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Re: IASB Exposure Draft *Insurance Contracts*

Comments by the European Federation of Financial Analysts Societies (EFFAS) Financial Accounting Commission – FAC

Dear Madam, dear Sir,

The European Federation of Financial Analysts Societies is the European umbrella organisation of national analysts' societies. It comprises 26 members representing more than 14,000 investment professionals in the areas of equity and bond research, asset management as well as investment advice.

On behalf of the European Federation of Financial Analysts (EFFAS), I am writing to comment on the Exposure Draft *Insurance Contracts* ('the ED'). This letter is intended to contribute to IASB's due process.

EFFAS is pleased that in developing the proposals in the ED the IASB addressed a number of concerns expressed in respect of the Discussion Paper *Insurance contracts* that was issued in 2007. We are also pleased, that after 13 years there is finally a project to address jointly both parts of the balance sheet of an insurance company.

A single regime/system for insurance contacts will enhance financial reporting by insurers.

While we welcome the reorientation towards more realistic measurement principles (fulfilment value versus exit value), we are very much concerned that IFRS 4, Phase 2 will not be coherent with IFRS 9-financial instruments. We fear that by not chosing the same type of valuation approach for both sides of the balance sheet, accounting mismatches will lead to even more volatile earnings than those we have seen since the application of IFRS 4 Phase 1. We therefore would suggest that the IASB considers permitting a cost option for insurance liabilities if the cost category is used for the underlying bonds (only for participating life business).

We further suggest a fundamental debate on which discount factor has to be used in which circumstances. The answer cannot be the risk-free rate, as in current market conditions this would mean only the money market rate at the Central Bank. All other rates contain risk components which tend to be very volatile.

We are also very much concerned about the profit and loss presentation. The summarised margin approach is just not suitable for a quick meaningful analysis of earnings streams as volume and sources of cost information are lost. We would favour a combined premium allocation and margin approach such as developed by EFRAG based on our former comment to the discussion paper.

We are also concerned about the transition requirements which, in our view, would make the P&L accounts of European life insurance companies meaningless for years to come.

While we would have wished a one-of-set account approach for accounting and solvency, we have to admit that Solvency II clearly goes another – in our view, wrong-way by adhering to the exit value approach for insurance liabilities.

Our comments are therefore based only on what would be good information for the users disconnected from solvency requirements.

Please do not hesitate to contact me or Carsten Zielke (+49697174502) for further information.

Question 1 – Relevant information for users

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

EFFAS response:

Financial information shall help users to get a holistic and realistic view of the profit drivers to help them to build reliable forecasting models. The proposed measurement model is a step in this direction.

We welcome the decision of the IASB to abandon the exit value approach. This approach was based on the wrong assumption that there are liquid markets for technical insurance reserves. The proposed fulfilment approach goes on the assumption that an insurance company will normally continue to keep the reserves until the obligation is fulfilled, which in our view is a much more realistic approach.

We believe the user gets a better picture of the risk and reward situation, as expected discounted cash flows are used to estimate the insurance companies' obligations.

We agree with the building block approach in general, we are however concerned about the following issues:

- Objectivity of the risk margin: as the Exposure Draft does not prescribe only one method to calculate this margin, we fear that it will not be comparable between companies.
- Subsequent measurement of the residual margin: we see the residual margin a little bit like an in-force value within the Embedded Value calculation. Thus, locking in the assumptions of this value does not make sense. We would rather advocate a

recalibration where changes in the assumptions for the future are booked against the residual margin.

- Transition: permitting insurance companies to offset changes in pre-application periods against shareholder's equity would lead to meaningless P&L accounts for years to come. Actually, especially life insurance companies underwrite long-term contracts lasting up to 60 years. Most profits derive from business in this segment which was written a long time ago. Permitting to hide these movements would harm any usefulness of the profit and loss account.

Question 2 – Fulfilment cash flows

(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?

As explained above, we fully agree with this proposal. In particular we welcome the fact that the cash-flows should be estimated in such a way that they realistically reflect the customer's behaviour and do not presume a fully rational client.

(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

We think that the level of detail is sufficient for the time being. However, we feel that only extensive field tests can show the practicability of these.

Question 3 – Discount rate

(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

We agree with this proposal. If there is no legal link between the performance of the assets and the liabilities, the liabilities should be looked at on a stand alone basis. On the contrary if such a link exists (e.g. participating contracts), the characteristics of the assets should be taken into account by a prescribed standardized method such as the one developed by the Canadian standard setter.

