

Accounting and Solvency Convergence – Dream or Reality?

Rob Esson with assistance from Peter Cooke

NAIC, 2301 McGee St Ste 800, Kansas City, MO 64108-2662, U.S.A.

E-mail: Resson@naic.org

For some time now the International Association of Insurance Supervisors has been working towards the harmonization of solvency assessment regimes worldwide. Having developed a common structure for solvency assessment, it is now working on more detailed requirements which will take the form of international supervisory standards. At the same time as this work has been progressing, work has been ongoing at the International Accounting Standards Board on Phase II of its Insurance Contracts Project. This project will result in an international financial reporting standard for insurance contracts. This article discusses the desirability of having a single methodology that can be used for financial reporting for both solvency assessment and general-purpose financial reporting purposes. It goes on to argue that, while absolute convergence is neither likely nor necessarily desirable, current indications are that the dream that a single model can form the basis for both reporting regimes might still be realized. This in turn would promote greater transparency and therefore enhance credibility in financial reporting by insurers. *The Geneva Papers* (2007) 32, 332–344. doi:10.1057/palgrave.gpp.2510135

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Introduction

Over the last several years, the International Association of Insurance Supervisors (IAIS) has been making considerable progress with a new, principles-based approach to insurer solvency assessment through its Solvency and Actuarial Issues Subcommittee. In view of the significance to the insurance industry and to insurance supervisors of the work of the International Accounting Standards Board (IASB) on insurance contracts, over 2 years ago the IAIS also established an Insurance Contracts Subcommittee specifically to coordinate the IAIS's position and provide input to the IASB with regard to Phase II of its project on insurance contracts (Phase II) and other key, related projects. The work of this subcommittee is closely coordinated with the IAIS's work on solvency assessment.

The Insurance Contracts Subcommittee has been an active participant in the IASB's Insurance Working Group and an active observer of the work of the IASB as it strives to formulate Phase II of its Insurance Contracts Project. The end result of this latter project will be a new and comprehensive International Financial Reporting Standard (IFRS) covering insurance contracts, and, possibly, a similar new U.S. Financial Accounting Standard.

The IAIS is also working in close cooperation with the International Actuarial Association (IAA) in its work on solvency assessment. With regard to the valuation of insurance liabilities, the IAIS asked the IAA for formal input to assist its work in this area. This has resulted in an exposure draft by the IAA of a paper entitled *Measurement of liabilities for insurance contracts: current estimates and risk margins*, which was released for consultation in February 2007. Work by IAA members on this paper has been ongoing in parallel with the recent IAIS work on insurance liability measurement, and IAA members have participated closely in the IAIS work streams on both Phase II and solvency assessment. (I shall return to this later.) The IASB has also taken an interest in this IAA project.

At the IAIS we have no cause to believe at this stage that there are significant differences in the philosophies underlying the IAIS work on solvency assessment and the European Solvency II project, or in the compatibility of the expected outcomes. The European Commission is represented in both of the IAIS work streams mentioned above. In addition, many jurisdictions represented in the IAIS subcommittees working on Phase II and solvency are also closely involved with the Solvency II project. Hence IAIS work in these areas is progressing in close parallel with developments on Solvency II.

As first enunciated in its paper colloquially known as the *First Liabilities Paper*,¹ the IAIS stated as an over-riding principle that it “believes that it would be most preferable if the methodologies for calculating items in public, financial reports are able to be used for, or are substantially consistent with, the methodologies used for regulatory reporting purposes, with as few changes as possible to satisfy prudential reporting requirements.”

Taking a cue from the title of this article, the dream of a convergence between accounting and solvency is enunciated for all to see. But can it become reality? This is the question that the rest of this article will try to answer, but this much is clear: there will be much work to do to achieve it, and there will be a need for goodwill on all sides.

In a nutshell, two things will be needed to achieve the convergence: firstly, Phase II of the IASB’s Insurance Contracts project will need to enunciate a model that contains the majority of the key features that insurance supervisors need to evaluate and monitor the financial aspects of insurer solvency, and secondly, the insurance supervisors will need to make a conscious effort to accept such a model as input into their solvency requirements.

