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Preliminary Comments by the European Insurance Industry on IAS 39

The IASB is currently undertaking extensive studies on the improvement of IAS 39 on Financial Instruments: Recognition and Measurement. At the same time, it is shaping the reporting environment of European insurance companies within the project to establish a Standard on Insurance Contracts. The current developments will substantially change the framework in which the European insurance industry works. European insurers would therefore like to give their preliminary comments on this important matter and, at the same time, would like to encourage the IASB to facilitate an open and in-depth discussion and analysis. Furthermore, it will be essential that – before the final Standard will be established – field-tests should be run in order to assess that the solutions are appropriate and workable. The IASB should then be able to provide industry with appropriate and field-tested application guidance well before 2005.

To facilitate the discussion, CEA has drafted this first comments. A more detailed analysis will follow.

1. Definition and classification of insurance contracts

At its meeting on 23 - 25 October 2002, the Board tentatively agreed that "a contract under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary."

The Board agreed:

(a) "to use this definition of insurance contracts throughout IFRSs;

(b) to change all scope exclusions in IFRSs that refer to 'insurance entities' to 'insurance contracts' (for example in the scope exclusions contained in IAS 18 Revenue, IAS 32 Financial Instruments: Disclosure and Presentation, IAS 37 Provisions, Contingent Liabilities and Contingent Assets, IAS 38 Intangible Assets and IAS 39 Financial Instruments: Recognition and Measurement);

(c) to define a reinsurance contract as an insurance contract issued by one insurer (the reinsurer) to indemnify another insurer (the cedant) against losses on an insurance contract issued by the cedant;

(d) to remove from IAS 32 and IAS 39 the scope exclusion for derivatives based on climatic, geological, or other physical variables (commonly known as weather derivatives). Such contracts would then be subject to the IFRS on insurance contracts if payment is contingent on an uncertain future event that adversely affects the contract holder, and subject to IAS 39 in other cases."

CEA comments:

- ***Appropriate guidance for application of that definition is needed: e.g. how to determine whether the insurance risk is significant or not?***

- ***The definition of reinsurance contracts does not reflect all kinds of reinsurance contracts.***

Furthermore, the staff suggests that credit insurance should be excluded from insurance contracts because it covers the credit risk, even if the event triggering the payment adversely affects the policyholder.

CEA comment:

This is not consistent with decisions regarding climatic derivatives.

2. Measurement of contracts sold by insurance companies and classified as investment contracts.

At its meeting on 12 - 14 November, the Board concluded that no further application guidance to IAS 39 was needed.

CEA comment:

> ***There are many issues not specifically addressed by IAS 39 which have not yet been considered by the Board:***
>
> - ***amortised cost basis valuation / fair value***
> - ***renewals option***
> - ***policyholder behaviour and management intent***
> - ***separate account business with minimal guarantee***
> - ***performance linked investment contracts (to be addressed in the same way than insurance contracts with performance - linked features).***

3. Unbundling of investment and insurance components

The Board agreed tentatively to unbundle deposit-like components from insurance contracts if the cash flows from the insurance component do not affect the cash flows from deposit-like components.

CEA comments:

- ***Until the Phase II project is decided, the requirement for unbundling is not appropriate.***

4. Embedded derivatives

Under IAS 39, embedded derivatives must be bifurcated and accounted for separately from a host contract if certain conditions are met. In November 2002, the Board agreed to make some modifications to IAS 39 improvement Exposure Draft.

CEA comment:

> ***Until the Phase II project is decided, the requirement for embedded derivative bifurcation is not appropriate, particularly for insurance contracts which will be accounted for under local GAAPs during Phase I.***

5. Transaction costs

The IASB has recognised that the transaction costs for some long-term contracts are proportionately much larger than for most other financial instruments. In addition, the revised definition of transaction cost under the proposed Exposure Draft of improvements to IAS 39 excludes all internal costs, including transaction commissions paid to employees.

CEA comment:

> ***IASB has not yet considered the implications for contracts sold by insurance companies.***
>
> - ***The external / internal costs distinction would lead to misleading treatment, whether the contracts are sold through external agents or internal networks.***
>
> - ***This distinction for investment contracts should be in contradiction with the acquisition costs as defined in most GAAPs and which would be in force during Phase I for insurance contracts.***
>
> - ***IAS 39 does not include any provision on acquisition costs with respect to the renewals of contracts.***

6. Classification and measurement of financial investments held by insurance companies.

The Board has agreed that it should not create a new category of financial assets (financial assets held to back insurance liabilities) that could be held at amortised cost.

CEA comments:

- ***This decision would lead to a mismatch between assets and liabilities creating undue volatility in shareholders' equity or insurance.***

- ***This decision is, furthermore, not relevant with the substance over form approach, which should lead to recognising assets and liabilities management, which is one of the unique features of insurance business.***

- ***Several solutions have been proposed (to create a new specific asset and category or to recognize the need for "Shadow accounting" for instance). However the industry senses that finding ways of allowing Held To Maturity accounting according to Asset Liability Management constraints could be a relevant practical and convenient solution. It would answer the industry's concerns without requiring excessive amendments to IAS 39***

7. Hedge accounting

***CEA comments*:**

- ***The application of IAS 39 with regard to hedge accounting would lead to misleading results, as it does not take into consideration the real policy of hedging by insurance companies. Especially with regard to:***

  - ***Hedging of Held To Maturity investments.***
  - ***Portfolio hedging***

- ***Managing assets and liabilities is the essence of managing insurance companies. Optimization of Asset Liability Management relies on macro-hedging whose accounting is hindered by IAS 32-39 and its exposure draft: the option of accounting for the hedged and the hedging instruments at fair value – although interesting in a pure academic approach – cannot be computed since***

  - ***some components must be accounted for according to amortized cost and***
  - ***some insurance contracts during Phase I will be accounted for according to local GAAPs.***

8. Own credit risk

Paragraph 100 of IAS 39 requires including the creditworthiness of the debtor when valuing a financial investment at fair value.

***CEA comments*:**

Under the hypothesis that investment contracts sold by insurance companies would be measured at fair value, that would cause confusing and counter-intuitive results not reflecting the characteristics of the insurance business.