



EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

IFRS – International Financial Reporting Standard

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**Re: IASB Exposure Draft Insurance Contracts
ED/2013/7**

Comments by the European Federation of Financial Analysts Societies (EFFAS)

Dear Mr. Hoogervorst,

The European Federation of Financial Analysts Societies is the European umbrella organization 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 revised Exposure Draft Insurance Contracts ('the ED'). This letter is intended to contribute to IASB's due process.

We would like to tell you how very much we appreciate that this project now seems to be coming to a successful conclusion.

EFFAS is pleased that in developing the proposals in the ED the IASB addressed a number of concerns expressed in respect of the Exposure Draft issued in 2010. We are also pleased, that finally after 15 years there is a proposal to jointly address both parts of an insurance company's balance sheet.

A single regime for insurance contracts will enhance financial reporting by insurers. We welcome the reorientation towards more realistic measurement principles. This shows that our criticisms were heard with the result that a link between an insurer's assets and liabilities is reflected in their measurement. However, we doubt that the proposed mirroring approach will provide a useful insight and would prefer an asset-liability-management approach as proposed by the insurance industry, but subject to the condition that all asset classes are considered.

Also, we would need more field-testing for the proposed revenue measurement to really support it. While we think it is a good idea to make insurance revenue comparable to general revenue principles, some education is needed in order to see its advantages / we should examine this further to identify its advantages. But we clearly favor this approach towards pure margin measurement.

We further suggest an alignment of first-time adoption/ application of IFRS 9 and IFRS 4 so as to ensure comparability over time and between industries. Given the complex discussions in the macro-hedge project we think an alignment in application dates would reduce complexity in this regard. We would actually favor a macro-hedge approach to measure duration mismatches for insurance contracts similar to financial instruments.

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

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

Please do not hesitate to contact me or **Carsten Zielke** (+4924087199500) for further questions.

Question 1 - Adjusting the contractual service margin

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:

(a) Differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

(b) Differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

We agree with this proposal. Already today, analysts are paying a lot of attention to embedded value numbers published especially by listed European insurance companies. These numbers are estimates of discounted future cash flows on the profitability of the insurance business. Any changes in estimates are booked against the profit margin. However, these measures are based on non-GAAP principles. IFRS 4 could harmonize and improve the transparency of these measures if a distinction could be made between future and past events. Differences between estimates and realized cash flows should be booked in the main profit and loss account for past events given that this reflects something that actually happened and cannot be changed anymore. On the other hand, since changes in estimates for future events are quite uncertain, a booking against the contractual service margin with the booking being made transparent in OCI should be

authorized. Otherwise the P&L would be influenced by a high degree of subjective estimates which might prove wrong.

Question 2 - Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

(a) measures the fulfillment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?

(b) measures the fulfillment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfillment cash flows as follows:

- (i) changes in the fulfillment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;**
- (ii) changes in the fulfillment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and**
- (iii) changes in the fulfillment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?**

Why or why not? If not, what would you recommend and why?

We agree in general with the idea that cash flows generated with insurance assets and having an impact on the liabilities should be measured interdependently. However, the mirroring approach developed by the IASB does not work as it does not reflect the reality. An investment portfolio cannot be split into one generating a guaranteed return and another one generating a surplus. In that case all life insurance company would have to invest only in structured products with a zero-coupon bond as an underlying. What they do, however, is to invest in a diversified portfolio where the diversification impact generates a basic return covering the guarantees. This should be reflected in accounting as it reflects their business model.

We would rather favor the alternative approach developed by the insurance industry, mentioned also in the EFRAG comment letter, which puts forward an Asset-Liability-Management-approach including all asset classes. We would therefore strongly advocate developing this approach in a way in which standards are set on how to project the expected returns. These standards should be applied to all asset classes including equities and real estate. We would be happy to assist the IASB with this work in order to ensure that results remain comparable between insurance companies.

Question 3—Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

We are happy that the IASB has listened to our criticisms about the margin approach. A profit-and-loss account should reflect more than just margins so as to enable the user to understand the underlying movements. This should be reflected on the face of financial statements and not only in the notes. The IASB is now trying to convince the insurance and the user community that a new definition of revenue is the right one for the insurance business. By extracting the investment component, future revenues will not be comparable with what was known as premium income. On the other hand this number will be more comparable with other industries and make especially general investors more comfortable in making their decisions concerning insurance securities. We think that it is necessary to show the user community what the key ratios are that can now be deducted from this new methodology to improve comparability. We would be happy to assist the IASB with this assessment as we think this is the right way to go.

Question 4—Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between:

- (i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and
- (ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

We agree with this proposal in general but have concerns about its application. While it makes perfectly good sense to use locked-in rates for separate accounts, we cannot see how a locked-in rate can be defined for an open portfolio as is common in Europe. We therefore would welcome a solution where every year a new portfolio interest rate is defined and the deviation from the former rate goes through OCI. These OCI movements should also affect the contractual service margin as mentioned in question 1. Obviously, this change in interest rate should exclude any items such as impairments or credit losses that would affect regular income. Any duration mismatch should be addressed in a way similar to the macro-hedge project within IFRS 9. This means that insurance companies have to reveal their risk management practices in order to justify their hedging approach.

Question 5—Effective date and transition

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

We agree with this proposal, especially with the fact that retrospective application becomes somewhat mandatory as it enhances comparability over time. However, we strongly suggest that the IFRS 9 changes are made together with the introduction of IFRS 4 to ensure comparability over time and reduce complexity.

Question 6—The likely effects of a Standard for insurance contracts

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?

How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:

(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that

issue insurance contracts; and

(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

We think that the costs and efforts justify applying this new standard as we assume it will increase comparability between insurance companies and possibly other industries if the number of options is limited and common standards on evaluating future investment returns are defined.

Question 7—Clarity of drafting

Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB?

If not, please describe any proposal that is not clear. How would you clarify it?

In general we think the ED is sufficiently clear except for the section about the mirroring approach. As we explained in Question 3, this approach should be changed.

Best regards,


Carsten Zielke
