

**The European Insurance CFO Forum
Comité Européen des Assurances**

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

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Dear Sir David,

Response to IASB Discussion Paper - Preliminary Views on Insurance Contracts

We have read your proposals and welcome the opportunity to comment on your Discussion Paper - Preliminary Views on Insurance Contracts (the “Discussion paper”). This letter has been drafted by the European Insurance CFO Forum, which is a body representing the views of 20 of Europe’s largest insurance companies, and the Comité Européen des Assurances (CEA), representing 94% of the European Insurance market. The letter aims to provide a consensus view on issues impacting the European insurance industry.

We welcome the release of the Discussion paper as an important step towards achieving a comprehensive financial reporting basis for insurance contracts. We share your objectives of producing a standard on a timely basis that will result in financial statements that are relevant, reliable, understandable and comparable with other industries as well as within the sector. It is important that our accounts are perceived by users to be transparent and that they are meaningful by reflecting the economic realities of our business and the contracts we write. We therefore support a prospective current assumptions based model that reflects all expected cash flows associated with a contract and hence we believe that the proposals set out in the Discussion paper in many ways represent a good starting point towards achieving our mutually shared objectives.

The tentative conclusions of the Discussion paper, however, do not reflect important matters we have raised with the IASB in the past in the CFO Forum Elaborated Principles for an IFRS Phase II Accounting Model, as supported by the CEA, (the “Elaborated Principles”), in letters, discussions and in educational sessions and we see many of these matters as key in achieving economically meaningful financial statements. The Board has applied constraints to principles in a number of areas and hence, whilst recognising that the IASB is intending to foster transparency, we believe that proposals consistent with economically meaningful financial statements have not

been achieved. We believe that certain aspects of the proposals will produce financial statements that are not relevant to users and hence do not believe that the proposals could be implemented as drafted in the Discussion paper.

The theoretical approach adopted by the Discussion paper is such that many of the Board's proposals will result in information that is of little relevance to users. In particular we believe the information produced will not meet the requirements of users, preparers, regulators and others in reflecting the economic reality of our business. Our response expands on these concerns. In considering our detailed responses we would request that the Board take these concerns around users' needs and practical implementation issues into consideration.

We would stress that we support the Insurance Contracts project and believe it should continue to move forward on a timely basis, building on the work done to date. It is equally important, however, that it be subject to the appropriate due process, that dialogue is maintained with stakeholders, and that the project reflects the linkages with other IASB projects. We would welcome the opportunity to work closely with you in the future to develop the final standard.

Due process and field testing

Given these concerns and the fundamental nature of the changes proposed, both for the insurance industry itself and also beyond the industry given the wider implications of some of the proposals, we believe that it is imperative that a process is established to discuss, test and implement the changes that reflect the significance of these issues. This should be more extensive than the existing Insurance Working Group process and should involve ongoing consultation with stakeholders prior to the issuance of an exposure draft. It is vital that stakeholders have an opportunity to consider, test and comment on the detailed principles that would be included in any final standard as they are developed. The time needed for companies and users to consider these proposals, given such a fundamental change to the basis of accounting, should not be underestimated and we do not believe that it should be left until a final exposure draft is issued. We would like to work with you to develop a mutually suitable programme over the coming months.

To support the consultation process outlined above, extensive quantitative field testing of the proposals, both pre and post publication of the exposure draft, must be undertaken. Our members are prepared to participate in such testing and believe that the iterative process adopted under the Solvency II Quantitative Impact Studies (QIS) will form a good basis for such testing.

Once the standard has been finalised it will be important to provide transitional provisions, reflecting both the need to assist in the user community's wider understanding of the new proposals and to help address the practical implementation issues facing the preparers.

The European regulatory framework

In addition to the measurement of insurance contracts in an accounting context there is a need to carefully monitor developments in regulatory reporting. The European

Commission is currently drafting a framework directive on the future solvency system, Solvency II. An important building block of the Solvency II system, as well as other capital adequacy regimes, is the measurement basis for assets and liabilities. The development of Solvency II and other capital adequacy regimes, as well as the future accounting standard for insurance liabilities are key areas of interest for our industry.

We believe that it is important that, as the IASB develops its proposals, it continues to monitor Solvency II developments and, if appropriate, liaises with regulators to ensure a broadly consistent regime where appropriate.

Interaction with other IASB standards

The IASB currently has a number of key areas of accounting under review, including the conceptual framework, revenue recognition and the recognition and measurement of liabilities. It has become evident to us during the discussions on insurance contracts that the insurance project is leading the way for much of the thinking being developed in these other areas. These concepts are often both untried and untested and we are concerned that the insurance industry is being used as a testing ground for many of the ideas in these areas. It is therefore important that the implications of concerns expressed on other IASB projects by industries other than insurance are adequately understood and considered as part of the debate on insurance contracts. For this reason we believe continued discussion and debate in the areas we have raised in this letter is essential.

The measurement model

We support the three building block approach to measuring insurance liabilities proposed by the IASB which underpins the proposals in the Discussion paper but do have a number of concerns with how these blocks are evaluated and measured. The most significant of these are discussed below. Most importantly we believe that further investigation and discussion is required regarding the level of day one profit and its subsequent accounting treatment.

