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**Re: EFRAG draft comment letter on Exposure Draft Insurance Contracts**

Dear Françoise,

We are pleased to have the opportunity to provide our comments in order to contribute to the finalization of the EFRAG comment letter on the IASB's Exposure Draft *Insurance Contracts* (hereinafter, the "2013 ED" or the "ED").

We appreciate the IASB's decision to consider making improvements to the model proposed in 2010. In our comment letter on the ED 2010, we appreciated the IASB's effort in trying addressing the complexities inherent in revising the existing accounting framework for insurance contracts. At the same time, we noted that further work was needed in order for the proposals to be applicable and to faithfully represent the economics of the insurance business.

Although the 2013 ED has addressed some of these issues, several concerns remain with respect to the ability of the proposals to properly reflect the business model of entities issuing insurance contracts. We are convinced that the IASB should carefully consider the impacts of the standard on insurance contracts, combined with IFRS 9, before its completion. To this end an involvement of NSS and relevant authorities in the effect analysis is highly desirable. Field tests with relevant stakeholders should be planned in advance of the finalization of the standard giving the appropriate time to adequately respond.

As we explain in more detail in the Appendix:

1. we commend the proposed definition of the contract service margin (CSM) as unearned profit and the proposal to introduce an unlocking mechanism; however, we believe that further work is needed in two areas: (i) how to distinguish the changes in estimates of cash flows that adjust the CSM and those that do not; and (ii) how to take into account the

effect of changes in financial variables to properly reflect the profitability of certain contracts (i.e. participating contracts).

2. Although we find that the “mirroring” principle is conceptually correct as it pursues the aim of reflecting the association between insurance liabilities and the underlying assets, we find that it poses a number of practical challenges. Particularly, this principle should be applicable to the wider range of participating business rather than being an exceptional solution. Also, in order to apply mirroring approach an entity is required to split a single insurance contract into separate cash flows and this exercise appears to be both complex and theoretically weak.
3. We understand the rationale behind the introduction of the insurance revenue concept, but we believe that this measure would deliver a message to users of financial statements that is both misleading and difficult to reconcile with the typical performance metrics used in the insurance industry. In addition, we remark that the use of traditional insurance metrics is also important when reconciling the information contained in the financial statements with those included in regulatory reports.
4. The use of Other Comprehensive Income (OCI) to present the effect of changes in the discount rate for the insurance liability goes into the right direction because it mitigates the effect of non-economic volatility in P&L, thus better portraying the insurance business model. However, it is key that the IASB aligns any OCI solution for the insurance liabilities with the definition of a Fair Value Through OCI category provided for within the financial instruments standard.
5. The transition proposals represent an improvement compared to the 2010 proposals, however it is important that the effective dates of both the revised IFRS 4 and IFRS 9 are aligned and that the early adoption is encouraged for both standards, also in light of the regulatory changes which are expected in the next future.
6. Finally, we believe that the consultation overlooks the key aspect of disclosures. In our view, the ED proposals may lead to an information overload which could overshadow the most relevant disclosures on insurance contracts. Therefore we suggest that before finalising the revised standard, the IASB exposes for public consultation the draft disclosure requirements.

Should you need any further information, please do not hesitate to contact us.

Yours sincerely,

Angelo Casò  
(Chairman)

## **ADJUSTING THE CONTRACTUAL SERVICE MARGIN**

### **Question 1**

**Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if:**

- a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and**
- b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in Profit or Loss?**

**Why or why not? If not, what would you recommend and why?**

In general, we agree with the definition of the contractual service margin (CSM) in Appendix A of the ED because we believe that the CSM shall represent the unearned profit in an insurance contract (i.e. the expected future profits arising from the provision of insurance coverage).

In this respect, the revised proposal to "unlock" this margin is welcome, as it better depicts the pattern based on which profits are released over the life of an insurance contract.

However, the ED requires that the CSM is not adjusted for changes in the risk adjustment; in fact, even if they refer to risks arising from future coverage, in the proposed model these changes are recognised immediately in profit or loss.

In principle, the unlocking of the margin should consider both changes in financial and non-financial variables because the former, as well as the latter changes, are integral parts of the future coverage provided for by insurers. Therefore, both changes in the risk adjustment – when referring to future cash flows – and changes in cash flows arising from modifications in financial variables, conceptually should form part of the unlocking process.

In our view, the IASB should further elaborate on the unlocking mechanism in order to:

- better clarify how to distinguish changes in cash flows relating to past coverage and those related to future coverage, also considering the high degree of judgement that may be involved in segregating changes in estimates for future coverage from changes resulting from experience adjustments. Furthermore, we suggest to introduce specific disclosures to explain how the entity has made the split between changes in cash flows relating to past coverage and those relating to future coverage; and
- take into account the effect of changes in financial variables, where appropriate, to properly reflect the profitability of certain contracts (i.e. participating contracts). In fact, when changes in cash flows relating to financial variables affect the future profitability of such contracts, the CSM should be adjusted to face the effect of such changes.

