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Reference: Comment letter to the IASB on its Discussion Paper "Preliminary Views on Insurance Contracts"

Dear Mr Enevoldsen,

I am very pleased to provide you with the following comments on the EFRAG draft comment letter on the IASB Discussion Paper.

If you wish to address any questions to the comments made by CEIOPS we are happy to respond.

Best regards,

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Comments on the EFRAG draft comment letter

on IASB Discussion Paper

Preliminary Views on Insurance Contracts

Introduction

CEIOPS will send a comment letter to the IASB. We have nonetheless read with attention the EFRAG draft comment letter, and welcome the opportunity to comment on it.

Some points raised by EFRAG warrant more in-depth comments on our own letter. In general, CEIOPS is strongly in favour of an accounting standard for insurance contracts and is grateful to the IASB for its valuable work in this area. CEIOPS is keen to achieve a reporting regime under Solvency II which allows insurance undertakings to use their financial reporting as a basis for regulatory reporting, with a minimum number of solvency adjustments applied to satisfy the specific needs of supervisors. In this context we support an approach of maximum commonality between Solvency II and IFRS and have a particular interest in the proposals made in this discussion paper.

In light of this general approach, we wish to express our support for the underlying accounting principles on which the IASB's discussion paper is built. We believe the IASB's approach to accounting for insurance contracts is closely in line with our own work on Solvency II, and although the exact terminology used may occasionally differ, we believe that in practice the two regimes are capable of achieving very similar outcomes. We welcome the similarity of approaches taken in defining insurance technical provisions under both the Solvency II valuation rules and this Discussion Paper. Both sets of rules aim to achieve a reliable set of principles which reflect the economic reality of insurance contracts. We intend to have a close look at terminology differences and foster convergence of terms used where possible.

There has been intensive debate within CEIOPS on the accounting for gains at inception. Although this issue is distinct of the measurement of insurance liabilities, there is a consensus among CEIOPS members for stressing that the two issues are very closely inter-related and have to be examined in parallel by the IASB.

Comments on the draft letter

Because of the late finalization of our comment letter to the IASB, we could not react to all points raised in the EFRAG letter, but nonetheless feel we can make a useful contribution to the EFRAG process by underlining a few points, especially in relation with the Solvency II principles and on-going project.

Current Exit Value

Under Solvency II, it is envisaged that technical provisions shall be current, market consistent, and made up of explicit building blocks – criteria that are indeed those of the Discussion Paper. In fact, we may contend that the concern expressed in § 4 (c) of the DP[1] will no longer hold under such a regime, which clearly distinguishes the accounting question (what assets and liabilities does an insurer have?) and the supervisory question (what assets should an insurer hold?). The latter is addressed explicitly through capital requirements and adequacy rules.

Moreover, we do not believe that § 1.50 in the draft comment letter is necessarily correct in identifying a difference between the current exit value as per the DP and the liability measure in Solvency II. Our understanding is that, if a service margin were identified by the Board as useful information (which we question), it would not sit on top of the Solvency II liability, but merely be a separate part of the latter. In other words, the sum of Best estimate and risk margin under Solvency II would equate the sum of Current Estimate, risk margin and service margin under IFRS 4 Phase 2. Of course what we are saying here applies to the service margin as we understand it, ie it does not include any modelized profit margin that is not effectively a price paid for bearing risk of any nature.

Similarly, we wish to respond to the question asked by EFRAG in § 1.4:

> *"One of the issues that EFRAG has been discussing is whether it is appropriate to include some sort of margin in a litigation provision. EFRAG has not made its mind up on this issue, but has nevertheless also been discussing whether, if the answer to the above is 'no', there are any differences between litigation provisions and insurance claims liabilities that justify a different accounting treatment. We would welcome your views on this issue."*

[1] *« In some cases, accounting for insurance contracts has been heavily influenced by supervisory concerns. This has sometimes resulted in methods that do not clearly distinguish clearly between an accounting question (What assets and liabilities does the insurer have ?) and supervisory question (What assets should an insurer hold to give sufficient assurance of satisfying its existing obligations ?)"*

In our view, the inclusion of a market consistent risk margin in the measurement of liabilities is not an insurance specificity but rather an adequate reflection of the intrinsic difference between certain and uncertain cash flows, which in a risk-adverse environment impacts their respective valuations.

