EUROPEAN INSURANCE
AND OCCUPATIONAL PENSIONS AUTHORITY

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Response to Exposure Draft ED/2013/7 Insurance Contracts

Dear Mr Hoogervorst,

The European Insurance and Occupational Pensions Authority (EIOPA) welcomes the opportunity to comment on the IASB's revised Exposure Draft Insurance Contracts (ED).

EIOPA was established as part of the European System of Financial Supervisors to support the stability of the financial system, transparency of markets and financial products as well as the protection of policyholders, pension scheme members and beneficiaries within the European Union.

EIOPA fully supports the development of a single set of global, high quality financial reporting and accounting standards and therefore, appreciates the opportunity to provide input to the development of an international accounting standard on insurance contracts.

EIOPA notes that this ED builds on the previous consultations undertaken by the IASB in the area of insurance contracts and that the IASB seeks to understand whether the revisions to its proposals create extra complexity for users of financial statements. EIOPA is supportive of the "building block approach" for measuring insurance contracts and the unlocking of the Contractual Service Margin. However, EIOPA has some concerns regarding other aspects of the ED including:

(1) the "mirroring approach" which according to EIOPA adds unnecessary complexity and is not consistent with the fulfilment value as presented in the draft standard;

(2) when applied in conjunction with this draft standard on insurance contracts, the amendments outlined in the IASB's

Exposure Draft/2012/4 Classification and Measurement: Limited Amendments to IFRS 9 will not address all of the accounting mismatches that arise and, in places, will introduce additional mismatches. Therefore, EIOPA recommends that the IASB addresses this issue by taking a holistic approach to IFRS 4 and IFRS 9; and

(3) the ED does not satisfactorily address the calculation of the discount curve and the determination of relevant diversification benefits when calculating the risk margin.

EIOPA has provided its detailed responses to the questions raised in the ED in the attached Appendix 1.

The attached Appendix 2 outlines:

- areas which EIOPA believes should have been addressed in the ED and were not; and
- areas of the ED which EIOPA would like the IASB to address in its future consideration of the draft standard, but where no question was specifically asked.

If you have any questions or wish to discuss this further with us, please feel free to contact Ms Sandra Hack at Sandra.Hack@eiopa.europa.eu.

Kind regards,

Appendix 1

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?

1. EIOPA supports the principle that, if the Contractual Service Margin (CSM) is a margin that reports the profitability over the coverage period, then it makes sense for the CSM to be re-measured in order to reflect the profitability including changes arising from the re-estimate of future cash flows. Furthermore, EIOPA agrees with the ED's proposal to adjust the CSM for differences between the current and previous estimates of the present value of future cash flows in so far as:
   - they relate to future coverage and other future services; and
   - as long as the CSM does not become negative.
2. EIOPA has the following comments regarding the CSM:
   (a) As the CSM needs to be allocated in line with the transfer of services it is important that the draft standard is definitive to which services this is applied to. The ED defines the CSM as

   > *"A component of the measurement of the insurance contract representing the unearned profit that the entity recognises as it provides services under the insurance contract"*

   with an insurance contract being defined as

   > *"A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."*

   However, the Basis for Conclusions states in BC 26 that

   > *"The main service provided by insurance contracts is insurance coverage, but contracts may also provide asset management or other services. An entity that provides services will typically require a payment of more than the risk-adjusted expected present value of the expected cost*

> *for providing the services. Thus, the measurement of an insurance contract at inception includes a contractual service margin, which represents the margin that the entity has charged for the services it provides in addition to bearing risk..."*

It would appear that what is referred to as a "service" in the Basis for Conclusions differs from the definition that is applied in the draft Standard. EIOPA recommends that the IASB addresses this apparent discrepancy and provides more guidance on what types of "services" are captured in the CSM. Furthermore, the IASB should outline its rationale on whether or not the settlement of claims is a service to policyholders.

(b) It appears from the paragraphs 29 and 30 (c) and (d), that the amount adjusting the CSM includes the change over the accounting period in the present value of future cash flows. However, it seems from the wording that this amount includes both the effect of changed estimates and the effect of changes in the discount rate over the period. EIOPA believes it is important that changes stemming from changing discount rates are recorded separately as they occur. Otherwise, the effect of the entities' interest rate risk management will not be properly depicted. Therefore, EIOPA suggests the IASB clarifies that, in accordance with paragraphs 29 and 30 (c) and (d) the discount rate applied when calculating the present value of the estimated future cash flows at the end of the period, shall not be changed, as compared to the rate applied at the beginning of the period, i.e. the rate applied when the contract was initially recognised shall be used in the whole contract period when calculating the adjustments to the CSM.

(c) From a conceptual perspective, EIOPA sees merit in allowing the CSM to be adjusted for changes in estimates regarding the risk margin, which relate to the future. However, EIOPA understands that this may be very complex and that the costs may outweigh the benefits.

