



HUB global insurance group

Industry Proposal

ED IFRS 4 Insurance Contracts

FASB Insurance Contracts DP

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Discussion Paper

Prepared for IWG Members and Official Observers

Why accounting matters – particularly now

Financial statements should provide understandable, transparent, comparable and reliable information about the company's performance. Inadequate accounting requirements can lead to an inaccurate picture of a company's performance.

The loss of confidence in the health of a company or sector can trigger erratic market movements, as evidenced by recent events. In the current economic context, having a correct understanding of risk and performance is particularly important.

Insurers play a key role in the economy. They absorb risk, provide solutions for an aging society and are among the largest institutional investors. It is essential that their role is not hampered by accounting shortcomings.

In contrast to other industries, insurers do not have certainty with regards to their accounting framework yet. While for the asset side insurers apply the financial instruments standard IAS 39 or IFRS 9, there is still no final IFRS for insurance contracts (i.e. most of their liabilities).

Our proposal is to present a single, global accounting proposal for insurance contracts based on the following principles:

- Investors and financial markets need an accurate picture of a company's performance.
- Insurers should be put on a level playing field with competing financial institutions.
- At the same time, accounting rules should reflect the way the insurance sector manages its business and the business model that is adopted by individual insurance companies.
- Artificial volatility, such as short-term mark-to-market movements stemming from illiquid markets, that could further destabilize already dysfunctional markets needs to be avoided.
- The IASB should not prescribe a new model for short-term policies, as the current model is time tested and well understood.
- Insurers should be allowed to use a discount rate that is used for managing their business to calculate the present value of their future payments to policyholders.

This paper presents the consensus views of the involved parties. We strongly urge the IASB and FASB to consider our proposal in its entirety.

I. Introduction

We welcome the Boards' efforts to develop a joint standard.

On July 30, 2010, the IASB released an exposure draft (ED) outlining a new accounting standard for insurance contracts. Shortly thereafter, the FASB released a discussion paper (DP) on the same topic. We support a new single high quality global IFRS for insurance contracts and we agree with many of the measurement attributes outlined in the ED.

Nonetheless, we believe that the ED is flawed in a number of key areas. This paper addresses our major concerns about measurement and certain related presentation issues and proposes solutions.

II. Concerns

We need a level playing field with other financial institutions, e.g. banks: Banks won't show economic or artificial volatility in the balance sheet and the P&L of their banking books, yet a consequence of the ED is that it forces insurers to show the full spectrum of volatility in their financial statements. Insurers should not be placed at a disadvantage.

IAS 39 allows insurers to use a current measurement approach for AFS assets on the balance sheet, while reporting changes in fair value through OCI. The elimination of the AFS category in IFRS 9, coupled with the fact that the ED effectively prevents insurers from holding assets at amortized cost, obliges insurers to value assets at fair value through P&L, or for equities, to value them at fair value through OCI without recycling.

Denying insurers a transparent, yet manageable, P&L places the industry at an unfair disadvantage relative to other competing financial institutions that can benefit from using the amortized cost category available to them under IFRS 9, which may lead to misrepresentation of the performance of insurers and a higher cost of capital, depending on the business model.

Don't fix what isn't broken: While general insurance liabilities may be longer than bank liabilities, the term of many of our contracts is short. The measurement model currently used for short-duration insurance contracts is tested and proven. It would be ill-advised to change it.

The ED unnecessarily requires the use of a materially different measurement model for short duration insurance contracts where there already is broad global acceptance of the existing insurance accounting measurement approach. The existing, broadly accepted, approach results in an effective measurement model that includes continuous measurement in a manner that is highly transparent, understandable, and comparable between insurers and across geographic jurisdictions.

Artificial volatility needs to be avoided: Calculating liabilities using a discount rate that does not reflect the management of the company would create unmanageable movements unrelated to insurers' performance that could further destabilize already dysfunctional markets, for example, short-term mark-to-market movements stemming from illiquid markets.

The ED requires an approach to setting discount rates based on risk free rates plus an adjustment for illiquidity. This approach may be inconsistent with the pricing and on-going management of obligations under insurance contracts. It also requires determination of values that cannot be easily

calibrated to any market values. A discount rate that reflects the asset-liability management of portfolios of insurance contracts is consistent with the characteristics of the insurance contract liability.

