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Re: Discussion Paper *Preliminary Views on Insurance Contracts*.

Dear Mr. Clark,

We are pleased to provide our comment on the "Discussion Paper *Preliminary Views on Insurance Contracts*".

The goal that the DP on insurance liabilities has set itself can truly be defined as epoch-making. It is attempting to introduce into insurance a valuation approach that would make regulation for the sector as similar as possible to that for the financial sector.

We believe that this goal can be achieved provided that the specific nature of insurance is not ignored, that is to say, its distinctive features must be respected. However, we feel that, at various points, the DP suffers from the need to try to unify regulation at any price, extending it to the insurance sector while ignoring its specific characteristics. The result of this is that for several key points of the DP the solutions proposed appear to be wholly abstract and remote from the realities of the insurance sector.

First, there is the notion of current exit value, in which we detect the attempt to adapt the fair value principle and concept to insurance liabilities, but which in our opinion cannot ignore the need to adopt "entity specific" data whose use is necessary, in the insurance sector, given the absence of a liquid market of reference.

Consequently, second, there is the ban on using the specific data of each entity, that is the insurance historical time series data for each individual insurance firm, on which are based both the premium expectations and the cash flows for the entity, and, therefore, which the valuations of the liabilities cannot ignore.

Third, there is the concept of unbundling – already widely introduced and accepted in the current IFRICs where the financial element predominates over the insurance one – which is now to be extended also to those cases where the insurance element is predominant; this without any real gain in terms of information (both elements are valued at fair value) and, moreover, without valuing the costs of the unbundling.

Another aspect concerns the decision regarding the recording of profit at inception. In this case, in the context of a brave but acceptable decision to enhance transparency – that is of recognizing the profit right from the outset, that is, well before the insurance contract has run its course and shown whether or not there is a profit (a decision that we support in any case) – it seems to us that attributing it to the balance sheet, rather than the income statement, provides users with same information and does not suffer from the imprudence of attributing as a given to the income statement something which will become so only, and possibly, in the future.

Last, with regard to constructive obligation, the opportunity could be taken to explore more thoroughly the separate elements that make it existent in an unequivocal way.

The various issues are addressed in more detail as follows:

1. Current exit value.

The criterion of current exit value for valuing insurance liabilities is an attempt to adapt the fair value concept to insurance liabilities. However, it suffers from great ambiguity in its definition and, **unless it is interpreted as a best estimate based on internal data and including a risk margin (and therefore, related to a real economic value)**, it does not seem to offer the best solution in seeking to attain the information objective of the financial statements as per the Framework.

The reference to average market data cannot generate a true and correct accounting view because, first and foremost, there is no liquid market where significant insurance portfolios are exchanged, that is, where the risks of the contracts and portfolios can be correctly priced. The average market data that would need to be referred to are completely hypothetical and would end up in a totally abstract valuation.

It is necessary to repeat: for a true and correct definition of cash flows, it is necessary to adopt specific data that are deemed to reflect more fully the reality of the entity compared with market averages.

2. Entity specific approach

In valuing insurance liabilities, especially in the field of damage insurance, it is not possible to ignore the historical series data of the entity and therefore of the company's specific risk.

It is these series that enable the most appropriate information to be provided to users precisely in regard to future cash flows.

It is essential that this principle be considered in the building blocks concerning the estimation of the cash flows and the definition of the risk margin.

3. Unbundling

Where the deposit element of the contracts is significant, this already leads to separation under the existing IFRS.

However, the DP is referring to insurance contracts where the insurance element is significant and therefore the financial one is not. Both elements are measured at fair value, they are interdependent, and their separation could only be made on an arbitrary basis. Thus, we do not see the need to separate them.

4. Profit at inception

Implementation B provides for the recognizing of a profit at inception on the basis that all the contract assets and liabilities are appropriately valued. Prohibiting such a recognition would result in an unreliable representation of affairs (the profits would be included in the liabilities). While we accept the approach relating to implementation B, we nonetheless believe that the profit at inception should be recognized in the balance sheet, so reflecting the contract duration and respecting the release of risk.

5. Constructive obligation

Clearly, the estimates of future cash flows must take into account the legal obligations to pay dividends to the policyholders.

