Paul Horgan, Melanie McLaren and Annette Olesen examine the parallels between the planned prudential and financial reporting regulations and look at how insurers can realise the benefits of a more proactive and integrated approach to implementation.
The proposed disclosure and measurement criteria for Solvency II and International Accounting Standards Board's (IASB) International Financial Reporting Standards (IFRS) Insurance Contracts (Phase II) (referred to as 'IFRS Phase II') are showing increasing alignment.

Clearly, Solvency II and IFRS Phase II will serve fundamentally different purposes. The scope of the twin frameworks also differs. In particular, prudential regulations focus on the entity, while IFRS looks at the contract. Therefore, some insurance products that do not meet the IFRS definition of an insurance contract could still fall under the umbrella of the insurance entity for solvency purposes. There may also be variations between the shareholders’ equity reported under IFRS and what the solvency rules consider to be part of the regulatory capital. However, where possible and where appropriate, supervisors, accounting standard setters and industry groups are actively seeking to enhance the synergies between Solvency II and IFRS Phase II and reduce the potential duplication and cost burdens for insurers.

Overall, the solvency and financial reporting frameworks are moving towards a more ‘economic’ basis of evaluation and disclosure. The parallels between IFRS and Solvency II can already be seen in the approach to risk. The existing IFRS 4 for insurance contracts requires companies to ‘disclose information that helps users to understand the amount, timing and uncertainty of cash flows arising from insurance contracts’. This includes concentrations of insurance risk and sensitivity analysis of the assumptions underlying cash flow projections.

IFRS 7 Financial Instruments: Disclosure and the associated amendments to IFRS 4 are set to take risk reporting a stage further by insisting that disclosure should be ‘based on information provided internally to the entity’s key management personnel’. The need to present risk information through the eyes of management consciously mirrors the ‘use test’, which already forms part of Basel II for banks and is likely to be a critical element of Solvency II compliance. A consultation paper published by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) in December 2005 states that ‘issued IAS/IFRS, especially IFRS 4 and IFRS 7, may be a common reference in building up the Pillar 3 (disclosure) requirements for the new solvency system’. However, CEIOPS may require more extensive disclosures than current IFRS (see Consultation Paper 15).

Common basis of evaluation

IFRS 4 will be replaced in Phase II with a finalised insurance contract standard. The IASB’s search for a consistent cross-sector approach to financial reporting is challenged by the unique features of insurance compared with other contracts. This drive for consistency and comparability may lead to accounting decisions not anticipated in a solvency regime. Nonetheless, key aspects of IFRS and Solvency II evaluation are converging. In particular, the proposed ‘market-consistent’ bases for evaluating insurance liabilities reflecting the anticipated amount, timing and uncertainty of future cash flows are closely related. According to the European Insurance and Reinsurance Federation (CEA), ‘valuation of the technical liabilities for solvency purposes could be different from, but reconcilable with, the accounting technical provisions’.

A key challenge is to determine an appropriate basis to measure insurance risk. Industry support is for ‘cost of capital’ techniques as required under the recently introduced Swiss solvency test rather than ‘percentile’ approaches already established in Australian financial reporting.

Within the supervisory community, there is some debate about whether or not to include an additional margin for prudence within the technical provisions. Speaking at the CEIOPS annual conference in November 2005, Florence Lustman, Secretary General of the French Commission de Contrôle des Assurances des Mutuelles et des Institutions de Prévoyance, said: ‘I would like to hear the word ‘prudence’; I do not think a market in insurance liabilities exists.’

In contrast, John Tiner, Chief Executive of the UK Financial Services Authority, has described such prudence margins as ‘inflexible’, ‘opaque’ and ‘outdated’. In a speech to the CEA/Geneva Association Seminar on Solvency II in November 2005, Mr Tiner argued that additional prudence would be unnecessary, as ‘if case estimates are probabilistic best estimates, then one would expect the quantum of technical provisions to exceed their aggregate value.’ Speaking at the 2005 CEIOPS annual conference, Mel Carvill, Deputy General Manager of Generali, argued against what he believes is ‘arbitrary prudence’. ‘This is an issue of the doubling up of prudence. The outcome would be a ‘solvency mismatch’, similar in principle to the ‘accounting mismatch’ that IFRS is on the way to eliminating’. In particular, many within the industry strongly oppose the use of aggregate surrender values as being contrary to the fundamental insurance principles of the pooling and sharing of risks.

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Aligning implementation

Although neither Solvency II nor IFRS Phase II is likely to be finalised or introduced until at least 2010 and will be most likely to come into force at separate dates (see Figure 1), the industry’s opportunity to influence the debates is imminent, with an IASB discussion paper expected very soon and a draft directive on Solvency II due in July. In the meantime, insurers must tackle the initial move to the ‘common reference’ of IFRS 7.

IFRS 4 and IFRS 7 have dramatically increased the risk management disclosures for financial reporting. In turn, CEIOPS’ recent consultation paper CP15 proposes extensive public disclosures.

The proposed volume of information required under CP15 may place an undue burden on insurers and may not improve the ability of market participants, particularly policyholders, to make more informed decisions.

Common data and systems requirements underpin much of the information that is likely to be required for each set of valuations and presentations. Exploiting the synergies now, rather than later, would therefore allow insurers to avoid some of the costs and potential disruption of applying and managing the frameworks separately.

From a competitive perspective, a proactive and integrated response to the evolving disclosure requirements could provide early mover advantages in meeting growing market demands for more transparent and assured risk and capital management disclosure. This not only includes enhancing the depth of the information presented to stakeholders, but also being able to tie this information to other audited IFRS presentations and therefore enhance its credibility.

Companies’ existing enterprise-wide risk management (ERM) initiatives and capabilities can provide the necessary infrastructure of information and assurance for IFRS, Solvency II, Sarbanes-Oxley and other risk-based reforms. This includes the ability to bring the data from internal models and management information systems up to an auditable standard for compliance and external communications (as outlined in the next article ‘Turning risk into reward: Making the most of economic capital’).

Robust ERM’s primary objective is, of course, to control and manage risks effectively, in doing so thereby also reducing the regulatory capital demands on the business.

A common front

IFRS Phase II and Solvency II are moving in the same direction. The implications include fundamental changes to the measurement of insurance liabilities.

Producing reliable, consistent and understandable disclosures on a timely basis will be essential for maintaining market credibility. Early recognition and exploitation of the synergies between Solvency II and IFRS will reduce the long-term cost of implementing both sets of requirements through aligned systems and management controls.