Furthermore, we have very significant concerns about the IASB's views on the recognition of certain of the rights and obligations of insurance contracts in estimating future cash flows. In our view the proposals will not meet the requirements of users, preparers, regulators and others in reflecting the economic reality of our business if these issues are not satisfactorily addressed. In particular:

- The obligation to pay discretionary future benefits to policyholders should be recognised as a liability at the start of the contract and should be measured with regard to future expected benefits payable; and
- The right to receive all expected cash inflows arising under an existing contract, including expected future premiums, should be recognised from the inception of an insurance contract.

We believe that these issues can be addressed by stipulating that once an insurance contract has met the recognition criteria, all the cash flows attaching to that contract

are relevant to its measurement and no further consideration is required as to whether the separate rights and obligations created by that contract meet the recognition criteria established in the IFRS framework.

Measurement attribute and the risk margin

Whilst we support the three building blocks concept, we are concerned that the measurement attribute proposed by the Board is based on a hypothetical transfer value rather than being reflective of the expected outcome of the contract. In our view an insurance contract should be measured based on the expected cash inflows and outflows together with a margin for risk and uncertainty. This margin is defined as the cost of risk, i.e. a risk margin in addition to the expected present value of future liability cash flows required to manage the portfolio.

In our opinion, this margin is best evidenced by the cost of capital that is required to be held by the insurer to support the contract. This cost of capital would reflect the excess return over risk free rates that any company (either the originating company or a transferee) would require to manage the insurance obligations over the lifetime of the portfolio. We do not believe that the risk margin should include any compensation other than this compensation for risk.

We believe that our proposed basis of valuation represents an economic reflection of the expected outcome of the insurance contract, which could be considered to represent a transfer value in a run-off scenario and hence the most appropriate form of exit value for insurance contracts. There is therefore no need to introduce any additional or separate components.

In our view the concept of the service margin is unclear as expressed in the Discussion paper. Notwithstanding this lack of clarity, we consider that the elements of the service margin are already adequately reflected in the measurement model we have outlined above and hence should be excluded from the final standard.

Profit recognition

As set out above we believe the insurance liability measurement should consist of the best estimate of future cash flows and a risk margin represented by the cost of capital. Together these two components comprise the full economic value of the liability. The residual difference between the premium (after deduction of relevant acquisition costs) and this insurance liability represents an element of the profit expected to be generated by the contract over its lifetime. We believe that this amount is available capital for regulatory solvency purposes since it goes beyond the economic value of the liabilities and will not be paid to policyholders. We refer to it in this paper as the “initial profit margin”. We believe that this initial profit margin is more significant than that envisaged by the IASB in the Discussion paper. The size of the initial profit margin is demonstrable in market transactions and in published market consistent embedded value figures. It is therefore important that the presentation of this initial profit margin is carefully considered in the development of the final standard.

We have considered three conceptually viable options on how this initial profit margin can be presented for accounting purposes. These options were: presentation

within liabilities or presentation as part of equity, either immediately as part of profit (i.e. gains upon inception) or as a component of other comprehensive income with recycling to the income statement over the contract term. After careful consideration of their respective merits and consistent with our Elaborated Principles, our current view is that the accounting presentation should reflect the provision of risk coverage, i.e. recognised in line with release from risk. In this context, since the initial profit margin is akin to deferred income, our proposal for accounting purposes is that it is presented separately in the liability section of the balance sheet.

The resulting profit recognition pattern is consistent with the concepts of performance of obligations and provision of services currently being debated by the IASB as part of the revenue recognition project. Such treatment will provide clarity for the users of accounts and, in particular, will ensure that the regulatory position is clear. In this regard we fundamentally believe that the initial profit margin represents available capital for regulatory solvency purposes and we would not support the presentation of the initial profit margin as a liability if this were to jeopardise this position.

Beneficial Policyholder Behaviour

Policyholders' behaviour is one of the important factors underpinning the amount, timing and uncertainty of future cash flow payments. Policyholders make decisions based on personal circumstances, including their own need for insurance and to maintain protection without further underwriting, which often results in behaviour that is counter to the general economic environment. We therefore support a valuation of insurance liabilities which reflects all expected policyholder behaviour as we believe that this provides more relevant and reliable information to the users of financial statements.

As indicated above we believe that, once an insurance contract is recognised, policyholder behaviour is an aspect of the measurement of the liability rather than the right to future premiums being a recognition issue in itself. By its emphasis on identifying separately rights and obligations from the same contract, the proposed model does not reflect all the cash flows implicit in a contract.

An economic exit value should include all expected cash flows that arise from existing contracts, irrespective of whether the insurer can enforce those cash flows. In our experience, an acquirer of a portfolio of contracts will allow for all expected future cash flows under a contract. We have a fundamental concern with the IASB's guaranteed insurability criteria as we believe that future premiums under many insurance contracts will be excluded from the best estimate of cash flows. We have conducted research amongst our member companies and identified a variety of contract types which will see restrictions on future expected premiums under the guaranteed insurability proposals. Given the requirement to expense acquisition costs, this will lead to the incorrect reporting of accounting losses in the early years of the contract. Such a situation will not be meaningful or useful to users of financial statements since the economic reality will not be fairly portrayed.