III. Business Models

No one-size-fits-all: Insurers operate according to different business models. The accounting standard needs to take that into account.

The objective of general purpose financial reporting is to provide financial information about a reporting entity that is useful to existing and potential investors, lenders, policyholders and other creditors and users. The usefulness of financial information is enhanced when it is comparable, verifiable, timely and understandable. For the measurement and reporting of insurance contracts to meet these objectives, it must be consistent with the insurer’s business model and the way the business is managed.

We believe insurance contracts should be measured consistent with the basic business model applied by the insurer for both assets and liabilities. This approach establishes the relevance and representational faithfulness of the financial information provided to existing and future users.

We have identified two basic business models in place around the world:

- ❖ The Integrated Insurance Business Model (“II-BM”) is used primarily, but not exclusively, by life insurers. It focuses on all cash flows of the business.
- ❖ The Continuous Risk Re-underwriting Business Model (“CRR-BM”) is predominantly focused on the continuous re-underwriting, pricing, classification and management of insurance risk. The primary performance metric, underwriting income (loss), is comprised of premiums received from policyholders, claims and related claims expenses, and other expenses incurred. Investment income, while not unimportant, is of comparatively less importance for underwriting the business.

In addition to these business models arising from the management of insurance liabilities, there are also different business models arising from the management of an insurer’s assets. Under IFRS 9, those different business models determine whether assets are held at amortized cost or fair value.

IV. Proposals

Find the right discount rate: The discount rate should be determined in a manner consistent with the insurer’s expectation, e.g., top-down approach.

For those portfolios where the insurer applies the II-BM, we believe a discounted measurement of liabilities is appropriate. There are also entities that manage their CRR-BM liabilities on a discounted basis. They should also discount their liabilities.

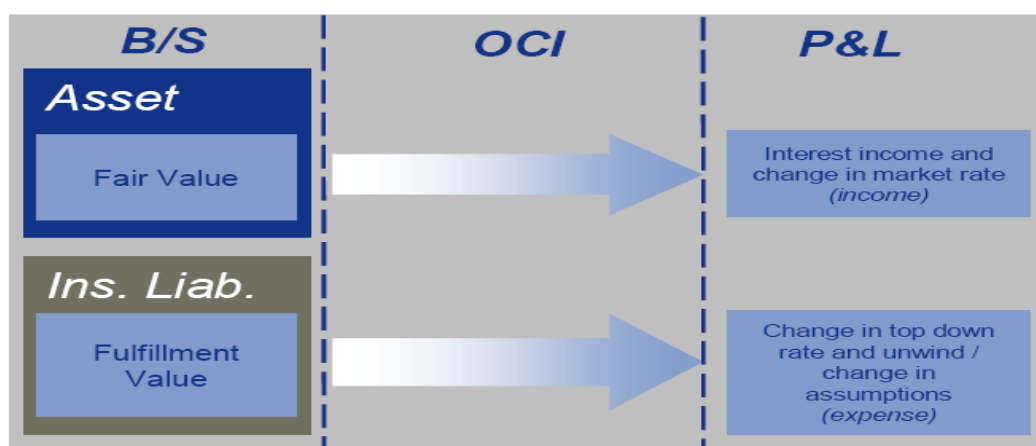
Liabilities in portfolios that are managed on an II-BM basis should use discount rates based on how the portfolio is managed. The discount rate should be determined each reporting period based on the entity’s expectation including the projection of future yield on those assets and investments to

be made on future cash flows. The projection of future yield rates should be determined after full reflection of investment expenses and expected future default costs (and other risks that are not part of the risk margin), determined in a manner consistent with the entity’s expectation and the equivalent determination for asset values and the yield rates should be determined based on the carrying value of the assets. In this way, the discount rate will reflect the characteristics of the liability.

