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Re: IASB Exposure Draft *Insurance Contracts*

We welcome the opportunity to comment on IASB Exposure Draft *Insurance Contracts (*the ED in the letter*)*.

The IASB's Exposure Draft "Insurance Contracts" is an important step forward in finding an internationally agreed approach to the valuation of technical provisions and to the presentation of information on insurance contracts.

Before examining the details of Q&As, it is important to highlight the main critical issues emerged from the ED.

– ***Business model***
  While we are fully committed to the IASB's efforts to face the complexity of the insurance business, we believe that some changes to the ED are essential in order to fully encompass the insurance business model. Thus, we look forward to seeing further steps to address completely the correlation between assets and liabilities, that is typical of the insurance business.

– ***Accounting mismatches***
  As the insurance business is heavily conditioned by the correlation between assets and liabilities, it is not possible to analyse the ED without bearing in mind the principles laid down by IAS 40 and IFRS 9 concerning assets that usually exists in front of the technical provisions.
  In particular, the removal of the category AFS in IFRS 9 and the recording of all changes of insurance liabilities in the income statement should necessary require a change in the contents of the ED.
  Moreover, and to be consistent with the provisions of IFRS 9, for those assets that are most aligned with the cash flows of the liabilities, the valuation will be made at "cost" in order to take into account the underlying business model and the characteristics of the assets themselves; instead, on the basis of the ED, the liabilities correlated with the these assets, evaluated at amortized cost, must be valued at a different criterion, that is very far from the "cost". Thus, accounting mismatches will be inevitable. However, these accounting mismatches could be avoided by making some changes to the ED.
  Highlighting the effort made by the Board in developing the fulfilment value model, it becomes apparent how this approach enables the use of "entity-specific" and "liability-specific" assumptions, in addition to market-consistent hypotheses, as well as expected value approach consistent with the insurance business model.

- ***Residual Margin (Recalibration*)**
  We believe that the nature of the residual margin, obtained as the difference between the premium and the fulfilment value, implies its continuous updating where there are changes to the current value of the future cash flows of issued insurance contracts, which affect the profitability of the insurance contract.
  Therefore, it would be appropriate that changes in the fulfilment value are compensated by changes in the residual margin, which will act as a "shock absorber".

- ***Presentation***
  The first aspect to be highlighted in relation to the presentation of the income statement as proposed in the ED relates to the absence of an organic project for the review of insurance financial statements as a whole. Moreover, there is an IASB project to reform the structure of the financial statements and it is unclear how this project may affect the ED income statement.
  Give the above, the proposed presentation model may provide information able to reflect the substance of the business for life contracts, but it is necessary to highlight the difficulty of applying this model not only referring to short-term contracts but also against medium and long term non life policies.
  Also, the analysis of the specific business and the management of an insurance enterprise cannot ignore aspects such as premiums and claims; in this regard, we could think about key indicators such as loss ratio and combined ratio.

- ***Transition Rules***
  While appreciating that the aim for "simplification" underlies the Board's choice to account for the residual margin to equity at the transition date, we believe that such a move could lead to a distorted presentation of the accounts; we could think, for example, about the impact that such treatment would have on market indicators such as ROE. In this regard, and essentially sharing the objective of practical simplification that drove the Board's choice, we would ask that the proposal in the ED could be left, as an option, as a simplified approach.

- **Consistency with IFRS 9 and IAS 40**
  As highlighted in relation to accounting mismatching, the correlation between assets and liabilities is the main feature of the insurance business. Therefore, it is essential that the Board defines the criteria for the valuation of insurance liabilities consistently with the envisioned measurement for the assets, which, above all reflecting the long-duration insurance business, can be valued at "cost", and be in line with IAS 40 and IFRS 9.

- **Reconcilability with prudential regulation**
  It is really important that the final standard reflects measurement and presentation principles that are able to fully represent the insurance business model.
  Furthermore, as the respective frameworks may be different, we believe that it is essential for the users of financial statements to have transparent information that allow the results of applying the ED to be reconciled (also through a specific disclosure) with those derived from the implementation of prudential regulation rules.

Question 1 – Relevant information for users

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?

We agree that, in most of insurance contracts, the accounting principle proposed by the IASB will generate information that are useful, on the one hand, in understanding the impact that the insurance contracts have on the financial statements and, on the other, in helping the investors to assess the companies results. However, in some cases, the model proposed does not seem to achieve the desired objectives. For example in the principle laid down for in measurement and subsequent valuation of the residual margin, for the presentation of the income statement, for the transitional rules and for the long-term life participating contracts with guaranteed benefits.
It is really important that the measurement criterion can fully represent the business model adopted by insurance companies and is consistent with the valuation criteria they apply to their assets. In our opinion, the measurement model presented in the Exposure Draft does not enable that goal to be achieved in the case where, consistently with the business model, the company's assets or part of them are valued at cost as permitted under IFRS 9 and IAS 40.
Thinking about next years, it is necessary to assess very carefully the approach to adopt in the transition phase to the new accounting principle.