Another question asked by EFRAG is as follows (§ 1.38):

> *We would particularly welcome your views on this issue. Do you believe that settlement value and transfer value will be the same, or at least very similar, and if so why? Or, to put it another way, why might it be relevant to include in a settlement value the amount that a market participant would require to bear the risk inherent in the liability?*

Because there is no deep and liquid market for insurance liabilities, we understand the transfer value as described in the DP represents the amount required by a theoretical market participant, which in turn would have to settle the liability in full; thus we do believe that the settlement value will be reflected in the transfer value used for accounting and solvency purposes[2].

While not necessarily the only way to conceptualize it, the amount a theoretical market participant would require to bear the risk inherent in a liability is indeed a correct characterization of the value of the uncertainty linked to it, and in fact is the approach chosen in the Solvency II framework (cost of capital approach).

Independently of the reference model used, we do believe that liabilities with a similar best estimate but highly different standard deviations should not be accounted for at the same amount. In fact, because the level of uncertainty should be reflected in the accounting and because it has to be modelled anyway (cf our comment on § 1.4 above), its comparability and reliability will be enhanced by using such a market consistent framework.

As a matter of consequence, we endorse the view expressed in § 1.56 and chose alternative (c) in our answer to question 4 of the DP. However, because we share some of EFRAG's concerns expressed in *Gains recognition* § A1.31 and A.32 and *Links with other IASB projects* § A1.46 and A1.47, we are reluctant to follow the DP on day one gain recognition issues without further thoughts, comments and explanations.

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[2] See further the IAIS's Second Liabilities Paper: *"The IAIS stresses that any transfer would need to be made to an entity capable of accepting the transfer which, in the case of a regulated industry like insurance, implies that the transferee would also need to be regulated and capable of settling the obligation to the claimant/beneficiary. Accordingly, the IAIS believes that any transfer notion would be strongly influenced by the settlement obligations that the transferee would undertake.*
Likewise, if the transfer market is insufficient to enable a mark-to-market valuation then a mark-to-model approach would be used. Such a model of the value on transfer would similarly assume that the transferee would measure the liability being transferred on the basis that it would ultimately be settled rather than potentially transferred again."

Day One Gain

We acknowledge that, because the premium may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence, the measurement model put forth in the discussion paper can result in gain at inception (by which we merely mean a difference between the premium received and the exit value).

As mentioned in earlier papers or by the IAIS, CEIOPS believes that gain at inception should be allowed only if the undertaking has an appropriate and reliable risk margin.

We also wish to emphasize that the risk margin (and service margin, if any) should be risk based and unbiased and cannot be used as a plug to “smooth” profits: its calibration should be market consistent and consistent over time, regardless of potential consequences on profit at inception. Hence, observation of gain at inception should not lead to re-measurement of the insurance liability.

However, we recognize that the accounting treatment/presentation of gain at inception is linked to a number of other IASB projects, dealing with financial statements presentation and performance reporting, or revenue recognition. We understand the IASB has not yet conducted a profit recognition project that would consider appropriate treatment of day one gains.

Our reading of the discussion paper[3] is that the gain at inception would be recognized through profit and loss. We also note that other treatments exist in other IFRS, such as deferral to equity or separate liability followed by subsequent release.

CEIOPS is of the opinion that the present version of the DP does not deal with profit recognition at sufficient length and is in fact pre-empting a debate about performance reporting and revenue recognition, including the treatment of gain at inception, as well as that of premiums, changes in liabilities and other insurance expenses and income referred to in questions 18-20, which we would expect to require proper discussion and consultation. We believe that it is of utmost importance that these issues should be addressed as soon as possible so as to allow for a comprehensive standard on insurance contracts.

We do not think it is appropriate for this DP to decide on recognition of day one gains through profit and loss. The IASB should first consider a consistent treatment of day one gains across the financial sector and in other IFRS and on-going projects. We would be concerned that even a transitional discrepancy on such a vital aspect of some businesses could have strong adverse consequences in terms of competition and trump the resulting financial statements’ usefulness and understandability for users.

