



Association pour la participation des
entreprises françaises à l'harmonisation
comptable internationale



Mouvement
des Entreprises de France
MEDEF

A F E P

Association Française des Entreprises Privées

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Paris, November 19, 2007

Re : DP *“Preliminary Views on Insurance Contracts”*

ACTEO, MEDEF & AFEP welcome the opportunity to comment on the IASB discussion paper presenting “Preliminary views on Insurance Contracts”.

We concur with the IASB that a comprehensive standard on how to account for insurance contracts is much needed, and believe that the issues raised, and preliminary views formed, by the IASB are fully relevant to the discussion of this topic. Although we do not necessarily share every proposal set up in the paper, we believe that arguments pros and cons have been appropriately debated and greatly help to formulating our own view.

We are however concerned that there are many issues addressed in the DP for insurance contracts that are relevant to other IASB & FASB active projects, so that the IASB’s preliminary views could have far reaching implications for other businesses, before full due process on those issues has appropriately taken place. Revenue recognition is one of those very critical issues.

Basically our main concerns can be summarised as follows, some of which being fully consistent with the views we have expressed on the DP “Fair value measurement” or on the revision of IAS 37 “Liabilities”:

- we disagree that fully executory contracts should trigger recognition of assets and liabilities ; we believe that insurance liabilities should be recognised at the time insurance coverage starts being provided ;
- Although we accept that insurance contract liabilities be measured on the basis of some form of current-exit value for the reasons we explain in detail in the appendix, we do not accept the revenue and profit patterns which, based on the framework, would automatically be derived from such measurements. In particular, we disagree with the analysis provided in the DP, where insurance services are analysed as being rendered at the time the insurance contract is signed, ignoring the need to manage portfolios of similar risks and to handle claims over the whole duration of the contract ;

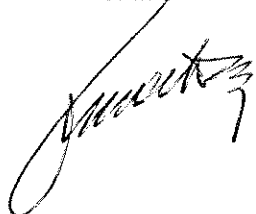
- We believe that, in the absence of available market data, entity-specific data should be used ;
- We disagree that the risk of non-performance should have an impact on the valuation of the liability ;
- We believe that discretionary participation features trigger an economic compulsion to pay dividends beyond the contractual requirements and that this should be included in the valuation of the liability ; the definition of a “constructive obligation” as contemplated by the IASB as part of the IAS 37 revision is far too restrictive in our view to provide useful information to users on future cash-outflows ;
- We believe that policyholder behaviour has a direct influence on future cash-outflows and that this influence can be estimated reliably, on a portfolio basis ; as a result, we believe that it should be taken into account in the valuation of the net liability, beyond guaranteed insurability.

A detailed analysis of the above issues has been incorporated as an appendix to this letter, in the form of answers to the questions raised in the invitation for comments.

Should you wish any supplementary comment or explanation, please do not hesitate to contact us.

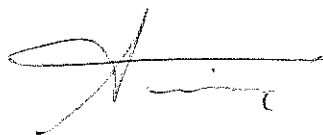
ACTEO

Patrice MARTEAU
Chairman



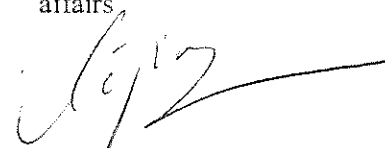
AFEP

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Appendix to ACTEO – MEDEF – AFEP’s letter on IASB DP “Preliminary views on Insurance Contracts”. Answers to the specific questions raised in the invitation for comments.

Question 1—Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

IAS 39 recognition criterion calls for financial instruments to be accounted for at the time the entity becomes a party to the contract. However IAS 39 in its application guidance (AG35b)) alleviates the implications of such a principle, indicating that no recognition takes place “until at least one of the parties has performed under the agreement”.

Similarly in our view, no asset or liability should be recognised before one or the other party in the contract has started to perform, unless the contract is onerous¹. In the specific circumstances of insurance contracts, this would usually take place at the time insurance coverage starts being provided to the policyholder.

We accept that IAS 39 derecognition requirements can apply to liabilities arising from insurance contracts until the Board has completed its project on derecognition.