However, it is necessary to define better the terms of the constructive obligation with regard to insurance contracts. In our opinion, a constructive obligation must always be based on a constant and homogeneous practice where no resolution by the board of the entity is made known to third parties.

Questions

1.
Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?
Yes, the criterion proposed for the recognition and derecognition of insurance contracts is consistent with those underlying IAS 39.
However, there is a need to examine more thoroughly the consequences that the proposed criterion could open up for insurance contracts where the risk arises at a moment following the signing of the contract. Furthermore, the event to be recognized is not always linked to a counterpart. In such cases, there should, as in IAS 39, be the options of immediate and subsequent recognition.

2.
Should an insurer measure all its insurance liabilities using the following three building blocks:
(a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,
(b) current market discount rates that adjust the estimated future cash flows for the time value of money, and
(c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)? If not, what approach do you propose, and why?

Yes, the three building blocks are reasonable. However, we would suggest the following:

- to consider the estimates of the portfolio cash flows using the entity-specific estimates obtained at portfolio level and not market-consistent ones, as this latter reference does not exist;
- consequently, to add together with the "probability-weighted" approach also that of the portfolio;
- to limit the third building to risk margin alone. Is there a basis for distinguishing the profit from a service correlated to the core business? We do not consider there to be a basis for calculating the margin of a future service at the outset when the fee is implicit, and when explicit, it would increase the arbitrariness of the calculation.

Going into specifics, it seems clear to us that in the damages sector it would not be possible to determine the service margin because:

a) the premium is all inclusive for the risk;
b) the service has no autonomy of its own;
c) there are no services that are independent of risk.

In respect of life assurance, it should be noted that the cash flows from additional services are already included in the best estimate and, therefore, it is not necessary to make, as regards the third building block, a distinction for that amount.

3.

Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

We would comment with reference to the individual points of the guidance provided for determining cash flows and risk margins:

- There is no risk portfolio market that is able to determine the coherence with the expected margin in the case of the transfer of rights and obligation to third parties or, in any event, the market data are seldom available. We suggest including the reporting data of each entity.
- Consistent with the philosophy underlying the IASB project, we believe that the DP should follow the principles-based approach and, therefore, should contain only guidelines.
- In our opinion, the intermediate solution – halfway between the guiding principles and the guidance notes – is not acceptable as it "says yet does not say", leaving room for the possibility of various interpretations (with effects on the comparability of results) that would all, at the same time, be possible and consistent with the IAS principle.

4.

What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.
(a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.
(b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?
(c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.
(d) Other (please specify).

The solution indicated in c) would be the most appropriate one, where at stipulation a reliable risk margin has been included in the valuation of the insurance liability.
We suggest exploring further the hypothesis of allocating the profit at inception to net worth, defining the criteria for the transfer to the income statement on the basis of the release of risk.

5.

This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.
(a) Is that measurement attribute appropriate for insurance liabilities. Why or why not? If not, which measurement attribute do you favour, and why?
(b) Is 'current exit value' the best label for that measurement attribute? Why or why not?

First, we would suggest replacing the term current exit value – an expression that in itself indicates the difficulty of identifying a fair value that cannot exist in the absence of a market – with that of best estimate. In our opinion, it is essential that the measurement take into consideration also the entity-specific factors that always influence any external valuation, for which are noted the prices and quality of the risks to be transferred, the speed of liquidating the claims reserve, etc.
Last, it is necessary to clarify the concept of future premiums together with their indication.

6.
In this paper, beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:
(a) incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?
(b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?
(c) not recognise them? Why or why not?

7.
A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?
(a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.
(b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?
(c) All cash flows that arise from those terms of existing contracts that have commercial substance (ie have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).
(d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.
(e) No cash flows that result from beneficial policyholder behaviour.
(f) Other (please specify).

The proposal to identify in the future behaviour of the policyholders "beneficial" contracts compared with "unfavourable" ones would create significant operational problems and it would be open to abuse through "accounting engineering", for information that is often not significant.

The fundamental question is the following: Does the insurer have the power to constrain the policyholder to pay those premiums? If the answer is no, the insurer should not recognize the expected net economic benefits of future premiums.

