a common, high quality standard that will address recognition, measurement, presentation, and disclosure requirements for insurance contracts.

Manulife/John Hancock support the NAIC’s work on the Solvency Modernization Initiative and strongly supports a solvency framework based on a total balance sheet or total financial resources approach. However, we believe that such an approach can only be effective in concert with a sound accounting framework that is not overly conservative, or overly volatile. We are concerned about potentially moving to an accounting and solvency model that has severe consequences. The discount rate is at the core of the issue.
From all of the discussions that have, and are taking place, we believe IFRS, as it is currently drafted, and global solvency models are “fundamentally flawed” for long-duration guarantee products. These products, whole life, payout annuities, LTC etc, proliferate in the companies you regulate. The same issues are shared by our Canadian and many of our US peers. European peers also have issues with the proposals but are less exposed to the concerns regarding long duration guarantee products.

The IASB, which is developing IFRS, proposes that the discount rate “should reflect the characteristics of the liability and should not reflect asset returns”.

- This is interpreted to mean that the discount rate should equal the risk free rate or possibly the risk free rate plus a liquidity premium.
- Currently under CGAAP and USGAAP the liability valuation considers the valuation of invested assets.
- Under the IFRS proposals the balance sheets of insurance companies are expected to be at fair value.
- Even modest inconsistency between assets and liabilities will result in significant fair value differences, which will result in extreme balance sheet and earnings volatility that is not representative of the risks inherent in the insurance business model.

**Simple Illustration Earnings/Capital Volatility Due to Discount Rate**

To illustrate the potential volatility, consider the following simplified example:

Assume:
- $100 B of 7 year duration policy liabilities valued using the swap curve.
- $100 B of 7 year duration fixed interest cash flow matched assets (single A bonds) at fair value.
- Single A credit spread movement of 100 basis points over the quarter, (with relatively no change in swap rates).

Thus fair value of assets drops by $7 B pretax! [($100 B x 7 x 100 bp)]

Recent history has shown that spread movements of this magnitude are very possible.
Implications of using an inappropriate discount rate for Accounting/Solvency Valuation

We believe that use of an inappropriate discount rate for accounting/solvency valuation has the following 5 implications:

1. **Disconnect with business model**
   a. If the financial reporting is disconnected from the actual business model, earnings and financial position **will not represent useful or relevant financial information** for users of financial statements. The Asset and Liability Matching concept is the cornerstone of the business model for insurance and annuity products which have a long duration and guaranteed rates.

2. **Extreme volatility of earnings and capital**
   a. The potential for extreme volatility in earnings and solvency ratios does not provide a useful framework for shareholder reporting or determination of prudent levels of regulatory capital.

3. **Substantially higher capital levels at transition**
   a. New rules could cause an immediate need to raise substantial amounts of new capital – which could be insurmountable. This in turn could reduce the availability and/or substantially increase the cost of retirement savings products.

4. **Impaired ability to compete**
   a. Higher capital and more volatile earnings would damage the global competitiveness of North American Insurers compared to banking peers in N.A. and European insurance peers. Current IASB/FASB proposals seem to permit an “amortized cost” model for the banking industry “bread and butter” loans and deposit business and therefore limited earnings volatility.

5. **Disruption to financial markets**
   a. All of the above could lead to less ability to invest in important investment classes to the N.A. / global markets, reducing the liquidity in the N.A. financial markets and significantly increasing local borrowing costs and thus negatively effecting the ability to raise new capital.
In closing I want to leave you with the following 4 key messages:

1. Moving away from the current capital regime requires careful consideration and should not be done in haste. It is important to ensure that *theoretically sound models can be implemented and produce desired outcomes*.

2. North American businesses are sufficiently different than their European counterparts, (for which solvency II was based), to warrant a unique approach to the determination of solvency.

3. Discount rate selection is critical for long duration guarantee products to avoid severe capital volatility and to ensure the financial results are relevant without the use of extensive non GAAP measures.

4. Appropriate transition guidance needs to be provided. Possibly grandfathering of in-force contracts?

I hope that these remarks will prove useful as the NAIC’s work advances from examining a new solvency framework to consideration of the accounting framework upon which it will be based.

Thank you.