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Datum: April 16th 2007

Position of the Austrian Insurance Association on Question 10 of the Discussion Paper “Fair Value Measurements”

Ladies and Gentlemen,

the Austrian Insurance Association (VVO) has studied with care the draft EFRAG has issued on the Discussion Paper on Fair Value Measurements. We therefore like to respond to the call made by EFRAG to respond to Question 10 describing the practice and our view on how liabilities should be measured in the insurance sector. Our comments are as follows:

Position on Q10 of the Fair Value Measurement Discussion Paper on the Measurement of Liabilities


I. Introduction

The measurement of insurance liabilities is a main issue for the preparation of the financial statements of an insurance undertaking. A final IASB-standard for measuring the insurance liabilities is not yet available. In the available IFRS 4 on insurance contracts (phase 1) the use of national measurement rules according to the existing national GAAP is allowed; a harmonized practice for all insurance undertakings is only envisaged for the phase 2 of the IASB's insurance contracts project, which is elaborated at present.

II. The specificities of the insurance business

At measuring insurance liabilities, as the Austrian Insurance Association (VVO) believes, the specificities of the insurance business have to be taken into account.

These specificities result primarily from the fact, that the premium for the service of the insurance undertaking (risk carrier) must be fixed and paid by the insured before underwriting the contract. At that moment the insurance undertaking does not know the future expenses (cash flows) caused by the acceptance of risks; it has to forecast the future expenses (cash outflows) based on significant inputs,

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Ihr Schreiben vom:

Ihr Zeichen:

Unser Zeichen: Mag. Di
Aktnummer: 205
Ausg Nr.: VW-123/2007

Seite 1/1



which are derived from statistical material regarding the past, combined with predictions about future developments. The available data for the forecast of future cash flows out of insurance contracts are for the individual insurance classes of a varying reliability; the most reliable data exist normally for life insurance. It must also be taken into account, that the behavior of each single insured is highly relevant for the future claim costs, which is the most important cost factor borne by premiums. The insurance undertaking tries to separate out bad risks by executing a risk-check before underwriting the contract; that means, insurance contracts with individuals, where a higher loss potential is expected, are not underwritten at all or a higher (risk proportional) premium is charged.

Seite 2/2

III. Classes of insurance liabilities

Insurance liabilities can be classified as follows:

- Liabilities resulting from losses incurred but not yet settled,
- Liabilities for future claims due to losses and benefits of policyholders,
- Liabilities resulting from the participation of policyholders in the surplus of the insurance undertaking and from bonuses for claim-free contracts or contracts with low loss ratios.

1. Liabilities resulting from losses incurred, but not yet settled

The uncertainty about the amount of cash flows for the losses and claims already incurred but not yet settled is highly varying. There are claims, for which the amount to be paid can be estimated with a high degree of certainty and the payment can be accomplished in a short term¹ and there are claims, for which the amount to be paid by the insurance undertaking remains uncertain for many years; the latter case is especially true, if the obligation for the cancellation of the claim is adhered to a court decision. The uncertainty about the amount of liabilities out of already incurred, but not paid losses is not principally different to the measurement of liabilities, which are uncertain by its merits and size, of other economic sectors. Different opinions exist whether for such liabilities discounting of forecasted, future cash flows (loss payments) is appropriate. Although there is some theoretical background for discounting future cash-flows, from a practitioner's view, it can be argued, that for those claims which are not paid in a short time frame, the uncertainty about the amount to be paid and about the timing of the payment is higher than the effects calculated by discounting the estimated future payments.

¹ For life and health insurance contracts normally the measurement of liabilities (incurred, but not paid claims) don't present problems.



2. Liabilities for future claims due to losses and benefits of policyholders

For the measurement of liabilities a distinction has to be made between long-term insurance contracts linked to a saving process and other contracts (short term and pure risk contracts).

a.) Insurance contracts linked to a long-term saving process

Seite 3/3

For these contracts the calculation of the premiums and the measurement of the liabilities are strongly influenced by the return of the investments of the technical provisions.