It is worth stating here, upfront, that the key word in the last sentence is “input.” There is a widely held misconception that utilizing IFRS would somehow lock supervisors into every aspect of the IASB’s valuation methodologies. Nothing could be further than the truth. The mere fact that an asset, say, is valued at 100 Currency Units, and is used as input into a solvency framework does not, in and of itself, imply that the solvency framework will give the equivalent of 100 per cent credit in capital for those 100 Currency Units.

¹ IAIS (2005a).

The basics of convergence

Prior to attaining the long-term holy grail of accounting and solvency convergence, other convergence is required. For there to be accounting convergence, it is relatively obvious that jurisdictions will need to agree and converge regarding accounting issues. Equally, for there to be solvency convergence, jurisdictions will need to agree and converge regarding solvency issues. Let us examine both in turn, before even touching on the details of how one might possibly get the two processes to use the same methodologies.

Accounting convergence

At the risk of sounding parochial, there are probably only two sets of accounting rules with a realistic chance of being regarded as contenders for a worldwide set of accounting principles: IFRS promulgated by the IASB, and U.S. Generally Accepted Accounting Principles (GAAP) promulgated by the U.S. Financial Accounting Standards Board. Fortunately, in September 2002 the FASB and the IASB agreed to converge their standards in an agreement referred to as the Norwalk Agreement. The first paragraph of the Norwalk Agreement reads: “At their joint meeting in Norwalk, Connecticut, U.S.A., on September 18, 2002, the Financial Accounting Standards Board (FASB) and the IASB each acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, both the FASB and IASB pledged to use their best efforts (a) to make their existing financial reporting standards fully compatible as soon as is practicable and (b) to coordinate their future work programs to ensure that once achieved, compatibility is maintained.”

As a long-term observer at IASB meetings, I can confirm that this convergence is happening in practice. The IASB will tend in its deliberations to consider the current activity and current standards in U.S. GAAP when deliberating a new International Financial Reporting Standard, and vice versa. The stated intention is not to converge, necessarily, with either an IASB standard or a FASB standard, but for both Boards to converge to a better standard. They both recognize that this may result in changes to both International and U.S. GAAP standards in many cases.

Of particular importance to the insurance industry is the IASB’s Insurance Contracts project. This is currently being run by the IASB under what is referred to as a “modified joint project.” In a modified joint project, one Board takes the lead on an issue up through the issuance of a discussion paper. After that stage, the other Board takes an agenda decision as to whether to join with the first Board in a full “joint project.” At the beginning of May, the IASB released a discussion paper on the issues surrounding Phase II of the Insurance Contracts project.² We would therefore expect

² At the time of writing the discussion paper had not been published – it was released as this article was being finalised. Hence this article does not comment on the published contents of the discussion paper. Nevertheless, the general direction of the Phase II project and many of the preliminary views of the IASB were known prior to its publication.

that the FASB will make an agenda decision shortly as to whether to join with the IASB and work towards an exposure draft and ultimately a standard.

The timetable from the IASB's project summary³ indicates that an exposure draft would take at least 18 months from publication of the discussion paper, and a final standard would take at least another 12 months. Hence, the earliest that we might expect an exposure draft would be the very end of 2008, with a final standard at the very end of 2009. Based on prior experience, it would be unlikely that the final standard would be required to be implemented prior to 1 January 2011. Presumably this would also be the earliest timing that one might expect for any converged U.S. GAAP standard as well.

Solvency convergence

Solvency convergence is both easier in some ways, and probably harder in the long term. The reason that it might be a bit easier to converge is that there is a lack of an *implemented* internationally agreed common standard or framework – which means that we are starting with, if not a blank sheet, at least one that has much white space. The IAIS has, however, stepped into this arena, and has been working since 2004 on a set of papers that will form the framework for a comprehensive set of international standards on solvency. There are currently three papers that should concern us – the *Framework Paper*,⁴ the *Cornerstones Paper*,⁵ and the *Structure Paper*.⁶ In summary, the Framework Paper lays out a deceptively simple framework which – on the basis that a picture is worth a thousand words – can be illustrated as shown in Figure 1.

