Exposure Draft 5 – Standard on Insurance Contracts (phase I)

ISVAP Remarks

General aspects

- We would like to point out that – in spite of IASB's intentions – the standard may imply the necessity for undertakings to bring about significant changes to their accounting practices. Certain provisions, such as those pertaining to embedded derivatives, have a significant impact at the level of systems used. Considering the short term envisaged for implementing the standard, it is important that the required changes are really limited during phase I, and that in any case the re-organisation processes required are not made obsolete by subsequent reviews made in application of the final phase of the project. Therefore it would be useful in phase I to focus on aspects which are actually relevant, reasonably feasible and really definitive.
- The provisions of the ED5 do not define any method for the measurement of insurance liabilities and, at the same time, let the undertakings free to depart from the existing measurement practices. We believe that this approach is not consistent with the need for reliability and comparability of the financial information of a regulated sector. From a pratical viewpoint, this problem appears even aggravated considering the whole set of rules to be applied on insurance entities during phase I More specifically, the problem of asymmetries in the valuation of assets and liabilities arising in some jurisdiction from the application of IAS 39 on financial instruments covering technical provision, can force the company to change the existing practices for the measurement of insurance liabilities and can lead to the use of a variety of accounting practices which do not ensure reliable valuations and the comparability of financial statements even within the same jurisdiction.
- The use of the principle-based approach in the drafting of the ED5 is consistent with the need for flexibility and discretion in the application of the accounting standard; nonetheless – failing adequate application experience – the uncertainties that can arise (which are only partially offset by the indications contained in the *Implementation Guidance*) and the options contained in the ED5 may lead to significant application problems which may be difficult to solve within the very short terms envisaged for the use of the IFRS in Europe.

Questions

1. Scope

1.a

- The contractual approach which is used in defining the scope of IASs is acceptable to the extent that it does not lead to inconsistencies in the treatment of assets and liabilities of one entity.
  On the contrary, the application of IAS 39 in its present version to assets representing technical provisions could lead to asymmetries in the measurement

of insurance companies' assets and liabilities which are incompatible with a true and fair view of their financial situation. In phase I the treatment of these assets should be consistent with that of liabilities even if the latter, as it is the case in many jurisdictions, are measured on the basis of the amortised cost.

More flexibility in the possibility to use the *held to maturity* (HTM) category envisaged by IAS 39 could be an adequate solution for this problem in jurisdictions where insurance liabilities are presently valued according to methods based on the amortised cost.

EFRAG’s draft letter of remark proposes a solution in that sense, but it still seems not sufficient to solve the problem. In fact, for the purpose of allowing an appropriate management of financial instruments covering technical provisions it seems necessary to take account of all the risks which “drive” the ALM strategy, and not only of insurance and surrender risks. In other words, during phase I insurance undertakings should be allowed to use the HTM category for all fixed maturity financial instruments covering technical provisions, provided that they give evidence that their management is closely linked, even in terms of financial risks, to that of liabilities, and that any trading is the consequence of the correlation purposes.

This "relaxation" of IAS 39 rules, besides being subject to strict conditions, should be limited in time, because it should be granted only during phase I, and in scope, because it should apply only to entities issuing insurance contracts and only to assets covering technical provisions related to those contracts.

1.b

- No comments.

2. Definition of insurance contract

- In phase I the substantial difference in the treatment of insurance contracts vis-à-vis investment contracts makes the drawing of a boundary line between the two contracts very delicate. Although the concept of *significant insurance risk* seems reasonable from the viewpoint of materiality and elimination of arbitrage, it may imply excessive uncertainties in its first application.

  To limit this problem it would be preferable that, at least until phase II is defined, this concept be replaced in the definition by that of *any insurance risk*. However, the replacement should concern only insurance companies (and only phase I), so as to avoid arbitrage risks connected with the possibility that other types of entities can shirk the application of the appropriate accounting standards by artificially adding insignificant shares of insurance risk to other types of contracts.

  In short, the definition of insurance contract should be supplemented with a temporary provision enabling the undertakings authorised to issue insurance contracts in their jurisdictions to keep on classifying the insurance contracts (with any insurance risk) issued during phase I as such, regardless of the significance of the insurance risk connected to the contracts. This provision would eliminate said interpretative problems without introducing excessive arbitrage risks.

- We think that the *pure endowment* contract (see example 2.4 IG) is an insurance contract, for the payment of the benefit depends on the survival of the insured. The fact that this contract generally has a considerable financial component connected to the deferment of the benefit does not seem relevant at all to consider it an investment contract, as proposed in the IG. From a theoretical and practical viewpoint it is not acceptable to refer to the actual probability of survival of the insured in the cases specified in order to recognise the insurance contract, as the IG seems to maintain. Furthermore, from a technical viewpoint a life annuity – which is clearly considered an insurance contract in the IG – is merely the sum of various pure endowment contracts.

- It could be useful to introduce a definition of insurance risk with a more concrete content than that proposed in ED5. A definition of insurance risk based on the essence of the risk for this activity, i.e. the possible differences between expected and actual probabilities within a *pooling-of-risks* framework, could help clarify for instance the *pure endowment* issue. Indeed, the insurance risk is not the possibility that an uncertain event occurs, but the possibility that the estimate of the frequency and average cost associated to that event differs from the actual cost of claims of the relevant pool of risks managed by the company. According to this approach we would have to do with an insurance contract every time that to evaluate the benefit of a contract it is necessary to make an estimate of the frequency and/or the average cost of the uncertain event defined in the contract.

