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Market Consistent Debate

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Context of market consistency

The measurement basis for **both assets and liabilities** is an issue in accounting that extends across **all industries** and **geographies.**

- This is not just an insurance issue.

Currently, historical valuation practices differ between industries and countries and there appears to be no clear consensus between all vested interests: regulators; shareholders; analysts; and management.

Market consistency is an attempt to answer a global question across industries.

Pros of market consistent valuation of liabilities

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A market consistent value of liabilities (along with a market consistent value of assets):

- Is largely objective, transparent and verifiable for all hedgeable risks;
- Provides an objective method for the measurement of unhedgeable risks – always 'best estimate' of liabilities along with a subjective, but rigorous, approach to allow for the market value of risk;
- Enables like-for-like comparison between companies;
- Represents the value to transfer its obligations or the cost to meet its obligations;
- It allows comparison of the net asset value of the insurer to other investment opportunities;
- Earnings volatility and pro-cyclical issues only arise if one has open exposure to the market risk – hence earnings volatility is a choice; and
- Potentially provides an early warning system that may give insight into problem areas so that the risks can be reduced accordingly.

Subjectivity may be required where market are not deep and liquid.

Mixed measurement models

Some valuation approaches value assets and liabilities inconsistently – these are '**mixed measurement models**' (e.g. assets at market value and liabilities valued using DCF's where the discount rate is not the market implied yield curve.)

Mixed measurement models:

- can provide misleading information;
- can hide useful information;
- can introduce a difference between accounting outcomes and economic reality;
- hence can also lead to non-economic arbitrages; and
- introduce confusing volatility.

In an economic balance sheet , both assets and liabilities are measured on a market consistent basis.

Much of the criticism of market consistent valuation should have been aimed at inconsistent mixed measurement models.

What is the alternative?

Is the answer to revert to:

Historical cost?

Premium basis valuation?

- Is the alternative objective, transparent and verifiable?
- Are all assets and liabilities valued consistently?
- Does the alternative allow for risk? If so, does it provide for risk in a manner that incentivises companies to manage the risk appropriately?
- Does the alternative reflect the market cost of the hedge? If not, does it not create dangerous incentives to retain (and seek!) mismatches?
- Does the alternative potentially provide early warning signs that will enable the company to reduce risk accordingly or does it potentially hide problems that only come to light when the problem is 'material'?

Market consistency is not perfect, but it is the best solution available.

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