Question 2 - Fulfilment cash flows

(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?*

(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?*

(a) We agree that the liability of an insurance contract should, as a general principle, be determined on the basis of the "expected present value of the fulfilment cash flows", which is more consistent with the structure and the management of insurance contracts compared with the model provided in the IASB's 2007 Discussion Paper.
We also agree that the estimate of expected future cash flows in relation to the insurance business should be made at portfolio level. However, there are some points of the IASB's ED that refer to the concept of a single insurance contract (for example, in defining the principle of derecognition or the incremental costs). Such references do not appear to be fully consistent with the general approach based on a portfolio approach.
(b) We believe that the level of details as per Appendix B is the maximum that is compatible with a "principle-based" approach.

Question 3 – Discount rate

(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?*
(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?*
(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?*

(a) We agree with the principle under which the discount rate for non-participating contracts should reflect the characteristics of the insurance liabilities and must be consistent with the market prices of similar instruments whose cash flows reflect those of the insurance contracts in terms of timing, currency and liquidity. This principle should be adjusted in the case of participating contracts (see Question 10).

(b) We believe that a premium relating to the illiquidity of the insurance liabilities – which do not have a market on which they can be readily traded – should be able to be calculated with an effect on the discount rate applied.

(c) We believe that entity own risk should not be included in the determination of the insurance liability.

Question 4 – Risk adjustment versus composite margin
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.

We surely prefer – also with a view to providing third parties with more transparent accounting information – two separate margins (risk margin and residual margin) rather that just one composite margin. Moreover, the risk margin and the residual margin stem from different causes: on the one hand, the possible variability in the risks borne during the life of the contract, on the other, the profitability of the issued policies.

Question 5 – Risk Adjustment
(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?
(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?
(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 (i.e. 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?
(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?

(a) We agree with the definition of risk adjustment provided by the IASB in paragraph 35.

(b) We do not believe that the principle-based approach, generally followed in IASB principles, is consistent with the limiting, for determining the risk margin, to only three calculation techniques (confidence level, conditional tail expectation, cost of capital) – as given in paragraph B73 *et seq*. of the ED. We believe that a preferable solution is to indicate the three aforementioned calculation techniques only as a base hypothesis, leaving the company the possibility to adopt other risk valuation models, provided that these yield results are more reliable and plausible than those from the techniques explicitly mentioned in the ED.

(c) Disclosure in the financial statements of the confidence level regarding the calculation of the risk adjustment does not provide useful information to the stakeholders in situations where the confidence level technique would not represent the solution for determining the risk margin and so other valuation criteria should be adopted.

(d) We believe that for the measurement of risk adjustment, it is more correct, for the purpose of providing as accurate a picture as possible the management of the insurance company, to refer to the group portfolio level rather than the portfolio level. This enables, where the management approach requires, to include in the risk adjustment the effects stemming from diversification among different portfolios, a diversification undertaken by the company in order to limit its risk.
The effects of diversification underlie the model of the insurance business and should therefore be considered in accounting valuations where they can be reliably measured.

(e) We believe that Appendix B should not include details on the measurement of risk adjustment but remain a principle-based approach.

Question 6 – Residual/composite margin

(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?

(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?

(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?

(a), (b) We agree with measurement at inception of a residual margin. We believe that, at the moment of initial measurement, no profit should be recognized and that such profit should be spread throughout the period of the contract being in force. However, in the case of losses at inception, such losses should be recognized immediately in the income statement.

(c) We agree with a measurement of such a margin at portfolio level.

(d) We believe that the value of the residual margin, where there are changes in the current value of the future cash flows of the issued insurance contracts, should be updated in the subsequent operating periods. We could think, for example, of a situation where there is a change in the amount of the insurance liabilities as a result of a change in a non-financial variable (an increase in expected claims in future years because of actual claims being higher than initially forecast). A re-measurement of the residual margin to balance the effects in the income statement of such a variation seems fully consistent with the way of managing insurance contracts and with a conceptual approach that sees the residual margin as a “shock absorber”.
Of course, in situations where the negative effect of the variation exceeds the current residual margin, the excess should go to the income statement.

(f) On the accretion of interest on residual margin: we agree with the principle established by the IASB.

Question 7 – Acquisition costs

(a) 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?

(a) We agree with the inclusion of the incremental acquisition costs in the cash flows considered for the purposes of determining the insurance liability. However, it remains the issue of a clear definition of “incremental” costs. Indeed, such a definition seems to link back to a cost analysis to be made at the level of the contract (issued or not) rather than that of the portfolio (which is the reference parameter for the quantification of the technical provisions). Moreover, in the case of companies that sell their contracts directly, it would be appropriate to issue further guidance on how the concept of incremental costs should be applied.

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?
(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?

(a) We believe that the principle concerning insurance contracts should allow that companies, for short-duration policies, may apply a simplified liability measurement model. However, this simplified measurement should be optional and not mandatory given that the issue of the difficulty of determining the individual building blocks concerns more the small and medium-sized companies rather than the large ones, which could adopt internally a unique measurement model of their technical liabilities.