Question 2—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 the money, and**
- (c) an explicit and unbiased estimate of the margin that market participants require for bearing the risk (a risk margin) and for providing other services, if any (a service margin)?**

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

We agree that an insurer should measure liabilities arising from insurance contracts using the three building blocks approach described in the DP. We agree that estimates of future cash-flows should be explicit, that inputs such as interest rates and equity prices should be as consistent as possible with observed market prices at the reporting date. We disagree however to set as a principle that entity-specific cash-flows should be systematically considered as not relevant. Although the Board acknowledges that in practice insurers will rely heavily on entity-specific data in the absence of availability of market data, and although the discussion paper clearly distinguishes between portfolio specific data and entity specific data, we believe that entity-specific data should have precedence on hypothetical assumptions of what other market participants would incur.

¹ Whether an insurance contract is onerous requires the determination of the appropriate unit of account.

This is based on the following arguments :

1. To reflect that an entity is more or less efficient than other market participants would lead to the recognition of gains and losses that would reverse over time at the time the liability is being settled. Such a process would not provide the users of financial statements with relevant information on the performance of the entity ; it would delay – until settlement – the reporting of the entity’s performance. We do not believe that this is heading into the right direction or that this is what users want.
2. Even if a market based measurement is retained, priority should be given to entity-specific data in the absence of market data, unless there is objective evidence that these data are not representative of other market participants data. Although the DP indicates that in practice, for example, cost entity-specific data are likely to be used, we believe the statement should be reversed. In the absence of both market data and objective evidence that entity-specific data are not relevant in the measurement, the systematic call for setting assumptions of what market participants revenue and costs would be may turn into very subjective estimates and this comes as a contrast to the search for the greatest objectivity.
3. Users want to avoid management’s estimates to over-influence the preparation of the annual accounts. They however support that the entity’s factual data are reflected in the measurement of assets and liabilities. Reporting financial debt on the basis of contractual terms is an example of their call. Reporting revenue on the basis of premiums charged to policyholders is another.

We also agree that the third building block in the estimate should be a risk margin, in order to reflect the uncertainty inherent to the insurance business. We also agree that this risk margin should at all times reflect the level of risk the entity bears at the reporting date. For that reason we do not support the shock absorber view.

In our answer to the DP “Fair value measurement” we have explained when and why, in our view, exit or entry prices would be best used. On the basis of this industry-wide analysis, we would conclude that insurance liabilities ought to be measured on the basis of an entry price, because, in our view, the insurance service is rendered over the duration of the contract. The end profitability of an insurance contract is not, from inception, left to market forces. The entity will make decisions and take steps after inception that have an influence on the end profitability of the contract.

However ACTEO believes that reliable and efficient financial reporting does not allow room for various forms of financial reporting of the same facts and events. As the IASB is aware, Solvency II is calling for insurance liabilities being measured on the basis of an exit value. Insurance companies have already taken necessary steps for bringing their IT systems up to speed with these requirements and consider that it is essential that insurance liabilities are measured for external financial reporting and prudential reporting following the same principles. Consequently ACTEO supports that insurance liabilities are measured on the basis of an exit value, as an exception to the principle which ACTEO believes should prevail.

Consequences of that exception should, in ACTEO’s view, be drawn in terms of performance measurement. ACTEO believes that revenue and profit (including the retail margin) derived from insurance contracts should be recognised over the duration of the contract to best reflect the profitability of the insurance coverage sold to the customers.

In a context where insurance liabilities are measured on the basis of a current exit value, changes in the value of insurance liabilities should be recognised as other comprehensive income, and revenue and profit drawn from OCI until the insurance liability is finally settled.

Question 3—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 usually regard implementation guidance as useful in order to best illustrate and ease the understanding of the principles developed in the standard. As such, we believe the examples and guidance provided in appendices E and F are appropriate. However, we believe that this type of guidance must not form part of any mandatory guidance. Only principles should have a mandatory status, so that IFRS can grow into a fully principle-based set of standards.

Question 4—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 insurer 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).

This in our view would ensure that measuring assets and liabilities on the basis of hypothetical transactions does not open the door to very subjective estimates. It is difficult to further describe what indeed “objective evidence” would be, on the basis of which an entity would rebut the assumption. Judgement should apply. As a consequence of our answer to question 2 above, we believe the actual premium and margin have a role to play in the recognition of revenue and profit.