At Level 1 of the Framework, there are the fundamental pre-conditions for the functioning of a solvency regime: if one does not have the legal framework, for example, to support an insurance supervisory authority, the other levels are rather pointless. Level 2 sets out the basic building blocks of a solvency regime, which includes governance and market conduct requirements, as well as financial ones. Many of us, myself included, need to be reminded from time to time that the financial requirements – though vital – are not sufficient in and of themselves to provide an effectively functioning solvency regime. For example, one could postulate a financially strong insurer that keeps itself that way by denying claims and mistreating its policyholders. While such an insurer might not last very long anyway – as presumably the customers would move away – if the governance and market conduct blocks were not part of the regulatory requirements such an insurer might, though technically complying with the solvency requirements based on the financial block, appear to meet all of its regulatory obligations.

The Cornerstones paper elaborates on a set of high level principles governing the financial requirements. Some of these are so important to the convergence process with accounting that it is worth repeating three of them here.

³ International Accounting Standards Committee Foundation (2006).

⁴ IAIS (2005b).

⁵ IAIS (2005c).

⁶ IAIS (2007).

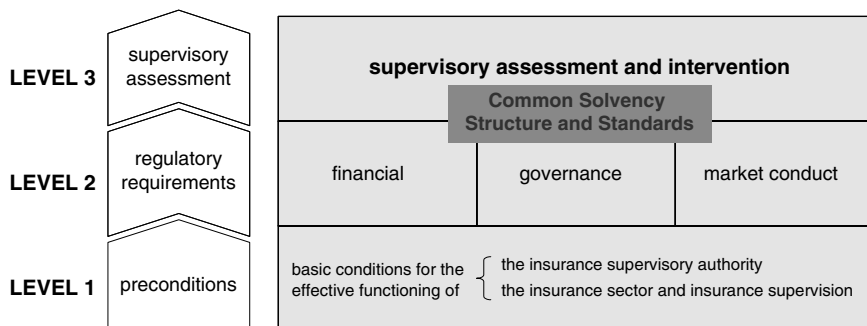


Figure 1. Framework for a functioning solvency regime.

- Cornerstone IV states that “the solvency regime requires a valuation methodology which makes optimal use of and is consistent with information provided by the financial markets and generally available data on insurance technical risks.”
- Cornerstone V states that “the solvency regime includes the definition of technical provisions. Technical provisions have to be prudent, reliable, and objective and allow comparison across insurers worldwide. Technical provisions include an explicit risk margin.”
- Cornerstone VI states that “the solvency regime requires the determination of a ‘best estimate’ of the costs of meeting the obligations arising from the insurance portfolio, taking into account the time value of money, determined by reference to the relevant risk free interest rates on the financial markets.”

We will see parallel wording in the recommendations from the IAIS to the IASB. There are two items regarding these cornerstones that are worth mentioning. Firstly, the terminology “best estimate” has now been superseded by “current estimate” and “risk margin” by “margin over current estimate”, and secondly, the use of the word “prudent” in Cornerstone V is sometimes misunderstood. Indeed, the word is regarded as pejorative by accounting standard setters, yet the concept of prudence and the concept of allowance for uncertainty are two sides of the same coin. In fact, if we allow a coin to have depth, the third side is compensation for risk. In my view, all three are different ways of describing the same thing – the margin over current estimate.

Regarding the margin over current estimate, I recently suggested that insurance obligations are, by their very nature, uncertain: the insurance industry exists to accumulate uncertainty from policyholders. Measurement of insurance obligations is currently under discussion by the IASB.

The current likely direction of the IASB is based on an exit value, that is, the amount that would be required for a transferee to take on the liabilities.

Were a deep liquid market to exist for insurance liabilities, the observed market price for an insurance liability would constitute the exit price. However, deep liquid markets do not exist for insurance liabilities, and consequently a proxy methodology is required to derive the exit value.

The proxy methodology is to measure a current estimate and add some form of margin to this amount. In trying to put this methodology into practice, we assume that a rational transferee would require something above the current estimate (even if transferor and transferee agree perfectly on the level of the current estimate): otherwise the transferee will receive nothing for taking on the risk if everything works out as expected. This amount, the margin over current estimate, can therefore be regarded as an additional amount “for uncertainty.” It therefore can also be regarded as a compensation for the transferee for the risk of taking on uncertain liabilities.