(b) The breakdown of contracts by duration, which underlies the criterion proposed by the IASB, could, in our opinion, lead to difficulties in the interpretation of financial statements and in comparing companies. Therefore, we would ask that the unearned premium reserve approach or the premium allocation approach could be applied on a voluntary basis as a simplified method of calculation without constraints or automatic adoption.

Question 9 – Contract boundary principle

(a) 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?

We agree with the definition of contract boundary presented in the ED, as there seems to be sufficiently clear as to the moment when an existing contract ends or a new one comes into being.

Question 10 – Participating features

(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?

(a) We agree with the approach envisaged, as it is consistent with the notion of fulfilment value. However, for some aspects of life contracts in the Italian market (segregated funds), the solutions suggested in the ED would give rise to considerable application problems and could involve significant accounting mismatches in the income statement.

(b) We believe that all participating contracts and financial instruments with discretionary participation features issued by insurance companies should fall within the scope of the application of the new accounting principle under consideration.

(c) We believe that, in this regard, the existing provisions of the current IFRS 4 should be confirmed.

(d) We agree with the model proposed for financial instruments with discretionary participation features relating to profits, as it is consistent with the fulfilment value.

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?
(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?

(a) We agree with the definition.

(b) We agree with the scope exclusions of paragraph 4.

(c) We agree with the approach proposed.

Question 12 – *Unbundling*
(a) 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?

No. We believe that unbundling is not consistent with the companies' business model and we therefore propose only an optional application.

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?
(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?

(a) With reference to the presentation of the income statement proposed in the ED, the first aspect to be noted concerning the lack of an organic project for a review of insurance financial statements as a whole. Only the income statement would be modified but nothing is said about the impacts that such a change could have on the balance sheet and financial statement in terms of providing useful information to stakeholders. Moreover, there is a project to review the structure of the year-end accounts being proposed by the IASB, and it is not clear whether and how it will affect the insurance sector.
Given the foregoing, it should be noted that, while the summarized margin model – which is the preferred one in the ED – may certainly provide useful information about performance for life contracts, it does not appear sufficiently explanatory in the case of non life companies. Indeed, we should not forget the importance that data on matters such as premiums and claims have for stakeholders. These information are fundamental to determine some financial statement indicators (among which: the loss and combined ratios) that are considered essential for the management and valuation of an insurance company.

(b) We believe that the OCI could be adopted also in relation to changes in insurance liabilities in order to avoid accounting mismatches. Furthermore, we consider necessary to use the residual margin as a "shock absorber" instead of recognizing variations in insurance liabilities in the income statement.

Question 14 – Disclosures
(a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?
(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.

(a) We agree with the proposed disclosure principle.

(b) No. The level of information envisaged in the ED is too detailed and the excessive amount of information required may not, in our opinion, facilitate an immediate reading of the financial statements.

(c) There is a need that the disclosure-based principle be sufficiently flexible to represent the business model of the individual companies and be concise enough to facilitate the reading of the financial statements. We propose confirming the disclosure model as per IFRS 4 and IFRS 7.As underlined before, we think it is fundamental, for the users of financial statement, to have information enabling the reconciliation (also through a specific disclosure) of the results of applying the ED with those derived from the implementation of the rules of prudential regulation.

Question 15 – Unit-linked contracts

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

Yes, we support the outlined proposals.

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?

(a) We agree with the expected loss model proposed in the ED as it is consistent with an economic approach to reinsurance.

(b) We believe that the measurement of the “reinsurance asset, risk margin and residual margin” should be based on the risk transferred by the cedant to the reinsurer and be consistent with the valuation criteria of the direct insurance.

Question 17 – Transition and effective date

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

(b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB’s tentative decision on transition (see the appendix to the Basis for Conclusions)?

(c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?

(d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

(a) No, we believe it is really important that the residual margin should be able to be determined also on the portfolio already being at the transition date. Indeed, it is not conceivable that all the profits in the existing portfolio be transferred to equity. This is extremely relevant for the purposes of providing a correct representation of the future results.
It may be useful to allow, as an option, a simplified approach similar to that proposed in the ED.

(b) We do not agree with a “composite” approach.

(c) Yes, consistency with IFRS 9 is essential, also in terms of effective date.

(d) Time needed to implement the new standard is strictly linked to the overcome by the IASB of the concerns raised. Therefore, it is not possible to propose at this stage an effective date for the new standard.

Question 18 – Other comments

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

We believe it is important that the project be carried on in a manner consistent with the business model of the companies and with the other international accounting principles and, in particular, with IFRS 9 and IAS 40.

Question 19 – Benefits and costs

(a) *Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.*

No. The Exposure Draft as formulated, not being fully aligned with the business model of the companies for the issues mentioned in the above responses not reconcilable with prudential regulation, implies implementation costs that, in our opinion, would exceed the benefits in terms of information generated by its application. In short, the evaluation of the costs and benefits of the accounting principle should, in our opinion, be made taking into due consideration the following elements: the business model of the companies, the presence of options and simplifications, consistency with the other international accounting principles (in particular, with IFRS 9 and IAS 40), and consistency with prudential regulation.

Yours sincerely,

Angelo Casò
(Chairman)