

Françoise Flores
Chair
European Financial Reporting Advisory Group
35 Square de Meeûs
B-1000 Brussels
Belgium

Email: commentletter@efrag.org

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Isabella Pfaller

Central Division Group Reporting
Tel.: +49 (89) 3891-4200
Fax: +49 (89) 3891-74200
ipfaller@munichre.com

Dear Françoise,

We welcome the opportunity to comment on EFRAG's comment letter on the IASB's Exposure Draft ED/2010/8 Insurance Contracts (the ED).

We support many issues you have dealt with in your draft comment letter. However, from the perspective of a reinsurance company we do have strong concerns with two proposals in the ED which are not addressed in this letter. Therefore we'd like to point out that these issues are of utmost importance for reinsurers and hence should be addressed by EFRAG as well.

Definition of an insurance contract (Question 11a)

In the draft comment letter EFRAG agrees with the definition of an insurance contract, the scope and the guidance and comes to the conclusion that the minor changes in the guidance will not change current practice under IFRS.

This position might be correct for primary insurance treaties. However, for significant parts of reinsurance business these "minor changes" would have unforeseen consequences, in particular around the requirement to have a loss scenario with commercial substance, hence:

We agree with the overall definition and welcome the fact that the IFRS 4 Phase I definition has been retained but we have concerns around the changes made to the related guidance, in particular around the requirement to have a loss scenario with commercial substance.

We do not fully agree with the stipulations in B25 that a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums.

From our perspective the definition of an insurance contract in IFRS 4 Phase I has worked quite well. Therefore, our preferred solution would be not to include an explicit risk transfer test in IFRS 4 Phase II and hence B25 should be deleted.

**Münchener Rückversicherungs-
Gesellschaft**

Aktiengesellschaft in München
Königinstraße 107
80802 München
Letters: 80791 München

Tel.: +49 (89) 3891-0
Fax: +49 (89) 3990-56
info@munichre.com
www.munichre.com

Vorsitzender des Aufsichtsrats:

Dr. Hans-Jürgen Schinzler
Vorstand:

Dr. Nikolaus von Bomhard,
Vorsitzender
Dr. Ludger Arnoldussen
Dr. Thomas Blunck
Georg Daschner
Dr. Torsten Jeworrek
Dr. Peter Röder
Dr. Jörg Schneider
Dr. Wolfgang Strassl
Dr. Joachim Wenning

Sitz der Gesellschaft: München
Amtsgericht München
HRB 42039

Alternatively, if such an explicit risk transfer test would be deemed necessary in the final standard, we consider it indispensable particularly for reinsurance business that other conceptual guidance currently included in US GAAP will also be included in the final standard, because those have to be seen as integral parts of an explicit risk transfer test, such as the substantially-all concept and the reasonably-self evident argument.

The main reason is that the smallest unit of account for reinsurance business – in contrast to primary insurance business – is a single reinsurance treaty, i.e. it is already a portfolio of single policies. Such portfolios in many cases benefit from diversification effects. Consequently, they often produce relatively stable expected results (i.e. only a small range of possible outcomes) and the probability of a loss (i.e. present value of net cash outflows exceeding the present value of net cash inflows) is relatively low. However, the overarching principle should be that business that meets the definition of an insurance contract in the primary insurance sector also should be considered as (re)insurance if this business (or parts of it) is reinsured and the reinsurer covers the risks related to the reinsured portion of this portfolio.

Another issue relates to paragraph B28 of the ED, which prescribes the risk transfer being assessed on a contract by contract basis, rather than by reference to the materiality to the financial statements. In parentheses, it also advises that for the purpose of assessing the risk transfer, “contracts entered into simultaneously with a single counterparty, or contracts that are otherwise interdependent, form a single contract”.

In our understanding, this could imply that fronting, retrocession and reinsurance programs might be excluded from the scope of the future standard on insurance contracts. However, these are typical business activities of reinsurers by which the reinsurer transfers some of the assumed risks to another reinsurer, the retrocessionaire. From our communication with the IASB Staff we have understood that this potential scope exclusion has never been intended by the IASB.