We acknowledge that the ability to distinguish between existing contracts and new contracts is important. The CFO Forum has already sought to identify wordings to clarify which cash flows should or should not be included for the purpose of the Elaborated Principles. We elaborate further on this in our detailed response to

question 7 in the attached appendix. Whilst advocating strongly that all cash flows attached to an existing contract should be included within the measurement of a liability, we are not trying to push the boundary. For example we would not seek to include annual renewals of motor or similar non-life policies.

We would like to work with you to develop a set of criteria that should be used to distinguish between existing and new contracts, recognising the variety of contracts written around the globe.

Participating Contracts

To ensure financial statements are relevant to users, and provide consistency of measurement of economically similar contracts, an economic basis of valuation for participating contracts is required. Such an approach should be on a portfolio basis and take into account all expected payments to policyholders including those that have not yet been allocated to individual policyholders. This is consistent with our view that it is inappropriate to split the contract into its underlying rights and obligations for the purpose of recognition.

We believe that a constructive obligation to declare bonuses is established upon inception of a participating contract and this constructive obligation should be recognised when measuring an insurance liability. This is consistent with any economic measurement basis including the exit value model being applied by the IASB where such expected cash outflows would be taken into account by a transferee. The recognition of an obligation to pay bonuses under participating contracts based on legal enforceability is extremely difficult to apply and demonstrate on a consistent basis and is inconsistent with the economic reality of the contract. Given that a variety of fund and contract structures are used around the globe such a definition is likely to lead to some companies treating such participating features as equity and others as liabilities. We do not believe that this will lead to relevant and reliable accounting.

The Discussion paper asks whether the guidance in IAS 37 is sufficient to establish whether a constructive obligation exists. Whilst we believe that the guidance quoted in the Discussion paper from the IAS 37 exposure draft will prove sufficient, we are concerned about the on-going debate in this area regarding the definition of the constructive obligation. We would oppose any narrowing of this definition. The IFRS definition of a constructive obligation must allow for such obligations to be included in the value of an insurance liability. This should be made clear in IAS 37 and the revised insurance contracts standard.

We believe that it is important that all participating contracts, whether classified as insurance or investment, should be accounted for consistently under the new Phase II accounting standard and this issue should be addressed in setting the scope of the standard.

We can see no rationale for mutual insurers to adopt different practices from shareholder-owned companies in the financial reporting of discretionary participation features.¹

¹ The Swedish mutual market has separately raised this issue with the IASB

Market consistent assumptions

We generally support the proposal that the estimate of future cash flows should be on a market consistent basis although we believe that it is important that “market consistent” is defined. In our view market consistent assumptions should not be confused with market average assumptions but should instead be based on the specific portfolio of insurance contracts held. Different assumptions will require a different approach. Economic assumptions based on financial indices, such as interest rates, will follow readily observed market data. For other assumptions, including expenses, the attempt to create a “market” leads to an approach that is too theoretical that will result in information that is neither understandable nor relevant to users. Accordingly, for certain non-financial assumptions, notably expenses, we believe that entity-specific assumptions should be used in valuing insurance contracts. This is consistent with our proposed basis of valuation which reflects the expected outcome of the contract.

Unbundling

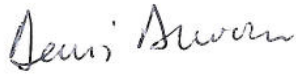
The Discussion paper looks at whether or not deposit and risk components in an insurance contract should be unbundled for the purposes of recognising and measuring the liability. We have always advocated that unbundling should not be required because a contract should be recognised as a whole, rather than as component pieces, reflecting the basis on which the company manages it. We do not believe that the unbundling proposals in the Discussion paper will provide meaningful and useful information to users of financial statements in most circumstances. Furthermore, in the absence of greater clarity over the definitions of the terms “interdependent” and, in particular, “arbitrary”, we do not believe that the proposals can be practically or consistently implemented.

We believe that the unbundling proposals introduce unnecessary cost and complexity into financial reporting. The proposals require that contracts with components that can be split on other than an arbitrary basis should still be measured under the Phase II model but that disclosure should be given of the component parts. The time and costs required for insurers to analyse their underlying contracts should not be underestimated as was demonstrated by the work undertaken on product classification under Phase I. Some offices will require significant systems changes. We struggle to see any real benefit to users of disclosure of the component parts, given that the underlying measurement model is the Phase II insurance standard and the ultimately meaningless nature of the insurance “plug” element, which could easily be an asset through application of the deposit floor in the IAS 39 measurement of the deposit element.

Further response

If you have any queries or questions that you would like to raise in relation to the matters raised in this letter, please feel free to contact us. The European insurance industry is fully committed to finding a comprehensive solution to accounting for insurance contracts. It is important that the proposals developed produce meaningful financial reporting for insurance reporting for the long term and so we support on-going discussions in the areas we have highlighted above.

Yours sincerely



Denis Duverne
Chairman of CFO Forum



Gérard de La Martinière
President of CEA