Rådet för finansiell rapportering

The Swedish Financial Reporting Board

RFR-rs 2010:19

International Accounting Standards Board
30 Cannon Street
London EC4M 6 XH
United Kingdom

Dear Sirs,

Re: IASB Exposure Draft ED/2010/8 Insurance Contracts

The Swedish Financial Reporting Board is responding to your invitation to comment on the above Exposure Draft (ED).

We are pleased that the IASB addressed some of the major flaws in the DP. We especially appreciate:

- That the exit value notion party has been abandoned and been replaced with a fulfilment notion based on an entity´s own circumstances
- That incremental acquisition costs have been included in the initial measurement of the insurance contract
- That the residual margin will be released over the coverage period in a systematic way that reflects the exposure from providing insurance coverage
- That a margin approach to revenue recognition has been introduced for life insurance businesses.

However, we have a number of concerns:

- We consider that volume information, such as premiums, claims and benefits should always be allowed to be presented gross in the income statement if the main business of an entity is to provide non-life insurance coverage
- The proposed transition requirements need to be abandoned since they will eliminate future profits in the present insurance business. We consider that the normal requirements in IAS 8 should be applied when the standard is implemented
- The risk adjustment should be calculated based on principles to be established by the IASB and not only based on the methodologies in the ED
- We consider that the inclusion of a liquidity premium in the discount rate used to adjust for the time value of money needs to be better justified, as this is not obviously consistent with a fulfilment notion. Furthermore, since we have noticed that there seems to be a confused debate regarding the definition of a risk-free interest rate, the IASB should clarify the definition of a risk-free discount rate to be used for the discounting of the fulfilment cash flows
- We consider that the IASB carefully should consider the interaction with other standards. Presently the ED introduces a large number of possibly artificial measurement mismatches

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- We have severe concerns regarding the proposal to classify issued financial guarantees as insurance contracts. We consider that the present possibility to either classify them as insurance or as financial instruments should be maintained
- We consider that the classification of some service contracts as either insurance or as covered by the revenue recognition standard is too ruled based. Instead a principle should be introduced that, in the same way as we propose for financial guarantees, makes it possible to classify those contracts either as insurance or as part of the revenue recognition standard depending on the reporting entity's business model
- We consider that the unbundling proposals are unclear and that they may be too restrictive.

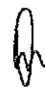
The measurement and recognition models

We agree that the measurement of an insurance contract should be based on a fulfilment value rather than an exit value. An insurer generally has the intention to fulfil insurance contracts, especially since the insurer normally will lack the ability to sell or transfer them. Consequently the fulfilment concept better reflects the business model of an entity that issue insurance contracts. Therefore we do not understand why a liquidity premium should be used in the measurement and the inclusion of this should therefore be justified

We welcome that the IASB has included incremental acquisition costs in the initial measurement of the insurance contract. We are, however, slightly concerned that the limitation to incremental acquisitions costs at the individual contract level rather than at portfolio level will lead to significant differences between companies with an in-house sales force and companies with other types of distribution channels.

We also consider that the IASB has made the right decision by proposing that the residual margin should be released over the coverage period in a systematic way that reflects the exposure from providing insurance coverage. We consider that the proposed methodology is a reasonable allocation mechanism for the initially expected compensation for accepting insurance risk and administrating the insurance contract during the life of the contract. However, we note that the IASB has chosen another model for reinsurance. In our view, it is equally inconsistent to recognise day-one gains both for the insurer and the reinsurer when a fulfilment value approach is used. Only if a day one loss is recognised at issuance of the contract and when a part of such contract is reinsured with a gain would it be appropriate to recognise such gain in income up to the part of the loss recognised that relates to the ceded exposure.

In our discussions regarding this ED, it has become clear that there is uncertainty with regards to the term "risk-free interest rate". This confusion partly seems to be the reason why some are in favour of including a liquidity premium. We therefore urge the IASB to clearly define the term risk-free. Especially in the Eurozone this causes concern since the financial markets have added different credit risk premiums for lending to different states.