(d) In addition, EIOPA believes that the accretion of interest for the CSM adds an element of complexity that is not matched by the benefits provided to the users of financial statements.

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 fulfilment 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 fulfilment 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 (i.e. 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 fulfilment cash flows as follows:

> *(i) changes in the fulfilment 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 fulfilment 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 fulfilment 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?

3. EIOPA understands the IASB's intention to eliminate accounting mismatches, but EIOPA is not supportive of the newly introduced "mirroring approach" as the resulting liability valuation is not consistent with the fulfilment value as presented in the draft standard. EIOPA does not believe that an exception should be made on the basis outlined in the ED. The mirroring approach introduces another level of complexity and it remains unclear what the scope of the approach is and what the impact on the treatment of those cash flows would be, i.e. one would supposedly need to record different discount rates for different cash flows of one contract. EIOPA considers the approach to be difficult to apply in practice. In particular, EIOPA would appreciate an example showing how the balance sheet of an entire entity could be "mirrored" when the contractual cash flows vary directly with the performance of the entity issuing the insurance contract.

4. EIOPA believes that the mirroring approach could reduce comparability e.g. between two otherwise identical contracts for which the assets are valued at amortised cost and fair value respectively. Furthermore, insurers applying a market-consistent valuation of their insurance liabilities for regulatory purposes, as is the case under Solvency II, will have to calculate two sets of valuations for such contracts.

5. If the IASB wants to introduce the mirroring approach, EIOPA suggests using the current FASB proposals that set conditions on the use of the mirroring approach, and require timing difference to reverse and enter into future calculations of participating benefits – otherwise the calculation should reflect the contractual features. If IASB does not do this, EIOPA believes that the mirroring approach may work in a very limited number of contracts e.g. where a contract requires the insurer to hold specified

assets and provides for a 100 per cent pass-through of all asset cash flows and the actual delivery of the asset at the end of the contract.

6. EIOPA recognises that if the mirroring approach is not adopted by the IASB, an accounting mismatch for participating contracts can occur. EIOPA believes that this mismatch could be adequately addressed via e.g. using the liability valuation to drive the asset valuation method and/or by using an OCI option for potentially both financial assets and insurance liabilities.

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?

7. EIOPA supports the effort made in the draft standard to apply the revenue standard to insurance contracts. However we remain to be convinced that:

   (i) the presentation will provide meaningful data e.g. it is not necessarily intuitive that an insurer should recognise more revenue in periods where claims are higher; and

   (ii) the actual benefits of having a revenue based income statement will outweigh the cost to insurers of implementing these proposals e.g. (a) identifying and eliminating any investment component from the measurement of revenue; (b) the need to adjust the CSM when expectations change; and (c) allocating the acquisition costs over the transfer of the service in the accounting period.

8. We believe that it would be very beneficial for the IASB to undertake a large use-test on these proposals before finalising the draft standard. We further believe that it would be beneficial to include the summarised margin approach (possibly combined with volume information) within this use-test to determine which approach is more meaningful for users.

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?

9. In line with our response to the IASB's Exposure Draft ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9, EIOPA believes on balance that there is merit in reflecting interest rate changes in OCI and we can agree that this can reduce volatility in the P&L (particularly for long term contracts). However, EIOPA notes that the proposed OCI solution adds complexity to the model and does not necessarily help to better understand the economics of all insurance contracts. In particular, the mandatory use of OCI for insurance liabilities introduces an accounting mismatch when the corresponding assets are being measured at fair value through profit and loss. This would justify the optional use of OCI on the liability side to address this accounting mismatch. In the case of unit-linked contracts, which are managed on a fair value through profit or loss basis, the presentation of both the insurance liability and the linked assets at fair value through profit or loss would correctly depict economic reality.

10. EIOPA understands that the intention of the IASB introducing a third category of classification is to take into account the interaction between the classification and measurement of financial assets and the accounting for insurance contract liabilities. However, EIOPA observes that the third category as currently defined by the IASB is too narrow and therefore not all accounting mismatches will be addressed. EIOPA recommends that the IASB addresses this issue by looking at the interaction between IFRS 4 and IFRS 9 on a holistic basis.

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?

11. EIOPA welcomes the decision from the IASB to not set the CSM at zero for insurance contracts reported at transition date. EIOPA acknowledges that there will be a certain cost for entities to comply with the transition requirements but we believe that the benefit of: (i) facilitating users of accounts to assess the performance of the entity; and (ii) the greater comparability between entities over time, should outweigh the costs.

12. EIOPA believes that in terms of comparability and operational burden it would be important that IFRS 9 and the draft standard are applicable at the same time.

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.

13. As outlined above, EIOPA does not believe that the "mirroring approach" facilitates the comparability of financial statements.

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?