(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?

We are not convinced about how the effect of liquidity can be measured. While we support a standardized method to integrate an asset based discount rate for participating contracts, as this should also implicate the impact of liquidity, we cannot see how you could apply this methodology to non-participating contracts.

In our opinion, the approach developed for Solvency II does not reflect the reality in markets. Therefore we would rather not have a liquidity consideration for non-participating contracts. However, we think that a fundamental debate should be initiated on which discount rate is to be used. The answer, in our view, is not the risk free one, as under current market conditions risk free would only be a short-term money market rate which would certainly not reflect the longer-term nature of insurance contracts.

(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

Including the own credit risk in measuring the insurance liabilities would not be advisable, as far as we are concerned. If the credit spread widens, the insurer would show lower liabilities, while the obligation to pay remains the same. This would be misleading for the users. Please also refer to answers in (a) and (b).

Question 4 – Risk adjustment versus composite margin

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

We prefer a risk adjustment to the residual margin. In the past insurance companies rather preferred to build in prudence margins in their technical reserves based on local GAAP numbers which were used for the IFRS accounts (Phase 1). These over-reservations were used to compensate big claim hits. By keeping a risk margin, we would feel more comfortable that technical reserves do not have to be adjusted every quarter.

Question 5 – Risk adjustment

(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?

While we agree in principle by having a risk margin, we doubt that one can define what the “maximum amount” would be. We would rather see a prescribed method for comparability reasons.

(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?

As indicated above, we would rather see one single method being proposed for comparability reasons. We would favour the CTE method as this figure gives a good idea to the users about the prudence built in.

(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?

We agree with this proposal. Our favoured CTE method would only give relevant information if we knew the confidence level.

(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (i.e. a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

We agree that the risk adjustment should be measured on a portfolio basis. However, regulatory constraints should be considered. If capital cannot be shifted easily from one country to another, these risks should not be aggregated as it would not reflect legal reality.

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

We think that the application guidance is detailed enough. But again we think that only field testing could provide a more concrete answer.

Question 6 – Residual/composite margin

(a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?

We agree with this proposal but would like to see the movements of this profit transfer in the P&L. For instance it would be helpful to have a position “Transfer to the residual margin” and “Transfer from the residual margin” to make the movements transparent.

(b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?

We agree with this proposal. Losses should not be transferred to the future if right from the beginning it is clear that the insurance risk was underpriced.

(c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by

similar coverage period? Why or why not? If not, what do you recommend and why?

We agree that the residual margin should be aggregated by lines of business. We doubt that the segregation by vintages is feasible on an operational basis. If yes, this would be useful information for the users.

(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?

We agree with the method proposed, however to us it is not precise enough. We would favour a clear guidance that changes in future estimates should be booked in a transparent way against the residual margin while changes for past events should hit directly the net income.

(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?

See answer in (d).

(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

As we favour a residual margin that is not locked, the accretion by interests is not necessary as we will have a discount unwind every year.

Question 7 – Acquisition costs

(a) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

We agree with this proposal. Acquisition costs are part of the overall cash flow measurement of an insurance liability and therefore should be included in the initial measurement. Other costs can be arbitrary and should therefore be expensed.

Question 8 – Premium allocation approach

(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?

We would be in favour of requiring a modified measurement approach for short term non-life liabilities. It does not make much sense to want to discount liabilities which do not run very long. By requiring this approach we assure that there is comparability.

(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

We agree with this proposal.

Question 9 – Contract boundary principle

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

We agree with this proposal but would again like to see the results of field testing to get a better feeling whether there are no operational issues.

Question 10 – Participating features

a. Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?

We agree with this proposal. Only the measurement on an expected basis can reflect the link to the assets for participating contracts.

b. Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?

Participating features can normally met only within insurance products. For comparability reasons we think that the answer should be yes.

c. Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?

We do not understand why investment contracts should only qualify for participation features, if insurance contracts are also in the pool. The characteristics of a participating element in itself are sufficient in our view.

d. Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

We consider the amendments to be appropriate.

Question 11 – Definition and scope

(a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?

(b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?

(c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

(a) We agree with the definition of an insurance contract and see no reason to disagree on the proposed changes. The changed wording in BC191 (a) and the changes made in (b) and (c) in accordance with US-GAAP, are not material. The option given in (b) that insurers could consider a fair value option and the additional test proposed in (c) broaden the basis for insurers in the direction of US-GAAP.