Presentation

We appreciate that the margin approach for presentation of revenue for insurance contracts has been introduced. The approach will increase the possibility to actually understand the profitability of life insurance business and increase the possibility to compare life insurance with banking and asset management industries. However, we consider that the relevance of a margin approach to presentation clearly can be questioned for non-life business. We therefore urge the IASB to consider allowing the methodology proposed for short-term contracts to be used for all kinds of non-life insurance contracts.

Furthermore, we consider that it should be possible to choose to present some of the line items in the notes instead of forcing them to be presented gross in Comprehensive Income. This is especially relevant for entities with an insurance business that is minor compared with the rest of the business; the proposals in the ED may put too much emphasis on the insurance business in those circumstances.

Financial guarantees

IFRS 4 states that financial guarantees may meet both the definition of insurance contracts as well as the definition of financial instruments. Thus it has been possible to either treat financial guarantees in accordance with the insurance standard or the standard for financial instruments. Now, the ED precludes those who have used IAS 39 for financial guarantees to continue with that practice. Instead all financial guarantee contracts will be forced into the insurance standard.

The effect of this change is that all financial guarantees will be measured at a fulfilment value (i.e. a form of current value) instead of being measured at the higher of cost and fair value.

Since financial guarantees have been used as part of the banking book business this proposed change will potentially have an enormous effect on financial institutions in a way that is in total contrast to their business models. Financial institutions uses financial guarantees as a form of collateral, when bought, or as part of a traditional lending business activity when issued, i.e. they pay for or are compensated for the bearing of the ultimate credit risks. We consider this proposal to be rule based rather than principle based. We consider that the IASB should keep the present possibilities, i.e. either a insurance contract or a financial instrument, based on business model.

We also question this proposed rule when noting that the IASB has chosen the opposite direction for investment contracts with discretionary participation features (DPF) (i.e. to require those contracts to be measured in accordance with the insurance standard even though investment contracts with DPFs do not meet the definition of an insurance contract.

Furthermore, applying the business model has been chosen for product warranties. For those the dividing line for the accounting is if they have been issued by a manufacturer, dealer or retailer in which case the ED will not apply.

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Unbundling

Unbundling is commonly used in Sweden for life insurance business in bank assurance groups. Entities that have active asset and liability strategies need to be able to use unbundling techniques, i.e. to be able to measure and present components of insurance contracts that are combined with non-insurance contracts separately. We, however, note that the ED is not clear when unbundling is appropriate. The meaning of "closely related" should be clarified.

There are several reasons for that unbundling is appropriate :

- There will be an artificial mismatch in the changes in value of hedging instruments and the hedged component in the insurance contracts if different measurement methodologies apply due to the fact that they are within the scope of different accounting standards,
- All similar risk components should be presented together, e.g. if an insurance contract contains a component that is equal or very similar to a financial instrument, that component should be presented together with other similar components
- If the insurance component is small in an insurance contract, the size of the insurance business may be presented in a non-proportional way in the financial statements. E.g. if the insurance component is around 5 percent and the savings element is 95 percent, the insurance risk business would appear to be 20 times larger than it actually is in the income statement compared to if unbundling is used. Especially if the life insurance business is part of banking business, where most income items are presented net instead of gross (e.g. net interest income, net commission income), a presentation of the insurance business without unbundling would be a bad reflection of the actual size of the respective business segments.

Our views when unbundling is, or is not, appropriate are as follows:

- If the business model is to manage different components of insurance contracts separately, i.e. in product development, in pricing, in risk management and in the way the management is evaluated, the only accurate way to present that business faithfully is to use unbundling in presentation and in measurement
- Contrary, if the business model is to aggregate different risk for single insurance contracts and also to write insurance agreements in a way with the customers that they all mutually share the risk and benefits together and the contracts are priced on that aggregated view of the business, unbundling would be arbitrary and the presentation of different components of the insurance business separately would be arbitrary and subjective.
- When the insurance risk is remote, a more faithful presentation of the insurance risk is normally achieved by using unbundling, especially if that insurance business is part of a financial conglomerate where the dominating part is a banking business
- If the entity actively manages its risks a false volatility in the income statement may occur if not all components that are interrelated are measured using the same measurement models.