The mechanics of the CSM may result in losses in one period (e.g. when the changes in estimates of cash flows relating to future coverage exceed the margin) and no reversals of such losses if and when, in subsequent periods, further changes in estimates positively affect the margin for amounts that allow a partial or full recovery of losses previously recognised. The above explained

mechanism appears to be inconsistent with other IFRSs; we believe that reversals of losses – which need to be booked in P&L – should be segregated from other increases of the margin and specific disclosures of the related effects should be provided in the financial statements.

## **CONTRACTS THAT REQUIRE THE ENTITY TO HOLD UNDERLYING ITEMS AND SPECIFY A LINK TO RETURNS ON THOSE UNDERLYING ITEMS**

### **Question 2**

**If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:**

- a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?**
- b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (i.e. using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?**
- c) recognises changes in the fulfilment cash flows as follows:**
  - i. changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in Profit or Loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;**
  - ii. changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in Profit or Loss; and**
  - iii. changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in Profit or Loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?**

**Why or why not? If not, what would you recommend and why?**

The proposal to include a measurement and presentation exception (so called "mirroring approach") in order to allow a proper matching between the measurement of insurance liabilities and the measurement of the underlying assets, goes into the right direction. In fact, such matching between the measurement of liabilities and that of underlying assets is critical, in some instances, to properly reflect the economics of insurance contracts.

In this respect, we have already noted in our response to the public consultation, launched by the European Commission, on long-term financing of the European economy that: "(...) *in establishing*

*the business model for long-term investments, it should be taken into account that some institutional investors, for example insurance companies, determine their investment strategy on financial assets in close conjunction with the features of their obligations towards policyholders (insurance liabilities). Especially in life assurance, the liabilities are usually long term, with quite predictable cash flows and linked to the investments performance - in terms of realized book returns - through participating features included in the contracts or in statutory regulation. For this business, it is key to reflect the asset and liability management strategy in the accounting, allowing for consistent financial reporting of long-term investments and related insurance liabilities".*

However, any accounting solution that aims at a proper matching between assets and insurance liabilities, should guarantee the availability of the most appropriate measurement criteria on the asset side. Particularly, for financial assets, the recent proposals to include a third portfolio for financial assets measured at Fair Value through Other Comprehensive Income (FVOCI), need to be refined in order to ensure the achievement of the ultimate goal to present correctly, when relevant, the combined management of assets and liabilities.

In our view, although conceptually correct, the mirroring approach proposed in the ED does not provide a fully satisfactory accounting solution for the reasons described here below.

In fact, from our point of view the IASB has not duly considered the need to find accounting solutions that allow to properly reflect the performance of the full range of participating contracts that are offered in the market. In this respect, the IASB decision to drop in this ED the "participating" notion is questionable. In fact, the absence of a proper definition of participating contracts at all, may lead to diverse implementations of the final requirements, also because local regulators may define these contracts in terms that differ by jurisdiction. In addition, our constituents found the participating notion intuitive to indicate only contracts that share similar economic features, but differ in specific – rather minor – contractual arrangements.

On the other hand, we are concerned that the strict eligibility rules for the mirroring solution – ie limiting this approach to selected contracts (which is not even applicable to all "participating contracts") – and the operational complexities related to its implementation, would impair its effectiveness. In fact, the narrow eligibility criteria proposed in the ED, may trigger a double effect: (i) reducing the ability of the proposed mirroring solution to provide a substantial relief to the issue of the accounting mismatch (if too few contracts would end up falling in this category); and (ii) treating contracts with similar economic characteristics differently.

The reasons underlying the "strict" eligibility criteria provided for the mirroring approach lie in the fact that the presentation and measurement exception would be "justified" only when there is no possibility of economic mismatches. As the IASB noted, this is the case when the contract is perfectly linked to the underlying items which the insurer is required to hold. We agree that for all other participating contracts which do not meet the eligibility conditions set out in the ED, an economic mismatch may well exist. However, this situation may not necessarily affect the future profitability arising from the insurance contract until there is a positive CSM. Hence, this component of the measurement model, in our view, should be used to "absorb" the effect of any mismatches and, only once it has been completely exhausted, the economic position of an insurer should be affected.

Also, the position of the measurement and presentation "exceptionality" itself may be counterintuitive, especially for those entities whose most significant business, both in terms of volumes and profitability, is represented by contracts to which the "exceptional" treatment would apply.

On the operational side, the mirroring approach requires the disaggregation of portfolios (if not also of individual contracts) into separate cash flows. This exercise is considered by some of our constituents as being both arbitrary and complex. While complexity may be outweighed by additional benefits to the users of financial statements, we note that the arbitrariness inherent in the split may result in a reduced degree of comparability among entities. It has been noted that this arbitrariness stems from a substantial lack of technical actuarial foundations of the proposed approach which, in substance, requires splitting a single "bundle" of rights and obligations into separate components.