8.
Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

The initial acquisition costs should be recognized entirely and separately in the income statement, so that the insurance liability would highlight solely the cash flows for claims.

9.
Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

We agree with the approach proposed.

10.
Do you have any comments on the measurement of assets held to back insurance liabilities?

For assets held to cover reserves, the current IAS valuation should remain as is.

11.
Should risk margins:
(a) be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?
(b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?

a) Yes, the valuation can be based on a portfolio of insurance contracts with the characteristics laid down in IFRS 4.
b) In regard to the issue of diversification, it is important to note how this aspect should, in our opinion, be considered both at the level of the individual portfolio and between portfolios of products that are not homogeneous to one another. Concerning the effect of diversification within the individual portfolio, there is a clear need to take it into account for valuation purposes, in this way properly reflecting one of the key principles of insurance, that is, the principle of mutuality among homogeneous risks.

12.
(a) Should a cedant measure reinsurance assets at current exit value? Why or why not?
(b) Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?
(i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.
(ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.

(iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

a) The approach proposed for reinsurance assets is acceptable and it is consistent with the approach indicated for the relative insurance liabilities.
b) Given the response to a), the responses to the questions in b) are in the affirmative.

13.
If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?

In the abstract, the principle of unbundling is correct. However, there are significant problems in its application:
a) The difficulties and costs of the unbundling operation are not balanced by the resulting information benefits, as indicated in the Framework.
b) Where it is significant, the deposit component of contracts is already separated as the contract is not considered an insurance contract.
However, where said component is not significant, we do not understand the need for unbundling as the valuation of both components is at fair value (with no further danger of accounting arbitrage). Moreover, any unbundling would create enormous problems in identifying the correlated costs.
c) We do not agree with the unbundling of the service margin, as explained in our response to question 2.

14.
(a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?
(b) Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?

We do not agree with the approach proposed. In the measurement of insurance liabilities, there should be no reference to the insurer's creditworthiness. This is because:
a) the transfer of insurance contracts – for which, we would repeat, there is no market – results in the transferring of the contract to a new entity that will have a relationship with the policyholders (the creditworthiness of the transferor is not relevant for the purposes of managing the contract);
b) there being no market with prices for the contracts, any change in creditworthiness will have no effect either positive or negative on the insurer.

15.
Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

The differences between the requirements of IAS 39 and IAS 18 with insurance contracts should be retained. They are justified by the different nature of insurance contracts and by the consequent fact that the matters concerned apply solely to insurance contracts.

Moreover, the possibility of accounting arbitrage, a danger to be avoided, would only arise in the case of unbundling, but the solution found – significance and non-significance of the financial component – already permits arbitrage to be avoided (see response b) to question 13).

16.

(a) For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?
(b) An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247–253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?

a) We agree with the approach to consider in the estimates of cash flows the legal obligations, deriving from the contract, to pay dividends to the policyholder.
On the other hand, constructive obligation needs to be better defined and limited in its distinguishing elements in order to transform it de facto into a legal obligation. To this end, the following elements are, in our opinion, necessary:

- a formal decision by an internal organ of the entity;
- a consequent continuous and homogeneous practice that has de facto created a valid expectation. For example: one year of payments is not sufficient to create an expectation.

17.

Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?
(a) Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).
(b) Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).
(c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).
(d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).

Yes, in the cases listed, we agree with acting to eliminate mismatching as per points a) to c). On point d), we would welcome further study in order to clarify its significance.

18.

Should an insurer present premiums as revenue or as deposits? Why?

As said with regard to unbundling, if the deposit component is below the threshold of significance, all the premium should be considered revenue; above it, the deposits will be separated from the revenues (which will be net).

19.

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

IFRS 4 already provides numerous indications of the information that insurance companies should present in their financial statement disclosures. In this regard, we agree with the principles-based approach of IFRS 4 and the option given to insurance entities to present additional information either directly in the income statement or in the descriptive part that accompanies the financial statements.

20.
Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

No, the income statement should not include all the revenues and all the costs arising from changes in insurance liabilities where the profit at inception may go to the balance sheet.

Yours sincerely

Prof. Angelo Provasoli
(OIC – Chairman)