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Interactions with other standards

We consider that the IASB should consider the interaction with other standards. As written the ED seems to introduce a large number of possibly artificial measurement mismatches. The most obvious examples relate to financial instruments, but other standards are also affected. One example of a mismatch in the ED is when a life insurance company conducts its business in a building whose unrealised changes in fair value are allocated to the policy holders. Today the entity recognises the changes in the fair value of the building in OCI and by using shadow accounting the part of the change in the life insurance liability that corresponds to the value changes of the building is also recognised in OCI, i.e. a methodology that presently is able to faithfully represent the economic substance of the insurance agreements and the value change of the building.

The reason for this obvious mismatch is that even traditional life insurance contracts may have a direct link to changes in fair value of assets that are recognised in OCI while the ED proposes that all changes in the insurance liability should be recognised in Profit or Loss.

We therefore urge the IASB to reconsider its decision to abandon the concept of "Shadow Accounting" presently allowed in accordance with IFRS 4. Shadow Accounting is in our view a very good practical expedient to handle equity instruments classified as available for sale and revalued property plant and equipment in accordance with IAS 16.

Discount rate

We agree that the time value of money should be considered. However, we do not share the IASB view that the discount rate should reflect the characteristics of the liability. We understand that the purpose of the ED has been to mitigate artificial measurement mismatches when the liabilities are dependent on the performance of the assets (e.g. unit linked liabilities). However, we consider that the proposal will include insurance liabilities that in our view should not be discounted using the return on the asset (e.g insurance liabilities that contain higher of options). In these latter cases we believe that the expected cash flows in the insurance liability should be discounted using a risk free rate. Using a risk free rate will, in our view, in an unbiased way reflect the characteristics of the liability.

Furthermore, the mismatch created between value changes on assets and liabilities should in some cases not be solved by using the same discount rate for assets and liabilities. The most obvious example is unit-linked contracts. The small components that reflect insurance risk should be discounted using the risk-free rate while the "unbundled part" (i.e. the direct link to the holdings of parts of mutual funds) should be measured at fair value (i.e. the present value of the holdings).

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Definition of risk adjustment

We understand that the IASB restricted the possible methodologies for the calculation of a risk adjustment with the intent of increasing the possibility of comparing different entities with each other.

We consider that the proposed rules will restrict the possible development of better models for the calculation of the risk adjustments. Therefore we consider that the IASB instead should develop clear principles combined with meaningful disclosures. We believe that this approach will foster market discipline and continuous improvements in the methodologies for estimating the risk adjustment.

Incremental acquisition costs

We appreciate the IASB decision to include incremental acquisition costs in the initial measurement of the insurance contract, although we reiterate our concerns about the Board's decision to restrict this to the contract level. That change combined with realising the residual margin over the coverage period is in our view consistent with the fulfilment value approach. Also, we consider that the chosen approach best reflects that an insurer is not earning any profit at inception but over the coverage period.

Transition

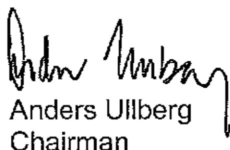
The proposed transition requirements need to be abandoned since they will eliminate future profits in the present insurance business. We consider that the normal requirements in IAS 8 should be applied when the standard is implemented, preferably with the acceptance of some appropriate 'short-cuts' to address the difficulties of full retrospective application.

Furthermore, the implementation date for the ED and the transition rules for IFRS 9 should be considered at the same time since the insurance industry presently has chosen to classify financial instruments in different categories depending on the measurement of their insurance liabilities.

If you have any questions concerning our comments please address our Executive member Carl-Eric Bohlin by e-mail to: carl-eric.bohlin@radetforfinansiellrapportering.se

Stockholm, 16 December 2010

Yours sincerely



Anders Ullberg
Chairman

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