

November 2007



AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

Comment Letter

**Discussion Paper: Preliminary Views on Insurance
Contracts**

The Austrian Financial Reporting and Auditing Committee (AFRAC) is the privately organised standard-setting body for financial reporting and auditing standards in Austria, and is supported by the competent Austrian authorities. The members of the Austrian Financial Reporting and Auditing Association, AFRAC's parent organisation, are several Austrian Federal Ministries and a number of public institutions. The members of AFRAC represent preparers of financial statements, certified accountants, academics, investors, analysts, and oversight bodies of capital markets and regulated industries.

The AFRAC International Financial Reporting Standards Working Group prepares comment letters on recent IASB publications and on publications of other standard-setting bodies pertaining to IFRS for final approval by AFRAC. Principal authors of this comment letter were Otto Altenburger, Rudolf Diewald, Christoph Krischanitz and Andreas Rauter. More information about the Working Group and AFRAC is available under www.afrac.at.

Austrian Financial Reporting and Auditing Committee – AFRAC
c/o Kammer der Wirtschaftstrehänder
Schönbrunner Strasse 222–228/1/6
A-1120 Vienna
Austria

Tel: +43 1 811 73 – 228

Fax: +43 1 811 73 – 100

E-mail: office@frac.at

Web: <http://www.afrac.at>

Copyright © Austrian Financial Reporting and Auditing Committee

All rights reserved

Outline

- 1. General comments2**
- 2. Specific comments.....2**

1. General comments

AFRAC welcomes the opportunity to comment on the Discussion Paper, *Preliminary Views on Insurance Contracts*, prepared by the IASB in May 2007.

AFRAC appreciates the efforts to harmonise the accounting treatment of insurance contracts and supports the aim of pursuing greater convergence in existing accounting practice. We see harmonisation as a top priority, because the current accounting treatment under IFRS 4 (Phase I) allows for a variety of different local GAAP valuation techniques for valuing insurance liabilities.

Nevertheless the proposals of the Discussion Paper (ie asset/liability approach) represent major changes of several financial reporting regimes worldwide. Even within the IASB these proposals are considered controversial. The IASB intends to decide in the future course of the project whether field tests should be performed. Because of these reasons AFRAC encourages the IASB to perform these field tests before an Exposure Draft will be published.

2. Specific comments

Q1. *Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?*

We agree that the requirements for recognition and derecognition of insurance contracts should be consistent with those for financial instruments. The general definitions in IAS 39.14 and IAS 39.39 which refer to entering into contractual obligations and extinguished financial liabilities – i.e., discharged, cancelled or expired obligations – appear in general suitable for insurance contracts.

Q2. *Should an insurer measure all its insurance liabilities using the following three building blocks:*

(a) *explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,*

- (b) *current market discount rates that adjust the estimated future cash flows for the time value of money, and*
- (c) *an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?*

If not, what approach do you propose, and why?

We accept that the measurement of insurance liabilities should be based on the following building blocks:

1. Estimates of future cash flows
2. The time value of money
3. A margin

Estimates of future cash flows

We also agree that estimates of cash flows should be current, i.e., based on all currently available information. Our detailed comments on specific elements of the cash flows are set out below.

We would emphasise that market-consistent fair values often include implicit risk margins, whereas portfolio specific cash flows do not. Accounting twice for the same risk (margin) should be avoided.

Rather than prescribing the use of a market-consistent value generally, it would be more appropriate to prescribe the use of entity-specific values for variables where there are no observable market values.

The Discussion Paper (paragraphs 56-62 and E27-28) states that the measurement of an insurance liability should represent faithfully the economic characteristics of that liability. As a consequence the measurement should not capture cash flows that are specific to the insurer and would not arise for other market participants holding an obligation that is identical in all respects (entity-specific cash flows). We agree that the measurement of insurance contracts should in general be based on an economic

measurement approach which reflects the amount an insurer would expect to pay at the reporting date to transfer the insurance contracts to another entity.

Nevertheless, we have to take into account what total costs should be included. Fixed costs usually vary between insurers according to their size of business and their economies of scale. Appendix E, section E24(h) (relevant cash flows), refers to “policy administration and maintenance costs, including all direct and indirect costs that market participants would consider in assessing the acceptability of a price” and obviously includes fixed costs. In some cases when insurance contracts are acquired, the acquirer will use acquired systems and personnel when administering the contracts acquired, in other cases only the contracts are taken over.

There is a gap because the policyholder pays for full cost coverage, and the insurer would be faced with marginal costs when administering additional contracts after acquisition. The split of this margin is likely to be the subject of negotiations when a transfer of contracts between insurers is priced. In practice, relevant market data would rarely be available. We therefore assume that entity-specific costs are a valid basis on which to project future cash flows for costs to be incurred.