Hence, a reasonably rational methodology for calculating this margin over the current estimate is to put oneself in the position of the transferee. What thought processes might the transferee go through in order to work out what extra amount it might require over the current estimate? Presumably the answer is as much as possible, but in a market in equilibrium, it would be a reasonable return on the risk of uncertainty. However, were evidence to exist that transferees would take on the liabilities at a very low return for uncertainty, then the margin would be this lower figure, whatever it may be.⁷

The recently published Structure Paper elaborates on the Cornerstones and other blocks of Level 2 of the Framework, introducing “Structure Elements” that expand on the principles enunciated in the Cornerstones Paper. The Structure Paper itself is an intermediate paper which is expected to be used as input into various solvency standards in the future. Indeed, some are already in the early stages of drafting.

A number of these Structure Elements were derived from the *Second Liabilities Paper*⁸ and, in particular, Structure Elements 6, 7, 8 and 11 contain critically important principles that – we believe – are compatible with the likely directions of the IASB.

These (or parts of these) are reproduced here:

Structure Element 6: A market consistent valuation of technical provisions should be based on the risk characteristics of the portfolio rather than the characteristics of the specific insurer holding the portfolio. However it may be appropriate to use assumptions that reflect aspects of the insurer’s specific business model and practices where they can be sufficiently substantiated.

Structure Element 7: Given the intrinsic uncertainty of insurance obligations, the technical provisions need to include a risk margin over the current estimate of the cost of meeting the policy obligations. The risk margin should be calibrated such that the value of the technical provisions is equivalent to the value that an insurer would be expected to require in order to take over the obligations.

Structure Element 9 (part): In a market consistent valuation methodology, technical provisions should be calibrated based on assumptions about diversification of the

⁷ Similar drafting is used in Section 6.1 “Goals of risk margins” in International Actuarial Association (IAA) (2007).

⁸ IAIS (2006).

relevant risk factors which are consistent with market assumptions. Lack of diversification within a risk factor, relative to these assumptions, should be reflected in (increased) required capital, not in technical provisions.

Structure Element 11 (part): The risk reflected in the risk margin in technical provisions relates to all liability cash flows ...

Those who are familiar with the considerations at the IASB will recognize that these principles are repeated, with different wording, in the tentative conclusions of the IASB's Insurance Contracts project summary. They are also highly consistent with the work underway on Solvency II.

So, in summary, the IAIS has promulgated a number of underlying principles in its solvency work that are believed to be compatible with the current direction of the IASB. Let us now examine the work at the IAIS Insurance Contracts Subcommittee which provides direct input into the processes at the IASB.

IAIS input to the IASB

The IAIS work on Phase II has been to study the possibility of using an IFRS compatible model as a basis for prudential supervision, taking into account the likely outcome of the IASB's Phase II project. More precisely, the mandate of the Insurance Contracts Subcommittee asks the question: "What methodologies for determining insurance liabilities, consistent with the likely outcomes of the ongoing IASB work, could be acceptable for prudential supervision?"

In its work to provide input to the IASB, the IAIS has assumed that the more likely outcome of Phase II will be a *prospective asset/liability model* with *time value of money* adjustments and *risk margins* (assumptions which remain valid based on the IASB's tentative decisions to date). The themes addressed by the IAIS in its comments explore, on the basis of these assumptions, the likely characteristics of a compatible, sufficiently robust, general-purpose and regulatory reporting measurement model for insurance contracts, and what characteristics should not be in such a model.

As a result of its work the IAIS has now provided two comment papers to the IASB as input into the Phase II project. The *First Liabilities Paper* was issued in May 2005 and followed up a year later with the *Second Liabilities Paper*.

The Second Liabilities Paper sets out a number of principles, or key observations, on measurement themes common to both regulatory reporting and general-purpose financial reporting that the IASB is addressing in Phase II.

The principles identified include various features of insurance liability measurement, risk margins and aspects of insurance accounting. In addition to the overriding principle, first introduced in the First Liabilities Paper and reiterated in the second, it is worth highlighting a few of the other key principles and observations:

- The future cash flows relating to full settlement with the claimant/beneficiary should be the basis for measuring insurance liabilities.
- An approach which uses observable inputs from deep and liquid markets to the fullest extent possible is appropriate in insurance liability valuation.