Therefore, it should be made clear that fronting, retrocession and reinsurance programs are not “contracts that are otherwise interdependent” in the sense of paragraph B28 of the ED and consequently, the assumed contracts and the ceded contracts, respectively, shall be checked independently from each other for significance of risk transfer.

In addition, it should be clarified that - in the case that changes in the definition or related guidance are introduced - the assessment of a contract only is carried out once, i.e. at inception. This also implies that no reassessment of the existing portfolio will have to be carried out at the date of transition (otherwise, this would be overly burdensome and expensive as well as almost not practical if a large number of existing reinsurance treaties would have to be reassessed).

Reinsurance assets (Question 16b))

In the draft comment letter EFRAG agrees with proposals in the ED on reinsurance.

We are concerned that the measurement of reinsurance ceded does not fully reflect the underlying economics of the business particularly in relation to the measurement of the residual margin of a reinsurance asset.

In our view, the measurement of assets and liabilities needs to be based on consistent principles. Therefore, it is essential that the measurement of reinsurance assets needs to reflect an assessment of the risk relief for the reinsured party by the reinsurance contract. In particular, this implies that in a net view the obligation on the side of the cedant should just reflect the part of the obligation which economically stays with the cedant. Therefore, according to our understanding, the proposal in the ED to calibrate the residual margin of the ceded business to the reinsurance premium leads to a misleading presentation. In most cases (i.e. when the reinsurance premium is not exactly the same as the respective premium of the business assumed by the cedant) the reader will get a wrong impression about the percentage of the primary insurer's risks reinsured.

If the reinsurance contract appears to be non-profitable from the primary insurer's perspective (if the reinsurer assesses the risk higher than the primary insurer and assumes business on conditions worse than the original conditions) the application of the proposal in the ED will result in a residual margin on the asset side that we consider as being too high. Due to this calibration of the residual margin the expected loss will be deferred rather than recognized immediately. In addition, a balance sheet reader gets the wrong impression that the reinsurance asset is higher than the share ceded in fact to the reinsurer.

Vice versa, a reinsurance premium that is beneficial for the cedant would result in a residual margin on the asset side that we consider as being too low. Preferred conditions the reinsurer can give under a contract should result in a gain. To the extent this benefit is irrevocable it should be realized at inception of the contract and not be deferred. Furthermore, a balance sheet reader gets the wrong impression that the reinsurance asset is less than the share ceded in fact to the reinsurer.

We believe that the total reinsurance asset should reflect the economics of the contract and this is the relief generated by the reinsurance cover – independent of the level of the reinsurance premium. Therefore we propose that the measurement of the residual margin of the reinsurance asset should be based on the risk transferred from the cedant to the reinsurer. This could be achieved if, at the initial measurement, the residual margin of the reinsurance asset is equal to the proportion of the risk adjustment of the reinsurance asset to the risk adjustment of the liability applied to the residual margin of the liability.

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Subsequently, the amortization of the residual margin of the reinsurance asset should be based on the same pattern as the amortization of the residual margin of the liability.

Furthermore, we are unclear as to how the reinsurance asset should be measured where the modified approach ("PAA") is used for the liability measurement and believe that it should be made clear that the simplified model should be available for reinsurance contracts where it is used for the related direct insurance contracts. We would also point out that certain contracts that meet the definition of short duration may be covered by a longer term reinsurance agreement which is less likely to meet the definition or longer term insurance contracts may be covered by a short duration (i.e. one-year) reinsurance contract. Accordingly, the mandate of the PAA could result in different measurement approaches between the underlying direct insurance contract and the reinsurance contract.

We would kindly ask you to take these considerations into account when finishing your comment letter on the ED.

Please do not hesitate to contact us if you have further questions on our position in context of the issues raised above.

Yours sincerely

Münchener Rückversicherungs-Gesellschaft



ppa. Pfaller
Chief Accounting Officer



ppa. Hörmann
Chief Accounting Policy