The following classes of insurance contracts are linked to a saving process:

- Life insurances (Term insurance) with capital payments in the case of death, surrender or termination of the contract at a certain date or at a certain age of the insured person. Capital payment has to be made in any case; the existing uncertainty is related to the timing of the payment.
- Annuity insurance contracts are providing regular payments to the beneficiary beginning with a date fixed in the contract and in most cases ending with the death of the beneficiary. The duration of the payment is uncertain.
- Multi-year life-risk insurance with a fixed premium amount during the whole term of the contract, which provide capital payments only in the case of death of the insured person. Due to the fact that premiums remain fixed for the contract period, the risk of death however increases with the rising age of the insured person, the annual premiums are for the first term of the contract higher and for the latter term lower than the required amounts to cover the risk of death. Therefore for the first term of the contract, a part of the premium have to be set aside to fill-up the insufficiency of the latter term (formation of an old-age-provision).
- Life-long health insurance with a fixed premium amount for the contract term. For this type of insurances the current premiums are measured according to the age of the insured at the moment of closing the contract. The premiums are increased until the end of the contract (by surrender of the insured or death of the beneficiary) only according to the increase of health costs measured by the health consumer price index; the fact of strongly increased health costs in later years for the insured person cannot be compensated by increased premiums. Therefore it has to be built up – in the same way as for multi-year life-risk insurances – an old ageing provision, which is for that insurance class even of more importance than for the life class.



In life insurance the amount of the insurance benefit is fixed in the contract, whereas the health insurance is a type of loss-insurance (compensation for the actually occurred loss) caused by illness.

For insurances linked to a saving process a technical provision calculated according to actuarial principals (this includes an old ageing provision) has to be set up. For the calculation assumptions about the following parameters have to be made:

Seite 4/4

- mortality rate for the individual age classes;
- interest rates (for discounting future expenses and income);
- morbidity costs for the individual age classes (health insurance);
- surrender probabilities for the single contract years (especially important for the calculation of the technical provision of health insurance).

In Austria this technical provision is calculated according to the national GAAP, which is admitted according to the IFRS 4 (phase 1) standard, with the so-called progressive method as follows:

Technical provision = present value of future costs (monetary outflows) **minus** present value of future income (monetary inflows), if the insurance contract stipulates current premium receipts.

As those insurance contracts are of the long-term type, the future development of the parameters determining the future benefits are tainted with significant uncertainty, the premium calculation as well as the calculation of the technical provisions is done with prudent assumptions. If because of those prudent assumptions surplus emerges, it is credited through the profit participation mechanism to the insured (as ex-post correction of the prudently calculated premiums).

If the calculation of premiums and the technical provision is done with prudent assumptions, a provision for future losses is necessary only under very rare circumstances.

b.) Other insurance contracts

For insurances not linked to a saving process, liabilities consist of one part of written premiums, which are reserved for the period after the balance date and of another one which feeds the provision for future losses. At splitting the written premiums to the period before balance date and thereafter, seasonal variations of the loss distribution have to taken into account.



3. Liabilities to policyholders resulting from the participation in the surplus and from bonuses.

The measurement of such liabilities cause no special problem.

IV. Position of the VVO for the measurement of liabilities for future claims and benefits

Seite 5/5

1. Principles for the measurement of liabilities for future claims and benefits.

For the measurement of liabilities for future claims and benefits, according to the opinion of the VVO, the following principles should be applied:

- at underwriting the insurance contract (contract initiation) no profit nor loss should be shown;
- profits are realized only after risks have expired (only realized profits can be shown);
- at each balance date the assumptions for the expected cash flows (in- and outflows) have to be examined, whether according to the forecasts at this moment of time a future surplus out of the insurance contracts still in force can be expected. In case a surplus of out-flows prevails a provision for future losses has to be set-up.