[3] Particularly § 85 and Example 2 in App. G, as well as wording of question 4

Policyholder behaviour and guaranteed insurability

In § A2.15, EFRAG asks a few questions about the proposed framework in taking into account beneficial policyholder behaviour and possible answers to questions 6 and 7 of the DP.

While we do not have a much clearer view on how to take into account future cash flows and particularly future premiums, we do endorse the need for an economically sound accounting standard. As a result, we support the EFRAG in supporting option (c) under question 6.

However, we are much more reluctant in opting for (b) in question 7. Going beyond economic substance, we think it is important that accounting only reflect obligations that are integral to the fulfilment of contractual obligations. We see the guaranteed insurability concept as a useful basis for developing a necessary framework that would distinguish cash flows arising under existing contracts, which must be taken into account, and cash flows arising from future contracts.

This stems from views that we could relate to the EFRAG questions as follows:

When one transfers a portfolio of insurance contracts it is almost inevitable that one transfers not only the rights and obligations themselves but also various customer intangibles. As a result, the transfer value of the portfolio includes things we would not normally wish to recognise in the financial statements, so is the argument in (b) above still a fair one?

We concur with the above sentence; hence the argument in (b) is mixing the measurement basis reflected in current exit value and recognition criteria, which should preclude accounting from reflecting features that are not part of the existing liability, but rather of the economic value of the entity itself.

In order to be able to argue persuasively for option (b), one probably needs to be able to argue persuasively that there is an economically substantive difference between renewal options and cancellation options. There is no doubt that there are differences in terms of effort etc but are there any economically substantive differences?

This is why we cannot support option (b): we cannot find a convincing way to reflect the difference between renewal and cancellation options, other than contractual features, which to us are an important characteristic of the liability. We believe it is necessary to make a clear difference between the transfer value of the company (including internally generated intangible assets) and the accounting issue of phase II which is limited to the identification of future premiums to be taken in account because they are supporting the stand ready obligations which are to be measured. This is partly why guaranteed insurability does not seem so wrong-headed to us.

Some EFRAG members believe that the answer might lie in refining option (a)'s notion of guaranteed insurability. Do you agree, and if you do what refinements do you suggest? For example, it is not just guaranteed insurability that causes policyholders not to stop making payments. What are those other reasons and how if at all should they be reflected in the accounting?

Yes, we agree. Unfortunately we do not have at this stage clear proposals on a way to refine the guaranteed insurability criterion. Reasons not to stop making payments at all will hardly be convincing if not contractual.

Entity Specific Cash Flows

We agree with the overall measurement objective of the paper. We think that the three building blocks should indeed be subject to the following three principles:

(i) market consistency

(ii) comparability

(iii) similar obligations with similar risk profiles lead to similar liabilities

In this context, we agree that inter-portfolio diversification benefits should not be reflected within liabilities (see below).

We expect more detailed guidance to be issued both within the supervisory framework under Solvency 2 and professional guidance ; while not a requirement under the IFRS framework, we recognize that the use of such guidance is not in itself contradictory with the aims of the current exit value model.

We welcome the tentative conclusion of the Board that the calculation of insurance liabilities should be market consistent. This important characteristic of the new framework should increase the comparability of accounting information across entities having similar portfolio of insurance contracts.

It is however important to analyze further this principle, especially to the extent that it would force reporting entities to replace their own expected servicing costs by those that market participants would incur.

We understand that the exclusion of entity specific cash flows may conceptually derive from the objective of obtaining "current exit" valuation of insurance liabilities and is consistent with the approach followed in the Discussion Paper recently published by the Board on Fair Value Measurement. However, we do not believe that the objective of "current exit value" for insurance liabilities should necessarily lead to the rejection of entity specific cash flow in all cases as explained further below.

Our position on the issue of "entity specific cash flows" is better explained by splitting out the different elements or facets of this issue.

First, we concur with the principle that insurance liabilities should not capture cash flows generated by other assets and liabilities or arising from synergies between the insurance liability and other assets or liabilities. We understand this as meaning that the cash outflows considered would be the cash flows strictly required to settle or transfer the obligation, i.e. cash flows that are necessary to service the obligations towards the policyholders/beneficiaries (with appropriate margins) and that would be transferable to any transferee. To this extent, the measurement would indeed not capture entity specific elements that are not strictly linked to the contracts.