14. EIOPA acknowledges that the revised draft standard is more complex than the proposals outlined in the 2010 ED. We believe that the revised draft standard relies too heavily on the Application Guidance and the Basis for Conclusions to provide the reader with an understanding of the principles the IASB wants to be applied. This is particularly relevant in the following cases:
    (a) Definition of an insurance contract/reinsurance contract.
    (b) Contractual service margin (BCA113).
    (c) Risk adjustment (B76).
15. EIOPA believes that it would be beneficial for the IASB to provide guidance on how premium receivables are recorded under IFRS 4. EIOPA notes that the FASB proposals 834-10-35-11 specifically state that premium receivables are recognised as an asset.
16. EIOPA suggests that further clarity should be provided on how an entity determines the underlying assets for the mirroring approach.
17. EIOPA finds that the reference to paragraph 21 in paragraph 41(b) (iii) is not appropriate and should be removed.
18. EIOPA recommends that the second sentence of Paragraph 60(h) should be clarified in order to confirm that the requirement applies only to cash flows that are not eligible for the mirroring approach.
19. EIOPA would also welcome more detailed examples in the following areas:
    (a) Cash flows that vary but are not eligible for the mirroring approach.
    (b) How and when other comprehensive income should be used.

(c) Recognition of directly attributable acquisition costs where the acquisition costs are subsequently incurred. We would also recommend for the example to include the presentation in the statement of financial position.

(d) Determination of changes in the investment component (not previously separated at inception) when excluded from revenue recognition. We note that there are two examples in the FASB ED (Example 18 (life) and 19 (non-life)) showing the complexity of the approach.

20. EIOPA recommends that the IASB clarifies its intention regarding paragraph 3 (c) of the ED. For example, in the case of a group including: (i) an insurance entity selling insurance contracts; and (ii) a bank (or insurer with its legal meaning) selling investment contracts with a discretionary participation feature (but not issuing insurance contracts) should:

(a) this entity apply the proposals of the ED to its investment contracts with a discretionary participation feature (considering that the issuer is part of a group which includes entities issuing insurance contracts); or

(b) the issuer treat its investment contracts under IAS 39/IFRS 9, rather than under the proposals of the ED, considering that the issuer does not issue insurance contracts at its own level?

21. Similar to the points raised in paragraph 20 above, EIOPA recommends that the IASB reviews its wording regarding financial guarantee contracts and clarifies the treatment at group level.

Appendix 2

Other comments on the ED.

(1) Discount Curve

22. As outlined in CEIOPS[1]' Comment Letter to the 2010 ED, EIOPA is of the view that when discounting insurance liabilities a relevant risk-free interest rate term structure should be used to reflect the characteristics of the insurance contract liability. EIOPA notes that the current ED differs from the previous ED in that the current ED provides an option for entities to apply either a top down or a bottom up approach to measure the discount rate. Whilst EIOPA acknowledges that in theory both approaches should arrive at the same result, it is generally agreed that in reality this will not be the case. This optionality will therefore reduce comparability between entities and could facilitate earnings management, especially as the ED does not prevent switching between approaches.

23. Also the guidance on how to apply both the bottom up and top down approaches is very broad and potentially inconsistent with the principle mentioned in paragraph 25 of the ED. This would likely result in entities applying different methods in the calculation. Again, EIOPA believes that this will have the effect of reducing comparability.

24. Further to the disclosure requirements in paragraph 85 of the ED, EIOPA would welcome if firms were required to disclose the difference between the recognised insurance liability and the insurance liability's value using a risk-free interest rate.

25. EIOPA notes that paragraph 94 requires a sensitivity analysis to be provided only for market risk that arises from embedded derivatives that are contained in the host insurance contract. EIOPA prefers the wording used in the previous ED which referred to sensitivity analyses on market risk in insurance contracts in general.

(2) Disclosure of the Confidence level

26. EIOPA disagrees with the provision in paragraph 84 of the ED, which requires insurers to disclose the (implicit) confidence level when the entity uses a technique other than the confidence level technique. EIOPA believes that this type of disclosure might lead to false comparability particularly if the inputs/assumptions applied in determining the relevant figure vary across product line and across firms thereby providing inadequate answers to the investors' expectations. Furthermore, this requirement:

    (a) indirectly suggests that the confidence level approach is superior to all other methods, which would not be consistent with the Board's principles-based approach;

    (b) could be an incentive for insurers to use the confidence level to avoid two sets of calculations; and

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[1] The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) preceded EIOPA until the establishment of the Authority on 1 January 2011.

(c) means that entities subject to Solvency II will in all cases be required to make two sets of calculations.

EIOPA believes that it would be sufficient for firms to provide adequate disclosure regarding the technique used.

(3) Risk margin: Diversification benefits

27. EIOPA notes the change from the 2010 ED, which restricted the recognition of diversification benefits to the level of a portfolio. The revised ED does not limit at all the recognition of diversification benefits, which could lead to a wide array of possible risk margin calculations with potentially significant effects on the value of the insurance liability.