However, having accepted for the reasons explained above that insurance liabilities be measured on the basis of some form of current exit value, we support answer d).

Question 5—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?**

As explained in our answer to the DP on “Fair value measurement” we do not believe that liabilities should be measured on the basis of a hypothetical transfer scenario, when such scenario is remote. Hypothetical transactions are, in our view, a sound basis for estimates when they feature transactions that belong to the entity’s business model and there is benefit to users to use some form of current measurement. Consistently with our answer to the DP on “Fair value measurement”, in the absence of Solvency II regulations which apply to the insurance industry, we would have recommended the settlement scenario be retained. However as already explained in our answer to question 2, insurance companies should be able to rely on a unique reporting system, for altogether external, internal and regulatory purposes. We therefore support the proposals in the Discussion Paper.

The second part of question 5 deals with semantics. As expressed in our answer to the DP « Fair value measurements », we encourage the Board to adopt descriptive labels for various measurement attributes so that each label conveys more precisely the type of measurement which is applied. In the context of the Board’s preliminary views, we believe that the adequate label would be « market-based current transfer value ».

We wish to add that in our view the measurement attribute proposed in the DP is not fully consistent with fair value requirements. Sales of portfolios of insurance contracts show evidence that the price for the obligation and the risk transferred:

- (a) takes into account positive policyholders’ behaviour beyond guaranteed insurability ;
- (b) values a portfolio of demand deposits at less than the nominal amount at first demand ;
- (c) takes participating discretionary features into account as triggering a liability.

Question 6—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?**

We believe the insurance business economics rely on the laws of statistics. As a result we believe that beneficial policyholder behaviour is necessarily reflected in pricing decisions, valuations and more generally estimates which are relevant to this business. Therefore we believe that beneficial policyholder behaviour should be recognised. We therefore would drop c).

We believe that insurance liabilities should reflect the substance of the contract signed between the policyholder and the insurance company. Renewal options are one of the contractual features. As a principle, IFRS prohibit offsetting of assets and liabilities when there is no economic link between assets and liabilities, and/or when counterparts differ. In the case of insurance contracts, we do not believe that any asset arises separately from the liabilities the entity incurs. We therefore support option b).

Question 7—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).**

We support option b) for the reasons explained in our answer to question 6. Renewal options are part of existing contracts, beneficial policyholder behaviour can be observed repeatedly through series of statistics, and therefore we believe they are an integral part of the contract. The difference with new contracts is the identifiable existing non-enforceable contractual relationship that exists between the insurance company and the policyholder. Sales of portfolios of insurance contracts bring evidence, in day-to-day business life, that the price agreed between parties to the sale is based on cash-flows as defined in b).

Question 8—Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

We agree that acquisition costs should be reported as expenses when incurred. That is the way all marketing and commercial expenses are reported today in all other businesses, in compliance with IAS 38.

Question 9—Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

We agree with the Board that a portfolio transfer should not result in any goodwill or intangible asset being recognised separately. However we have identified two areas where the preliminary views formulated by the Board would result in the accounting for gains and losses at the date of acquisition, without any economic underlying:

- as explained in our answer to question 7, the price at which a portfolio of insurance contracts is sold reflects cash-flows as defined in criterion b) of question 7 ; the preliminary view of the Board to limit those cash-flows to the guaranteed insurability would, if applied, generate a loss at inception of an acquired portfolio ;
- limiting participating rights to the payments the entity is contractually – or otherwise - committed is another source of discrepancy between the price that would be agreed in a portfolio transfer and the recognition of the insurance liability. The preliminary view of the Board would, if applied, generate a gain at inception of an acquired portfolio.

Question 10—Do you have any comments on the measurement of assets held to back insurance liabilities?

We agree that those assets should be accounted for independently, and reported separately, from insurance liabilities. However we insist that there should be no room left for accounting mismatches. We therefore call for an extension to non-financial assets of the available for sale category and of the fair value option, in order to include all assets which are held – at least partially - in view of backing insurance liabilities. An example of such an asset is a property occupied by the insurance company to conduct its operations.