- Similar obligations with similar risk profiles should result in similar liabilities.
- Probabilities which reflect likely policyholder behavior are needed to achieve meaningful results.
- Including adjustments for credit standing in the measurement of insurance liabilities would be misleading for users of general-purpose financial statements.

A number of the key principles and observations in the paper are in full agreement with the preliminary Board decisions on Phase II. There are other principles where the IAIS position is in agreement with the tentative conclusions of the Board, but include elaboration. For example, the IASB advocates the idea of an “exit value” model for the measurement of insurance liabilities. This model allows the concept that profits could arise at the inception of a contract (although the IAIS would not expect this to be a common occurrence). The IAIS supports this conceptually but would elaborate on this by allowing the recognition of such profits only where an appropriate and sufficiently reliable margin for uncertainty (margin over current estimate) has been provided for in the liability measurement.

When the Second Liabilities Paper was released there were two areas where the IAIS position disagreed with the preliminary conclusions of the Board.

1. *Participating contracts*: Whereas the IAIS view is that discretionary bonuses should be accounted for as liabilities on the basis of the expected future cash flows, the Board’s initial conclusion had been that an unconditional obligation was required for future distributions to policyholders to qualify as a liability. The IAIS believes that such an approach would lead to misrepresentation of the financial position and unnecessary volatility, arising essentially from the need first to record expected future policyholder distributions in equity and then to transfer these to liabilities once they became unconditional obligations. However, earlier this year the Board redeliberated this issue, resulting in a tentative decision that constructive, as well as legal, obligations to pay policyholder dividends would give rise to a liability. This brings the IASB’s position closer to that of the IAIS.
2. *Credit standing*: The IAIS believes that the credit standing of an insurer is not relevant to, and would be misleading in, the valuation of insurance liabilities. Despite strong opposition from its constituents the Board’s unanimous, tentative conclusion is that own credit standing should be included in the valuation methodology. The IAIS has submitted a comment letter to the IASB’s discussion paper on Fair Value Measurements, which elaborates on some of the arguments against the use of own credit standing within liability measurement.

Reaction to the second liabilities paper

Following its publication, I was invited to make a presentation on the Second Liabilities Paper to the Board, in my capacity as Chair of the Insurance Contracts Subcommittee, during an Education Session at the IASB’s meeting on 22 June 2006, and subsequently at the IASB’s Insurance Working Group meeting the following month. An important point made in the paper is that, if an insurance liability is measured based upon the notion of transfer, ultimate settlement with the claimant/

beneficiary would be a key consideration within such a model. This message in particular seems to have attracted a great deal of support with some Board members (as well as other parties) as it reconciles the idea of valuation based upon transfer with an insurer's settlement obligations towards the policyholder.

The paper has received wide support from international organizations. Notably, a letter of November 2006 to the IASB Chairman from CEIOPS' then Chair, Henrik Bjerre-Nielsen publicly supported the paper. The paper has also attracted much support from the insurance industry, and indeed the input received from IAIS industry observers was a valuable part of the process.

Insurance industry reaction

Notwithstanding the support received, it should be noted that there are certain areas of contention, as expressed by some trade associations. For example, certain sections of the industry oppose the discounting of non-life insurance liabilities, and many would prefer calibration of the margin over current estimate to the premium, thereby using a current entry value type methodology. Both of these are examined below.

The Group of North American Insurance Enterprises (GNAIE) has argued strongly that non-life claims liabilities should not be discounted. Their paper *GNAIE Extended Principles for Non-Life Insurance* argues that "discounting the post-claims liability is inappropriate due to the highly unpredictable payment patterns of most claims. By adding additional variables such as variable claim payment patterns and reinvestment rates which may be largely judgmental, the reliability of the postclaims liability might be compromised." The Insurance Contracts Subcommittee has agreed to hear more arguments on this issue, although a reversal of position by the IAIS would also affect the Solvency work underway at the IAIS if the overriding principle is to be maintained. At present, the IAIS view is that discounting for both life and non-life claims is appropriate. As a principle, there seems no doubt that money has a time value, and it is difficult to make a convincing principles-based argument that it should be ignored. Indeed, the suggestion that the payout patterns are "highly unpredictable" seems contrary to the basic premise of the entire insurance industry which exists to accumulate and manage risk, thereby reducing its unpredictability. If the risk is so unpredictable and judgmental, then it is an argument for a larger margin over current estimate. In addition, an argument that the industry that exists to manage risk regards risk as too unpredictable to measure endangers its credibility. Finally, the fact that a number of jurisdictions are already requiring discounting of non-life claims liabilities severely limits any arguments regarding impracticability. Accordingly, at present, the IAIS has taken a position that agrees with the IASB's current tentative decisions that time value of money adjustments are appropriate.

