Andrea Pryde,
Senior TechnicalManager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

7th December 2010

Dear Andrea,

Thank you for the opportunity to respond to the IASB Exposure Draft on Insurance Contracts.

The CFA Society of the UK represents more than 9,000 investment professionals working across the financial sector. For advocacy purposes, these members are represented by committees that consider proposals relating to Financial Reporting and Analysis Committee.

Insurance contracts response from the CFA Society of the UK

Introduction

The CFA Society of the UK supports the development of an insurance standard that makes it easier to understand both cash flows (actual and expected) and risk factors, and to compare one insurer with another.
It supports the three-building block approach for long-term contracts but doubts whether a residual margin is necessary – why have two parts to the third building block?
We have some reservations about complexity, especially for short-term contracts. In this area, at least, AV 13 rings true:

> *"Insurance can be described as being paid to assume risk, reimburse insurance claims, have some internal expenses and possibly earn a financial return between the payments of premiums and claims. Presentation should, in Mr Engström's and Mr Smith's opinion, follow that structure and should, regardless of performance measurement model, allow focus on revenue earned from paid premiums and actual insurance claims costs."*

It is worth noting in this context that in Europe at least 4 in 5 people have some form of non-life insurance, whereas only a quarter have a life or private pensions product.

We also found that insurance highlights some of the trickiest accounting issues, which means the outcome here will influence future debates about the direction of standards:

- whether the concept of conservative measurement should be excluded from calculations
- how to attach a current value to liabilities when there is often no market for them
- whether marking to market, or to a market-based model, is suitable for a long-term business with substantial funds and cash flows locked in
- to what extent a company's efforts to match assets and liabilities should be reflected in the accounting
- whether there should be initial gains or losses on a contract
- to what extent accounting standards should dovetail with prudential regulation

We have not attempted to answer every question, partly because of time pressure and partly because of a lack of detailed knowledge of the insurance industry. On that basis, we could have decided against responding, but we believe that this standard provides an opportunity to make the business models and performance of insurers more comprehensible (or at least more transparent) to investors in general.

In preparing this response the financial reporting and analysis committee also sought the views of a few other CFA members with specialist knowledge of insurance.

Question 1 – Relevant information for users (paragraphs BC13–BC50)
Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

Answer:
Yes. The one caveat is with short-term contracts where, as BC 20-21 point out, the new revenue recognition standard would work (and the current premiums written/claims and benefits paid lines are useful). So do the suggested modifications go far enough in making this important part of the industry more comprehensible to investors in general?

Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)

(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?

Answer
Yes (with above proviso about short-term contracts)

(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)

(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that

liability? Why or why not?

Answer
Yes

(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?

Answer
Yes but we appreciate the difficulty of putting a number on the (il)liquidity advantage of insurance liabilities. The example provided in the presentation discussed at the ARG meeting (2.11.10) showed a barely material addition of 0.3 of a percentage point to a risk-free-rate of 5%. At the height of the crisis, immunity from a short-term funding need would have been extremely valuable eg when LIBOR rates shot up by about 3 percentage points. What price insurance against that?
The discount rate should work with the requirements of Solvency 2 and other prudential regulations. This is not to say that the rate should be dictated by prudential regulators, just that it should have the same "risk-free" building block at its base and that any liquidity premium should be aligned. Obviously Solvency 2 is a European directive. Without knowing what the common elements are in the approach of prudential regulators to this, it is difficult to comment further.

(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

Answer
There is a strongly held belief by some analysts (although a minority among those who contributed to this response) that the credit risk of the insurer should be reflected in the discount rate. The reasons for shying away from this are not necessarily good accounting ones. They reflect:
a) an instinctive aversion to encouraging insurers into a race to the bottom in pricing risk, because a lack of creditworthiness (lack of capacity to keep long-term promises) results in a gain through the reduced PV of the liabilities;
b) the related view that a heavily regulated industry is different. This means that if prudential regulators will not allow under-reserving for obligations, then equity investors are not going to get access to the returns that would theoretically be available to an insurer that factors into its pricing that it might walk away from the liabilities. But this is not unbiased accounting. It would be interesting information to see regulatory deductions from gains calculated using the insurer's cost of capital. (Something similar has been suggested by David Tweedie and others for banks when they are required to build up economic cycle reserves);
c) the attractions of being conservative when valuing liabilities. Using the risk-free rate arguably gives a worst-case liability value, which we do want to consider. But, again, it goes against neutrality in accounting and does not reflect the economic reality. These liabilities are backed by companies, not the government, so the RFR looks too low.
d) other examples of risk-free-plus. In pensions accounting, the AA corporate bond rate is used, which does adjust for corporate rather than government sponsorship. (But there is also a push in pensions accounting towards a risk-free rate.)

In the group that contributed to this comment, the risk-free rate had more backing than the "own credit" rate. This was partly related to conviction about the nature of the liabilities and partly because respondents were unconvinced by suggestions so far for "tagging on a bit" to the RFR. If the RFR and own credit are two extremes, it would be useful to see both, even if the number that goes in the main statements is a modified version of the more popular RFR.

Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)
Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

Answer

We are not convinced of the need to split up the margin, which is effectively the reward the insurer gets for assuming the risk that the cash inflow/outflow equation will turn out worse than expected.
Much of the risk calculation should be taken care of in the probability weighting exercise in the first building block – the expected cash flows.
It is possible, especially if a risk-free discount rate is applied, that by the time a risk margin is applied there will be an initial loss. There might also be circumstances in which there would be an initial gain (if the risk margin is rigorous and consistent, rather than spongey). So be it.
FASB's composite rate may be a pragmatic approach to the profit margin (it's all residual margin after the first two building blocks). We have some sympathy with this view, but a risk margin looks like a more rigorous measure that would provide more useful information.

Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)

(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?

Answer

This is rather theoretical since there often is no market for the liabilities. Having said that, there is no simple alternative in what has become a sophisticated "mark to model" calculation, starting with the first two building blocks. So this step provides helpful information in attempting to capture the uncertainties, sensitivities or odd dispersions that were not adequately captured in the probability weighting exercise. (Providing the fan chart around falsely precise forecasts.) One way of looking at the market value stipulated in this question might be to assume that the profit margin built into the customer consideration, or policy payment, is designed to provide break even in the light of these other uncertainties. That way you do not need a residual margin and you would not have a profit or loss at inception. An insurer could, however, still decide the profit number and work back from that, albeit with a lot more transparency around the pricing of risk. The retesting of the calculation at reporting dates does provide an important check (and corresponds with the mark-to-market measurement of the assets).

(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not,

what do you suggest and why?

Answer
These techniques look as though they would cover the uncertainties listed in the answer above. If a convincing case is made for any other technique, then it would presumably be considered. But to avoid complexity and aid comparability, it is helpful to have some common discipline imposed. Preparers are rarely shy about putting forward alternative calculations where they think it helps explain what they are doing.

(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?
(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

Answer
Yes

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

(a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?

Answer
We would expect this to be rare (normally the margin would be calibrated to the receivable), and for the insurer to be wary of declaring such a gain because it would be pored over by analysts. But if that is the number that pops out of a rigorous calculation, applying common standards, so be it.
Should it be recognised immediately or spread forward? It is easier to identify and challenge it if it is taken immediately as a one-off gain/loss (like a fair value gain on an acquisition or an impairment loss).
One aspect of the dual approach to the margin is that profits are declared partly in the relatively smooth form of amortisation over the coverage period and partly as gains/losses on remeasurement. Is this economic reality or does it allow preparers to take the edge off the volatility of marking to current market conditions?
In a long-term business, short-term changes in market value are less relevant. But if the assets are being marked to market, then doing the same with the liabilities tends to counter the volatility in those prices and reflects insurers' efforts to match assets and liabilities.
In the long-term life and savings business, having a risk margin that is remeasured provides useful information. But bearing in mind the locked-in elements of the contract, we can also see the argument for releasing profits over the coverage period, with the over-ride of actual claims/benefits patterns.
[Apologies for the ambiguity/lack of clarity of this answer: we have not had time

to form a clear view on how profits should be taken.]

(b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?
(c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?

Answer
Yes

(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?
(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?
(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)
Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

Answer
How easy is it to separate incremental from other acquisition costs? Wouldn't it be simpler to apply the same rule as in par 59 of the revenue recognition ED ie the costs of obtaining a contract should be expensed as incurred?

Question 8 – Premium allocation approach
(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?

Answer
This is the minimum that should be done to simplify accounting for short-term insurance contracts. The existing composite margin measure of underwriting performance has not outlived its usefulness, we note that that information will still be disclosed. We have some sympathy for the alternative view (AV 12 and 13) on this.
Whatever is settled on should be required, for the sake of comparability.

(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

Question 9 <u>– Contract boundary principle</u>
Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

<u>Answer</u>
This looks like a reasonable approach in a minefield of different contract features.

Question 10 – <u>Participating features</u>

(a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?
(b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?
(c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?
(d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

Question 11 – Definition and scope

(a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?
(b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?

<u>Answer</u>
Yes

c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

<u>Question 12 – Unbundling</u>
Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

<u>Answer</u>
This sounds similar to unbundling criteria used in other standards. A consistent approach is sensible.

<u>Presentation (paragraphs 69–78 and BC150–BC183)</u>
Question 13 – Presentation

(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?

Answer

This is difficult to comment on without going through several examples converting familiar statements into the new format. The presentation would be simpler without both risk and residual margins. As noted above, for the short-term P&C/general business we are not convinced that consigning premiums written and claims paid to the notes is an improvement.

(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

Answer

Yes

Disclosures (paragraphs 79–97, BC242 and BC243)

Question 14 – Disclosures

(a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?

Answer

Paragraphs 79-84 look sensible and cover the main principles.
The reconciliations would be simpler without a residual margin.
Is paragraph 90 necessary? Why not just add to 85 (b) "and the main sensitivities of those methods and inputs"?
And instead of pars 91-96, could there not be an 85c requiring disclosure of other risk exposures.

(b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?
(c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

Answer

On the discount rate, if the wide range of strongly held views persists, it might be an idea to disclose the two ends of the spectrum: using the RFR and the company's current cost of debt.

Question 15 – Unit-linked contracts

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

Question 16 – Reinsurance

(a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?
(b) Do you have any other comments on the reinsurance proposals?

Question 17 – Transition and effective date...

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

We hope that these comments have been useful and would be pleased to provide additional feedback in future.

Yours,

Jane Fuller, Chair Accounting Advocacy Committee

Will Goodhart, Chief Executive