Question 11—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?**

We agree that risk margins should be determined for a portfolio of insurance contracts. However we believe that the definition in IFRS 4 should not be retained. In our view a portfolio should be defined as “a group of contracts managed together when assessing risks”.

We agree with the Board that taking entity-specific diversification into account is not consistent with valuing insurance liabilities at market-based current exit value.

Question 12

- (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.**

We would agree with a) but disagree with b) :

- (i) in our view, the risk margin would not be equal to the risk margin for the corresponding underlying insurance contract. Consistently with the views that we have expressed in answering question 2, reinsurance assets are not purchased in the insurance retail market.
- (ii) Although we agree with the expected loss model in principle, we believe that the incurred loss model should be retained, as there are only very few reinsurance companies, each of them with potentially very different credit characteristics.
- (iii) we agree that such a contractual right is not likely to be material and that taking it into account brings complexity and risks of errors without sufficient supplementary benefit.

Question 13—If an insurance contract contains deposit or service components, should the insurer unbundle them? Why or why not?

We do not think that unbundling should be required. Unbundling cannot result in relevant and reliable measurements as there is always some form of interdependency that is best reflected in one single measurement and there again there would be room for divergent practices in the assessment of the level of interdependency that triggers separate accounting.

Question 14

- (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?**

Consistently with the answer provided to the DP « Fair value measurement », we do not believe that the risk of non performance should be reflected in the valuation of liabilities. We do not believe that it is consistent with a transfer scenario, because only the obligations are being transferred, not the risk of non performance that the third party bears as part of relying on the entity to fulfil its obligations.

Question 15—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?

We do not believe that the development of accounting for insurance liabilities should trigger in itself the revision of the existing IAS 39. We understand that the Board is about to issue a due process document for a possible new standard on financial assets and liabilities and we support that these two projects remain separated. This will be we believe the appropriate time to consider and solve any possible inconsistency. However in order to sustain such a decision the Board needs to make two decisions that have an influence on insurance accounting:

- contracts with participating features should remain integrally within the scope of the revised IFRS 4 ; these participating features being fully interdependent with the underlying investment contract ; this is a condition for relevant accounting and for the avoidance of accounting mismatches ;
- paragraph 49 of IAS 39 which states that the fair value of a financial liability with a demand feature (for example a demand deposit) will be no less than the amount payable on demand. This requirement is inconsistent with the valuation bases proposed in the DP and overall with the insurance business economic characteristics. This paragraph should either be revised or decisions made so that it does not apply, even partially, to the insurance industry.

Question 16

- (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 paragraph 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?**

We believe that June 2005 proposed amendments to IAS 37 of the definition of constructive obligations are not appropriate as guidance to help an insurer determine dividends to include as part of the measurement of the insurance liability arising from a contract with discretionary participating features.

Indeed we believe that such a guidance would not lead insurance liabilities to be measured consistently with the exit price measurement objective retained in the DP. Prices agreed in portfolio transfers provide evidence that discretionary participation features trigger actual dividends payments beyond the contractual requirements ; because of the choice of the exit value model, we believe that this fact should be included in the valuation of the liability and do not believe that reference to the definition of a “constructive obligation” as contemplated by the IASB as part of the IAS 37 revision is adequate under these circumstances to provide useful information to users on future cash-outflows.

Question 17—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 great efforts should be made in order to avoid accounting mismatches as much as possible. We therefore encourage the Board to make even unlikely decisions in order to meet that objective.

We therefore fully support that b) and c) be fully investigated. We have already mentioned c) as a desirable solution in our answer to question 10. We also support b) under the condition of reliability of measurement. We would encourage the Board to fully explore a) and its possible implications. We however do not believe that d) should be considered.

Question 18—Should an insurer present premiums as revenue or as deposits? Why or why not?

Question 19—Which items of income and expense should an insurer present separately on the face of its income statement? Why?

Question 20—Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

We do not provide answers to questions 18 to 20 at this stage. We would encourage the IASB to undertake field visits and testing in order to test different scenarios with the help of the insurance industry and the users groups (CRUF, ARG etc...) that the IASB usually consults.

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