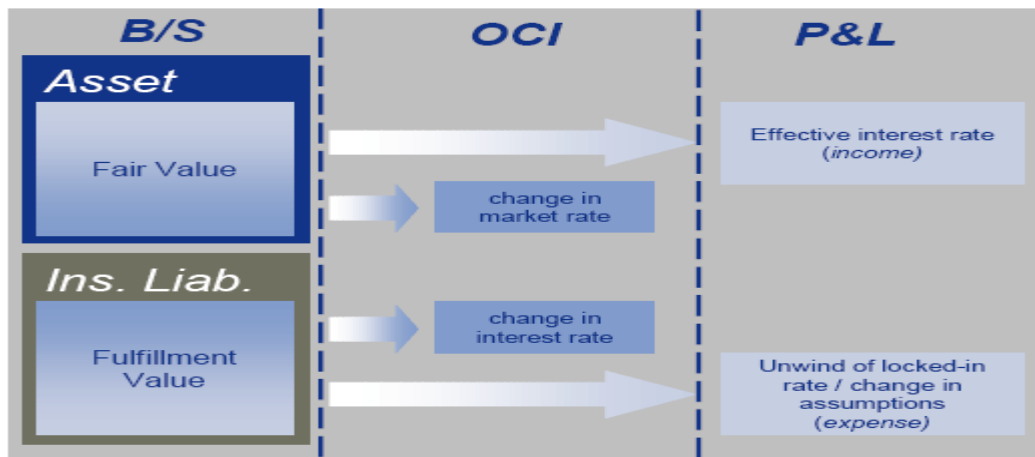
The P&L must represent a basis that aligns with the business model approach: To ensure a P&L that reflects the business model and is free of artificial volatility, the IASB should introduce other comprehensive income for the market/fulfillment value movements of assets and liabilities, or consider measuring liabilities using a locked-in approach with disclosure of current fulfillment values in the notes.

For portfolios which are not managed using a current interest rate, our objective is to have a P&L which reflects a locked-in interest rate. To achieve this goal, the introduction of OCI provides a suitable solution, which would give insurers a choice, based on how the business is managed, between OCI (the current-current through OCI approach) and the P&L (the current-current through P&L approach).

Under the **current-current through P&L approach**, an insurer would have the ability to mark the current value change of assets and liabilities through the P&L, as follows:



Under the **current-current through OCI approach**, an insurer would have the ability to mark the current value change of assets and liabilities through OCI, as follows:

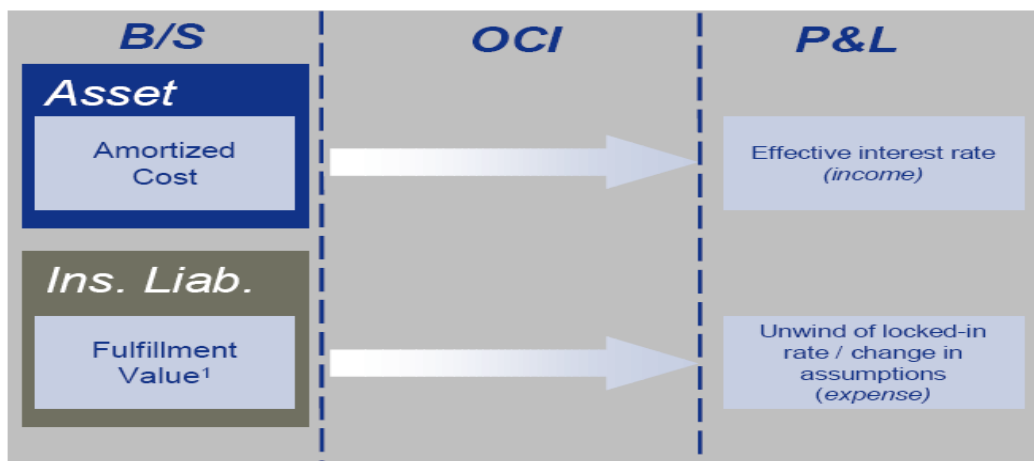


This approach requires that:

- ❖ the IASB follow the advice of many analysts and investors to reopen IFRS 9 including the associated Implementation Guidance and Basis for Conclusions and reintroduce the AFS category for debt and equity instruments with reclassification upon realization, and
- ❖ at the same time, allow interest rate related movements between the current and the locked-in interest rates in insurance liabilities to flow through OCI, ensuring an approach that maintains the relevance and representational faithfulness of the financial information and appropriately reflects the interaction between the asset and liability business models. Therefore, the P&L would show the unwind effect of the locked-in discount rate.