Both GNAIE and the CFO Forum argue for calibrating the margin over current estimate to the observed price for the transaction with the policyholder – that is, something akin to a current entry price. The IASB is itself split on this issue, with only a slim majority for a current exit value. The IAIS discussed this issue at length and, while it expects that in many cases, absent clear evidence to the contrary, the entry value will also be assumed to approximate the exit value, it felt that an explicit entry

value methodology was not the right principle. While rare, there are cases where the premium charged for risk exceeds any reasonable expectation of the liability, and consequently calibrating the margin over current estimate to the premium could not be the appropriate principle. In addition, if different insurers charge different amounts for the same risk, an entry value model will result in different liabilities – thereby breaching an IAIS principle enunciated in the Second Liabilities Paper that “similar obligations with similar risk profiles should result in similar liabilities.” This entire issue, of course, is intertwined with the debate about recognition of profit on inception. As mentioned above, the IAIS view is that such profit should only be recognized if “an appropriate and sufficiently reliable risk margin has been provided for in the value of the liabilities.”

A critical role for the IAA

Both the IAIS, in developing an international regime for solvency assessment, and the IASB, in developing an international financial reporting standard for insurance contracts, are proceeding on bases which are principles-driven rather than rules-based. For example, the IAIS has not prescribed a single method for calculating the margin for uncertainty (“margin over current estimate”) in the liability calculation. I also believe it unlikely that the IASB will specify a single method. This being the case, some degree of professional judgement will be necessary in measuring insurance liabilities for both solvency assessment and general-purpose financial reporting purposes.

Earlier in this article I referred to the close cooperation between the IAIS and the IAA with regard to IAIS work on the valuation of insurance liabilities. At a request from the IAIS for input, the IAA recently issued the exposure draft *Measurement of liabilities for insurance contracts: current estimates and risk margins* referred to above. Work on this paper by the IAA’s *ad hoc* Risk Margin Working Group has been ongoing at the same time as the IAIS has been developing its common structure for insurer solvency assessment and preparing its input to the IASB on Phase II. As Chair of the IAIS Insurance Contracts Subcommittee and an active participant at the IAIS Solvency Subcommittee, I have regularly attended meetings of the Risk Margin Working Group. Members of the IAA’s Risk Margin Working Group have also participated in both IAIS work streams.

It has been most important for the IAIS to receive input from the IAA and to proceed in a direction which is supported by the IAA on these issues. Ongoing work which has resulted in the IAA exposure draft has already provided input into the respective IAIS work, and the paper itself and further work in these areas will continue to inform future work of the IAIS. Similarly, discussions within IAIS working parties – in particular in the development of the two Liabilities Papers produced by the Insurance Contracts Subcommittee – in which IAA members have participated have also helped in the development of the IAA paper.

A brief summary of the IAA paper

The paper looks at the components of insurance liability measurement, breaking these down into the current estimate of the cash flows associated with the liability, a margin

for uncertainty in the estimate (risk margin), plus a service margin where appropriate. The paper also looks at the risks associated with insurance liabilities and categorizes these according to whether they should be reflected in the current estimate, the risk margin, the service margin, or should be included not in the liability measurement but reflected in capital.

The paper moves on to discuss various factors that may be appropriate to the development of a methodology for determining current estimates as part of insurance liability measurement, and makes a number of observations.