If we assume that existing products are repriced on a regular basis and do not follow the lock-in principle, market pressure will force insurers to price costs (included in the premium) on a market level of deemed costs per contract. Individual deficiencies will be tested using the Liability Adequacy Test (LAT) – which is still required – and efficiencies above market will true up period per period.

Time value of money

We agree with the view that discounting should be used for all insurance liabilities. The discount rate should be consistent with observable current market prices for cash flows comparable in terms of timing, currency and liquidity but should not include credit risk of the portfolio. In particular, valuation of cash flows deriving from options should be based on the best estimate projection of cash flows taking into account the asset allocation strategy for the contract. For participating contracts the

discount rate for the profit participation should be asset-dependent because the cash flow itself is asset-dependent.

A margin

We understand the definition of the margin given in paragraph 90(c) of the Discussion Paper, i.e., the margin is an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).

We agree with the Board in not prescribing specific techniques for estimating the margin but in aiming to explain the characteristics of the margin. We would like to point out that the technique used for valuation of the risk margin should be consistent with the prescribed methodology for the current estimate valuation.

Risk margin

We further agree that the risk margin is not a shock absorber, i.e., a buffer that is included in the liability to avoid recognising an expense in the future, but rather compensation that a market participant would require for bearing risk. We support the guidance given in Appendix F.

Service margin

We agree with the proposal of the IASB to include a separate margin for service in the insurance liability if not already included in the risk margin (e.g., unit and index-linked products).

Measurement basis

We agree that a theoretical measurement for insurance contracts could be based on an economic measurement which reflects the amount an insurer would expect to pay at the reporting date to transfer insurance contracts to another entity. However, as there are hardly any markets for insurance liabilities, we doubt that there is enough guidance available to ensure that all insurers will measure similar terms of insurance contracts at the same liability.

Profit recognition

The result of applying this measurement basis is a positive or negative deviation from the initial calculation of the premium. This amount we believe is the difference between Implementation A and Implementation B (we will call this amount the profit margin¹ from now on). We agree that such a profit margin belongs to shareholders if all goes as expected over the lifetime of the contract. Where rules for policyholder participation apply, any profit margin should be allocated according to these rules.

We believe, however, that the profit margin will go up and down over the lifetime of the contract, and that therefore it can not be said to be realised. As long as for the purpose of measuring operating profit our focus is on the income statement, we prefer to classify the profit margin calculated at inception as deferred income not treated as part of equity. The profit associated with the margin should be released following a pattern that takes into account the insurance industry's business model, i.e., recognising that value is created as services are supplied and/or in accordance with risk release patterns. As the IASB framework does not provide for intermediate balance sheet categories, the profit margin (deferred income) remains part of the insurance liability. We would recommend a separate line in the balance sheet supported by detailed notes to document the nature of the profit margin.

Q3. *Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?*

We feel that there is still too much room for varying interpretations. For example, estimated cash flows for future costs are not clearly defined. Indirect costs, overhead costs and fixed costs are usually part of the product price calculation but not necessarily part of the price another insurer would calculate when taking over a book of contracts. Also, the liability adequacy test is not described in enough detail in this respect.

¹ We understand that the notion "profit margin" cannot be labeled as "gain at inception".

- Q4.** *What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.*
- (a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.*
 - (b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?*
 - (c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.*
 - (d) Other (please specify).*

We believe that the premium charged by the insurer may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. We agree with the IASB that if this difference is significant, further investigation is needed. As long as for the purpose of measuring operating profit our focus is on the income statement, we prefer to classify the profit margin calculated at inception as deferred income not treated as part of equity. The profit associated with the margin should be released following a pattern that takes into account the insurance industry's business model, i.e., recognising that value is created as services are supplied and/or in accordance with risk release patterns. During the lifetime of the

insurance contract the reader / addressee of the financial statements should be provided with information disclosures concerning potential (probability-weighted) deferred future income.

Q5. *This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute ‘current exit value’.*

- (a) Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?*
- (b) Is ‘current exit value’ the best label for that measurement attribute? Why or why not?*

‘Current exit value’ is a suitable theoretical term for something which can not be marked to market. We therefore recommend working on further guidance to ensure that similar contracts will be valued so as to produce similar exit values regardless of which model or calibration an insurer chooses. The term ‘current exit value’ in itself is not as important as how it is defined.

Q6. *In this paper, beneficial policyholder behaviour refers to a policyholder’s exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:*

- (a) Incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?*
- (b) Incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?*
- (c) Not recognise them? Why or why not?*

If the best estimate valuation is based on stochastic simulations, the beneficial policyholder behaviour is shown in the model (probability-weighted) for each possible scenario. As a consequence, the total projected cash flows for the liability are af-

ected by policy holder behaviour under different market scenarios. The same holds true for the aggregated best estimate. Consequently, beneficial as well as adverse policyholder behaviour should already be reflected in the current exit value.