In doing so, the IASB would provide a solution where market/current fulfillment information is presented on the face of the balance sheet and at the same time free the P&L from artificial volatility. It is a solution which is both viable and credible, and meets the needs of diverse users across multiple jurisdictions.

An alternative to the current-current through OCI approach would be a **locked-in approach** where portfolios of insurance contracts that meet certain criteria and have assets measured at amortized cost would be measured using current (fulfillment value) assumptions, but with interest rates that are locked-in at inception, as follows:



¹ All assumptions current; discount rate locked-in

This approach requires that:

- ❖ criteria be developed for those portfolios of contracts where it is appropriate to use a locked-in discount rate,
- ❖ the assets for those portfolios be measured primarily at amortized cost when they meet the conditions of IFRS 9, also requiring that IFRS 9 including the associated Implementation Guidance and Basis for Conclusions be amended to ensure that insurers have the ability to measure the over-whelming majority of their financial assets at amortized cost within the insurer’s business model, and
- ❖ the discount rate be determined at issue of the contract on the above described top-down basis and in most cases be locked-in for the duration of the contract¹, with consideration given as to whether a liability adequacy test should be performed to avoid a premium deficiency, that is to ensure that the current present value of future cash inflows is adequate to cover all future cash outflows, and
- ❖ any financial guarantees or other embedded options in these contracts be measured at a current value.

In doing so, the IASB would provide a solution that assures a level playing field with competing financial institutions and provides transparency of current fulfillment values in the notes. As with the current-current through OCI approach, it is a solution which meets the needs of users.

No forced change to business models: Discounting of short-term policies should not be required and the IASB should not force the industry to change its business model. *Indeed, depending on an entity’s business model, both the Building Blocks Approach and the Unearned Premium Approach deliver relevant, reliable and understandable results in terms of P&L and value of liabilities.*

For insurers applying the undiscounted CRR-BM (typically property-casualty insurers) we believe they should be allowed to measure short-duration insurance contracts in a manner consistent with existing global practice; that is, including the use of the unearned premium reserve, without discounting and explicit risk adjustments, accompanied by a loss adequacy test.

The CRR-BM is consistent with how many property-casualty insurers throughout the world underwrite, manage, and evaluate the performance of most short-duration insurance contracts, for which success is heavily dependent on close monitoring of non-discounted underwriting results. For these insurers, investment income, while important, is a component of total corporate performance and not a component of underwriting income, the principal operating performance metric.

Because certain insurers discount their portfolios of insurance contracts, it is important that users have the ability to compare the liability established to the eventual claims payments made in satisfaction of those liabilities.

Measuring claims and claims expense liabilities on an ultimate basis allows investors and other financial statement users to evaluate the adequacy of those liabilities through direct reconciliation

¹ *Using a locked-in discount rate should not be seen as a failure to report duration mismatches, as the current fulfillment value of the liabilities on a unlocked discount rate basis, as well as the fair value of the assets, would be provided in the notes.*

with paid claim development data showing paid claims by date of payment and incurral. These data would be a required disclosure under a new standard.

For P&C business, we support the Building Blocks Approach (BBA) under the condition that the time tested and well understood traditional Unearned Premium Approach (UPA) approach is available as an alternative.

For companies who have been using the UPA for many years, the operational costs of converting systems and procedures to the BBA will far outweigh the benefits. Allowing the UPA as an alternative also addresses the operational difficulties of explaining interest rate volatility in externally reported results, when the business is not managed on a discounted basis for internal management purposes. For many companies, changing to the BBA simply for the sake of theoretical precision would be costly and would not provide additional useful information.

The decision to use the UPA should be unconditional and irrevocable, unless the business model changes (considered to be rare).

Additional disclosures can further facilitate comparability.

We would be pleased to discuss enhanced disclosures to further facilitate comparability.

V. Single Global Standard

We continue to encourage the Boards to create one single high-quality global insurance contracts accounting standard.

We support the ongoing efforts between the IASB and the FASB and believe that a single, high quality global accounting standard for insurance contracts that has the support of both Boards is desirable. We encourage the IASB and the FASB to jointly agree on a project timetable that maximizes the likelihood of achieving that standard.