Regarding the determination of the risk margin (or “margin over current estimate”), the paper identifies methods that can be used to determine risk margins within the context of the corresponding current estimates. It focuses on two methods: the “cost of capital” approach, which is based upon the cost of holding capital to support an obligation, and “quantile” (or “percentile”) approaches, which express uncertainty in terms of a confidence level. On the basis of a number of examples of calculations provided in the appendices, the paper concludes that “either method can be used to produce consistent estimates of the liabilities, provided robust guidance for the professionals involved is available...”

Quoting from the draft’s executive summary, one of the paper’s conclusions is that “...general purpose reporting and regulatory objectives of the measurement of risks can be mutually compatible. With robust guidance for the professionals involved, risk margin measurement methodologies derived from the compensation for risk or confidence level concepts can be used to develop risk margins that are consistent between product types and between insurers so that desirable balance sheet comparability in general purpose and regulatory reporting is achieved.”

It is thus the current view of the IAA Risk Margin Working Group that the IAIS’s goal of a single methodology which supports both solvency and general-purpose financial reporting regimes is achievable. We should remind ourselves at this point that the work of the IAA (as with the IAIS), and hence the view expressed, is premised on the assumption that the IASB’s insurance contracts project maintains a market-consistent exit value approach.

A need for application guidance

As we have seen above, the IAA paper stresses the need for robust guidance for the professionals involved. This is particularly the case in a principles-based environment in which both the IAIS and the IASB are developing their respective standards. If general-purpose financial statements (adjusted as necessary) form the basis for insurer solvency assessment in a principles-based environment, consistency in the implementation and application of the IFRS which emerges from Phase II will be a key issue. Owing to the complexities involved and the fact that the standard is unlikely to be prescriptive – for instance as noted above I believe that it is unlikely that the standard will specify a particular method of calculating the risk margin – there will be a need for application guidance to facilitate consistency and convergence, as well as to support the feasibility of using IFRS as a base for solvency assessment.

The excellent work of the IAA Risk Margin Working Group which has resulted in the exposure draft mentioned above, and the resulting paper, may well be seen to break new ground and become an important work in itself and a catalyst for further research and discussion on these issues. Both the paper and subsequent work on these issues may well form the basis for the necessary guidance to the various professionals involved.

Dream or reality?

The dream of course is that the accounting model for insurance contracts is one which is fully compatible with the one applied for solvency assessment purposes. Realistically there may be areas where different treatment of certain aspects is necessary and hence there may be a need for certain adjustments between the models. However, what is crucial to the IAIS is that a single methodology forms the basis for both reporting regimes so that any differences can be kept to a minimum and can also easily be reconciled. At the time of writing this article the Phase II discussion paper was just about to be published. This article therefore does not review developments in the light of the paper. Nevertheless, having followed the IASB's discussions on Phase II and other related projects (including the IAS 37 reconsiderations (liabilities) and financial instruments projects) indications were that the IASB model under development is one which at least in most respects would enable this objective to be achieved. However, the IASB's discussion paper is not necessarily attempting to express an IASB preliminary view on all aspects included within Phase II; further discussion will be undertaken before a firm IASB position is established. So there is clearly some way to go. As you read this article, the discussion paper is almost certainly attracting considerable further debate, including at the IAIS.

As to the reality, the joint work of the IAIS and IAA, in close liaison with the IASB, is important in promoting a regime where standards and guidance can be complementary with and support to the extent possible accounting and solvency convergence. If the relevant players continue to coordinate their effort, and with sufficient goodwill, at this stage there is still every reason to hope that the holy grail of accounting and solvency convergence can be achieved, whereby a single set of methodologies can indeed be used for calculating items in both general-purpose and regulatory financial reports with as few adjustments between the two as possible.

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About the Authors

Rob Esson was educated at Oxford University and is a U.K. Chartered Accountant. He is Senior International Advisor at the National Association of Insurance Commissioners (NAIC) in the U.S. At the IAIS, he is Chair of the Insurance Contracts Subcommittee and is an active participant on the Solvency and Actuarial Issues Subcommittee. He is also an official IAIS observer member on the IASB's Insurance Working Group and Financial Instruments Working Group.

Peter Cooke, who has contributed to this article, is also a U.K. Chartered Accountant and is Principal Administrator at the Secretariat of the IAIS supporting its work in the field of accounting. He has worked for a number of years as an auditor, as well as within the insurance industry and as an insurance Supervisor.