Q7. *A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?*

- (a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.*
- (b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?*
- (c) All cash flows that arise from those terms of existing contracts that have commercial substance (ie have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).*
- (d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained,*
 - (i) to bear insurance risk or financial risk, or*
 - (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.*
- (e) No cash flows that result from beneficial policyholder behaviour.*
- (f) Other (please specify).*

As already mentioned in our answer to Question 6, beneficial and adverse policy holder behaviour should be included in the current exit value of insurance liabilities. Question 7 addresses only a part of the problem; of the options available under Question 7, we therefore favour (d).

Q8. *Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?*

Acquisition costs are part of the business model and part of the projected cash flows. In conjunction with the – probability-weighted – future cash flows (including the effects of beneficial policyholder behaviour) the total net cash flow should be a positive one. Under a stochastic scenario there is no need to provide for a legal or constructive obligation. Where the concept of guaranteed insurability is applied, the same holds true.

Q9. *Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?*

No.

Q10. *Do you have any comments on the measurement of assets held to back insurance liabilities?*

Under the current IAS 39 there is scope for a wide range of income statement presentations. It remains to be seen whether the available for sale (AFS) category will still be an option if the full fair value of the liability is to be recognised through profit or loss. An insurer should present operating profit without any accounting mismatch.

Q11. *Should risk margins:*

- (a) *Be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?*

- (b) *Reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?*

Regarding (a): we agree, and the portfolio definition should be as in IFRS 4.

Regarding (b): depending on the model chosen for measurement purposes, risk margins can either be additive or not additive. If correlations exist, both positive and negative correlations should be taken into account.

- Q12.** (a) *Should a cedant measure reinsurance assets at current exit value? Why or why not?*
- (b) *Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?*
- (i) *A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.*
 - (ii) *An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.*
 - (iii) *If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.*

The measurement of the reinsurance assets should follow the measurement of the corresponding insurance liabilities.

- Q13.** *If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?*

Unbundling should only be done when the components of an insurance contract can be measured independently and without arbitrary assumptions. For many products, arbitrary measurement is inherent because of interdependencies between the com-

ponents. If there are no interdependencies, unbundling could improve transparency – provided the components are presented clearly in a way that allows investors to see the total amounts paid by policyholders.

- Q14.** (a) *Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?*
- (b) *Should the measurement of an insurance liability reflect*
- (i) *its credit characteristics at inception and*
 - (ii) *subsequent changes in their effect?*

Why or why not?

As long as there is no legal or contractual settlement, we see no sense in reflecting the credit characteristics in the valuation of liabilities. In addition, the scenarios described in this Discussion Paper (Appendix H15) demonstrate that there is no real transaction likely to be settled with a large impact on the credit characteristics.

- Q15.** *Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?*

No comment.

- Q16.** (a) *For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?*
- (b) *An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247–253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?*

Regarding (a): yes. If a legal or constructive obligation exists, the unbiased estimate of the policyholder dividends will vary according to the particular scenario. In the case of stochastic simulation, the profit participation will also vary for each path produced by the model projection. The mean value will be the result out of all modelled paths. The final probability-weighted unbiased estimate will allow for this treatment.

Regarding (b): we do not think that the draft gives enough guidance on a general, principle-based level.

Q17. *Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?*

- (a) Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).*
- (b) Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).*
- (c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).*
- (d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).*

We believe that the accounting mismatch for unit-linked products should be eliminated as follows:

- (a) Own shares should be recognised as an asset if the whole risk of the portfolio is transferred to the policyholders and the portfolio is deemed to be a kind of trustee account for the account of the policyholders.

- (b) As goodwill is an intangible asset which is hard to measure, we would prefer not to account for internally generated goodwill even when dedicated to assets covering unit-linked insurance liabilities. Obviously the regulatory regime would be more tolerant than the accounting rules are when accepting internally generated goodwill as a backing asset.
- (c) FVTPL should be accepted if it prevents accounting mismatches. The valuation of unit-linked insurance liabilities explicitly follows the movements of dedicated assets, and the economic view is that the product is portfolio management for the account of the policyholders. There would be no true and fair view of the operating income where the liability side was revalued through profit or loss without the matching revaluation of the relevant assets.
- (d) No. Any difference between the carrying amount and the fair value of an asset held to back unit-linked liabilities should be avoided, in accordance with the overriding principle of matching corresponding assets and liabilities. We would therefore prefer to remeasure the assets side to fair value and to use the same values on the liabilities side.

Q18. *Should an insurer present premiums as revenue or as deposits? Why?*

As long as interdependencies between the components exist, we would not recommend presenting premiums as deposits because this would result in arbitrary measurement. Otherwise, unbundled deposit components could be shown as deposits if this reflected their character. See also our answer to question 13.

Q19. *Which items of income and expense should an insurer present separately on the face of its income statement? Why?*

No comment.

Q20. *Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?*

Yes in terms of presentation, but no in terms of profit or loss determination. Please see comments above (Q 2–4).

Q21. *Do you have other comments on this paper?*

No.