2. Risks resulting from insurance contracts linked to saving process.

At underwriting contracts with a saving process an insurance undertaking assumes

- the risk of higher claims costs than those calculated by the premiums;
- the risk of higher operating costs than those calculated by the premiums;
- the risk of lower returns out of the investment of premiums as compared to those expected in the premium calculation;
- the risk of higher surrender values than the expected, if in the case of surrender higher payments are made as compared to the calculated insurance liabilities, or of lower of surrender values than the expected, if in case of surrender no or lower payments are made as compared to the calculated insurance liabilities.

3. Reasons for the prohibition to show non-realized profits.

The prohibition to show profits as long as risks out of a valid insurance contract have not yet expired, is justified with the fact, that verifiable and reliable – for insurance contracts with a very long term saving process -forecasts of



future cash flows are not viable. Referring to IAS 17, for services provided throughout various years a profit realization is only possible in the year the service is completed or – if a reliable estimate of the total profit made through the provision of the service is possible – a pro-rata realization in the single years – according to the delivery of the service – is possible. According to the specificity of the insurance business - risk equalization within the portfolio of the insurance class due to the law of big numbers - a realization of profits for insurance contracts at contract-end would not be appropriate; a pro-rata realization according to the rate of completion – this means in the insurance business release from risk – would be the appropriate solution for the measurement of insurance liabilities.

Seite 6/6

4. Adequate method to ascertain the realized profit

The aim to realize profits only after risks have expired can be achieved, if the assumptions used for the calculation of the premiums (mortality and morbidity tables, interest rates, operating expense rates, surrender expectations) are also used for the measurement of the technical provisions. In this case profits emerge in a business year only, if the claims costs, the operating costs and the surrender costs are lower and the return of capital investments and eventually the surrender-proceeds are higher than the assumptions used at the time of the premium calculation.

5. Analysis whether a provision for future losses has to be set up

The analysis whether a surplus of expenses is expected has to be conducted, not for single insurance contracts, but for the entire insurance portfolio or for separated, ring-fenced insurance portfolios. If the analysis results with the expectation that the settlement of claims gives a surplus of costs, a provision for future losses for the respective insurance portfolio has to be set up and adjusted every following year of the analysis.

The analysis, whether such a provision for expected losses has to be set-up and what should be the size of it, has to include future premiums not yet earned. Expected values of surrenders and extensions of insurance contracts at current premiums have to be taken into account. Such an analysis has to be made for insurance contracts with a saving process and without it.

6. Distribution of non-recurring costs at underwriting an insurance contract and of costs at premium collection.

If there are non-recurring costs at underwriting an insurance contract, they are to be distributed over the period of the lifespan of the contract. This is also true for costs, which are related to the premium collection, which should be



distributed over the period for which the premium is paid. The distribution of costs can either be done through the creation of an asset position or through the deduction from the liabilities of insurance contracts.

V. Disclosure of the expected future profits out of the insurance portfolio.

The VVO holds the opinion that at measuring insurance liabilities non-realized future profits for the reasons exposed should not be shown in the financial statement.

Seite 7/7

This does not preclude to recommend showing in the notes a forecast of the expected future profit of the insurance portfolio in force at the balance sheet date. The disclosure should include assumptions under which the future results are obtained. A supplement of such disclosures could be a sensitivity analysis.

VI. Measurement of insurance liabilities based on a fictitious price obtained through a transfer to a third party.

A measurement of insurance liabilities based on a fictitious price a third party would pay in case of a transfer of the insurance portfolio is strictly rejected by the VVO, as for such transfers no market exists and the hypothesis, that an insurance company transfers the whole insurance portfolio and consequently the whole liabilities, is far off from any reality. Unfrequently there are transfers of insurance portfolios to other undertakings; the amounts paid for it cannot be qualified as market prices, because usually special interests of the recipient (such as market entrance to the Austrian market, completion of a business segment, etc.) play a decisive role.

With the best regards

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