(b) We agree, as the scope of exclusions in Paragraph 4 seems to cover the full range of contracts with clients which do not have an insurance contract character (e.g. residual value guarantees).

(c) We agree with the view that financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts. In this regard, we agree on BC193, BC194, BC196 and BC197. Concerning BC194, our objection is that the financial guarantee contract, if qualified, should be treated as an insurance contract (or else as a derivative), but no longer defining a financial guarantee contract qualified as insurance contract might lessen the information provided to corporate reporting users, as the character of business written might be of interest too.

Question 12 – Unbundling

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

We agree on the proposal for unbundling of insurance contracts if possible. In case the contract can clearly segregated in the investment component, the embedded derivative and other contractual terms as described in IN21, we welcome the unbundling. In case the options and gurantees cannot be fully segregated from the investment component, we would not agree to enforcing an artificial unbundling.

Question 13 – Presentation

(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?

We do not think that a summarised margin approach gives sufficient information to the users. The components of revenue and costs are not visible on the face P&L. It will therefore be time-consuming for the analyst to make judgements about the sales success, and difficult to calculate traditional ratios, such as the Combined Ratio. We miss volume information. Analysts need information on the maximum risk insured, premium income, costs, and margins per nature, in order to build a full and logical P&L.

We would therefore favour a combined premium allocation and margin approach, as developed by EFRAG.

(b) Do you agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

We think that a full reconciliation of the balance sheet should be visible in the P&L account. This increases transparency. Especially there should be items like “allocation to the residual margins” and “allocation from the residual margin” as well as a well-defined line “operating profit” which excludes fair valuation changes of financial instruments. Here also, we refer to the EFRAG model.

Question 14 – Disclosures

(a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?

We agree with this proposal.

(b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?

Yes, we think so. Field testing will tell more.

(c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

As mentioned in our response to question 13, we would like to see more volume information and an operating profit line.

Question 15 –Unit-linked contracts

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

We agree with the proposal.

Question 16 – Reinsurance

(a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?

We agree with the proposal. We cannot see why there should be a different approach for reinsurance contracts. The purpose of taking reinsurance coverage should be to transfer risk, not to do earnings management.

(b) Do you have any other comments on the reinsurance proposals?

No other comments.

Question 17 – Transition and effective date

(a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?

We do not agree with the proposed transition requirements. Resetting the residual margin to zero for past business would turn the P&L meaningless for years to come as especially lif insurance companies underwrite very long term business. A comparison of business written before and after application of IFRS 4 would be impossible or at least very difficult.

(b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?

No, we don't agree with the FASB's tentative decision on transition. Resetting the composite margin to the IASB's like risk margin without permitting remeasurement does not help the user to compare results over time.

(c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?

We think it is paramount that the two standards coincide. Given that the IASB indicated that no changes were made for IFRS 9, this means that an insurance company which has already adopted IFRS 9 would not be allowed to reclassify its assets to overcome accounting mismatches resulting from adopting IFRS 4 Phase 2.

It is very important for the user that a coherent approach is taken between the asset classification and the measurement of liabilities. Currently, insurance liabilities are mostly booked at book value, while most of the assets are in the available–for-sales category. By abolishing the latter, an insurance company which has not yet adopted IFRS 4 Phase 2 and which elects the fair value option for its assets due to the reclassification prohibition, would show very volatile incoherent earning in the meantime.

(d) Please provide an estimate of how long insurers would require to adopt the proposed requirements

As users, we do not have a clear answer to this question. We believe at least two years.

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

We welcome the fact that the Exposure Draft addresses a lot of users' concerns. However, the presentation and measurement issues mentioned above have to be addressed. A lot of practical issues can only be seen if a broad field testing takes place. We urge the IASB to let users participate in these, otherwise we will live a "live field testing" on the financial markets. We are also concerned that this project may again be delayed. Insurance stocks have suffered enough since the introduction of IFRS 4. Don't create more uncertainty.

Question 19 – Benefits and costs

Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

We think that this standard is overdue. In the hope that insurance stocks will be better valued after the application of IFRS 4 Phase 2, the benefits should clearly exceed the costs.

Yours sincerely,

C. Zielke

Carsten Zielke
EFFAS Representative

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Giampaolo Trasi
Chairman EFFAS

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