Secondly, we theoretically concur with an objective that the valuation of technical provisions should be consistent with the estimates that other market participants would make. However, it can be observed that there are important practical limitations to the ability to achieve this objective and therefore believe that it needs to be further articulated instead of being presented as an absolute principle.

On this basis, we see the market consistency of measurement only as an overall objective, to be followed as far as practically possible and provided that the resulting information remains relevant and reliable for the readers of the financial statement.

It can be observed that only some variables can be estimated on the basis of *reliable* and *relevant* market data. We could agree with a principle requiring the use of available market references for variables and/or contracts that are truly common, homogeneous for all market participants as it is highly probable in this case that the market references will also be reliable and relevant for the reporting entity.

We would expect this to be the case for most financial variables (interest rates, inflation…). It could also be possible for some variables on insurance risk but only if the contracts *and* the variables present characteristics that are largely common, homogeneous on the reference market. For example, this could be applied to well diversified portfolios of common, homogeneous life contracts (on which many variables like mortality tables are readily available and reliable). Hence, this would not be possible if there are differences between the specific portfolios of the undertaking and the market references, and we understand that this is consistent with the Board's distinction between entity and portfolio-specific elements.

The fact is that relevant and reliable information on most expenses and on most insurance and reinsurance risk will typically not be available and there are not so many common, homogeneous contracts with relevant and reliable data on variables. Furthermore, it is not always practically possible to split the multiple elements intervening in the calculation of cash flows and to check the consistency of each element with market references (if they ever exist). Therefore, the objective of market consistency in valuations cannot be fully achieved in practice and could actually lead to hazardous estimations of the actual risks faced by the insurance undertaking.

In this context, we are of the opinion that the market consistency of valuation should remain as an overall objective subject to a practicality condition, i.e. that relevant and reliable market references should be mandatorily used for homogeneous contracts and variables only. Otherwise, we would expect insurers rather to use their own estimates of expenses and adjust the valuations where necessary in light of their past experience.

Also, we note that, while market cash flows are appropriate in principle, they should be used only where they are reliable, easily accessible and relevant to the liability being measured – ie they reflect identifiable characteristics that are sufficiently "homogeneous" on the reference market. Thus where market consistent, comparable and reliable cash flows are not available for reasons inherent to the portfolio, entity specific cash flows which reflect the entity's own cost structure will be considered a suitable proxy and will be favoured over artificial reconstruction of one-off "market" cash flows that would exclude too widely and strictly evidence of the undertaking's own experience in managing the portfolio.

Diversification

The following question is put forward by the EFRAG:

The DP's proposal that the benefits of diversification (and negative correlation) between portfolios should not be taken into account seems to be simple to implement, consistent with the IASB's proposal that a transfer value approach should be applied with the unit of account being the portfolio, and in line with Solvency II. But is it right? EFRAG would particularly welcome your views on this issue because it has been argued that whenever there is a diversification benefit it should be recognised, even if it results from diversification between portfolios. It is also suggested for example that insurers take such diversification into account in their modelling.

Whilst insurers do take into account inter-portfolio diversification in their modelling, we believe it should not impact the valuation of liabilities.

Our reasoning is as follows:

- the current exit value put forward by the DP, and consistent with the Solvency II framework, aims at providing an economically relevant valuation of insurance liabilities, whereby similar risks and obligations give rise to similar liabilities;

- we see the market-based principle used in the DP more as a means to that objective and that of coherence with fair value used elsewhere on insurers' balance sheets than as a goal in itself. In fact, when the DP mentions transfers (see our comments on § 1.38 above) we understand the valuation does not take into account actual transfers but a modelling basis which ensures comparability.

- In that respect, using an empty reference entity as a transferee satisfies both aims of comparability and homogeneous valuation of risks and obligations. Hence we do not necessarily see the comments in A2.31 as relevant; an actual market would either be liquid enough that in fact all transferees are comparable and maybe some market level of diversification is relevant for everyone, or adapt to each and every transaction and lose meaning.