3. Embedded derivatives

3.a

- We agree on the principle that the options contained in contracts which may have a significant impact on an insurer's commitments must be recognised in the valuation of liabilities. However, the fair valuation of these options is not the only way to deal with this issue.
  In any case, on the basis of the examples contained in the IG and considering the wide range of possible options in an insurance contract, unbundling and valuation at the fair value seem sometimes actually onerous and unproportional to the advantages in terms of transparency in valuation (see the example under 2.6 IG). It should be considered that the most significant options (not connected to survival) contained in life assurance contracts are those relating to the minimum interest in case of surrender, which are explicitly excluded by ED5 from the unbundling obligation. Therefore, taking also into account the need for application experience, it would be preferable not to introduce this requirement in phase I or to refer it only to derivatives that can have a relevant impact on the representation of the company's economic reality.

3.b

- We agree.

3.c

- The fair value of non-unbundled embedded derivatives cannot be disclosed if there is no definite model of fair value of insurance liabilities (see 10).

3.d

- See 3a.

4. Temporary exclusion from IAS 8

4.a

- In line with the general approach of phase I we agree on the exemption from IAS 8 (paragraphs 5 and 6). However we do not believe it appropriate to envisage a sunset clause for this exemption. In fact this exemption is the only viable solution pending the definition of phase II: as soon as this phase is defined it will apply to undertakings and all the provisions in phase I, including this exemption, will automatically be superseded without any need for a sunset clause. If a sunset clause is envisaged then we would run the risk (a significant risk, since the definition of phase II could take a long time) that in 2007 undertakings will have to follow a "draft" standard and not a defined one.

4.b

- As we said in our comments to the *Issues Paper*, we believe that equalisation and catastrophe provisions should be considered as liabilities when they meet specific technical requirements. This belief is based on the same considerations described in paragraph IG 47 with regard to catastrophe provisions, where the need to give adequate disclosure to low-frequency, high-severity risks is discussed. We believe that the definition of liabilities provided by the "framework" should be amended to take into account the need to recognize as liabilities this type of provisions in relation to risks which need a multi-year period for completing the insurance compensation process.

5. Changes in accounting policies

- This opening to a fair value model, which is not adequately defined, may lead to a lack of comparability, even between undertakings of the same country, a difficult intelligibility of accounts and competition problems. This situation is made even worse due to the afore-mentioned problems of asymmetry in the valuation of assets and liabilities which, in the jurisdictions where liabilities are valued at their amortised cost, would force undertakings to depart from existing policies. Therefore we strongly believe that any possibility to change the accounting policies during phase I should be allowed only when the "target" policy is clearly defined and clear conditions for the change are provided.
- The conditions envisaged for the change are "asymmetrical" where only "excessive" prudence is mentioned and not "sufficient" prudence as well.
  The loss recognition test, as stated in paragraph 11 of the ED5, does not seem to necessarily require a margin for the risk and the uncertainty in the valuation of liabilities (contrary to what stated in BC 79). In the lack of any other reference the general principle of prudence indicated in the framework is applied, which we do not consider sufficient in light of the particular measurement problems relating to the accounting of the insurance operation.

6. Unbundling

- Adequate guidelines for the application of the unbundling principle are still lacking. Although in case of "financial reinsurance" the concept of unbundling of merely financial components is quite clear and acceptable, it is not as clear when unbundling is required in the case of insurance contracts. However we believe that only clearly distinguished contracts should be unbundled, i.e. those contracts where the financial component is clearly an autonomous part, also from a commercial point of view. In fact (life) insurance contracts always include a more or less considerable financial component related to the time distance of aleatory benefits. These components are integral parts of the contract and therefore cannot be unbundled.

- In the definition of the condition for “not unbundling” (paragraph 7) there is an unclear asymmetry in the explanation of the notion of influence among flows.

7. Reinsurance

- We understand that the purpose of these provisions is to eliminate the misleading effects on the accounts of certain types of reinsurance contracts; nonetheless we believe that these provisions may be more organically defined in phase II of this project.

8. Business combination

- This provision may be difficult to apply pending a clear definition of fair value for a liability.

9. Discretionary participation features

- We believe that the provision of par. 25 is acceptable because it allows, under certain conditions, the use of existing practices for this type of contracts, postponing the definition of their treatment to phase II. In this perspective, however, we think that during phase I it would be more appropriate to extend all the requirements applying to insurance contracts also to financial contracts with discretionary participation features (temporary exemption from other IFRSs, loss recognition tests, etc.). In other words, they should be dealt with as they were insurance contracts under any aspect.

10. Disclosure of the fair value of insurance liabilities

- This provision is not acceptable. It is difficult to apply pending a definition of fair value of insurance contract and before making appropriate application tests. Also with regard to disclosure, any information not based on well-defined requirements may be misleading or be the cause of discrimination.

- Besides the statements of the previous indent we deem the request for indication of fair value in non-unbundled derivatives excessively onerous and difficult to apply. We would consider an adequate description of the risks connected to those derivatives as sufficient (see 3c).

11. Other disclosures

- Some provisions concerning disclosure are difficult to apply in case of consolidated accounts. A mitigation in the number and detail of the requirements would be necessary when groups are considered.
- Disclosure requirements are numerous and important, but lacking more precise indications on application or interpretation aspects we risk missing the objective of comparability.

- In general disclosure requirements for risks arising out of contracts should be presented in a way that is consistent with the risks resulting from related assets. The mere reference to IAS 32 does not seem sufficient to clarify this requirement. It is necessary to explicitly require that the risks to which an undertaking may be subject are illustrated on the basis of the overall financial situation (especially in case of sensitivity tests).

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