While different Italian constituents (audit firms, users, regulators and insurance companies) have agreed on the above comments about the mirroring approach proposed by the IASB, they have also indicated that an alternative approach, being developed by the insurance industry, may help overcoming some of the key concerns of the measurement and presentation exception proposed by the IASB.

The key features of this alternative approach can be summarised as follows:

- it eliminates the measurement and presentation exception requiring that all insurance contracts, including participating contracts, are accounted for according to the general building blocks approach;
- it provides that all insurance contract liabilities are measured without bifurcating the related cash flows;
- it requires that changes in insurance liabilities arising from changes in underlying assets are recorded, either in P&L or OCI, in a way that properly reflects the economic performance of the insurance contracts; and
- it provides that CSM is unlocked to reflect the unearned profit arising from the insurance contracts, including, for participating contracts, the unearned profit arising from investment returns.

Furthermore, some Italian constituents suggest that the service margin may be used to "absorb" the effect of changes in the time value of options and guarantees or, as an alternative, these changes are booked in OCI. This is because it has been calculated that these changes, if booked in P&L, may trigger significant swings (i.e. EUR 600-700 M per period) in reported earnings, which have no economic substance for the purpose of explaining the profitability of insurers.

Finally, we underline that the above alternative approach would have an impact on the following features of the proposed model: (i) the factors to consider when unlocking the residual margin, in order to improve the presentation of the performance of participating contracts; and (ii) the use of OCI, to present gains and losses arising from changes in discount rates.

Although we have not yet completely analysed the implications of the alternative approach, we suggest the IASB to consider the objectives to which the approach is aimed at and to improve the proposed model to measure insurance liabilities accordingly. In our view, this may lead to the finalization of an accounting standard for insurance contracts that is able to (i) faithfully depict the business model of insurers; and (ii) the performance of the contracts which they issue.

## **PRESENTATION OF INSURANCE CONTRACT REVENUE AND EXPENSES**

### **Question 3**

**Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in Profit or Loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts? Why or why not? If not, what would you recommend and why?**

Regarding the presentation of the insurance contract revenue, the OIC has traditionally favoured the inclusion of volume information in the income statement, such as premiums and claims, which we regard as being more representative of the insurance business. Also, these measures are commonly used to calculate specific key performance ratios by users of financial statements.

Therefore, we believe that the proposed revenue concept, would result in a measure that is more confusing than the existing premium measure, with the downside that users of financial statements will need to bear an additional learning effort to figure out what the insurance revenue depicts and how it reconciles with the traditional metrics used to calculate key performance indicators.

We understand that the "Insurance Revenue", in the IASB intention, would provide users with revenue figures comparable with revenue recognised by entities operating in other industries. To do so, the IASB has tried to overcome the main downside of the summarised margin approach proposed in 2010, which lied in the lack of a gross performance measure for the income statement resulting directly from the application of the building block approach.

Although we acknowledge the IASB's effort in trying to provide a gross performance measure for insurance contracts, backed by consistent feedback from our constituents, including analysts, we note that:

- the concept of insurance revenue as shown in the ED, does not reach the objective of comparability with other industries and we are unsure that such a comparability is needed; in fact, it would provide the misleading message that the top line of the insurance income statement conveys the same type of information as the top line of a manufacturing, service or construction company;
- the separation of investment components from the "host" insurance contract may not be practicable and may result in unnecessary complexity;

- the proposed revenue figure appears difficult to reconcile with the usual metrics considered by users in calculating performance indicators for insurers;
- there might be a significant unbalance between the costs involved in calculating the revenue figure proposed and the related benefits; and
- there is a significant risk of excess of information and it is not clear which measures (insurance revenues, premiums and the changes resulting from the application of the building block approach) are critical to depict the economic performance and financial position of insurers.

In our 2010 comment letter on the previous IASB ED "Insurance Contract", while we favoured a summarized margin model to present the income statement for life insurance contracts, we recalled "*the importance that data on matters such as premiums and claims have for stakeholders*" and particularly for analysts.

Consistently with our previous position, we do not support the presentation of the proposed insurance revenue figure in the top line of the income statement and suggest that the IASB reconsiders the introduction of an "expanded" summarized margin presentation model which presents volume information (such as premiums and claims).

## **INTEREST EXPENSE IN PROFIT OR LOSS**

### **Question 4**

**Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:**

- a) **recognising, in Profit or Loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and**
- b) **recognising, in other comprehensive income, the difference between:**
  - I. **the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and**
  - II. **the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?**

**Why or why not? If not, what would you recommend and why?**

Provided that the proposals regarding changes in discount rates has to be assessed keeping in mind that the proposed measurement exception for some participating contracts (i.e. the mirroring approach) may need to be revised and, as a result of this revision, other parts of the model may require adjustments as well, the OIC praises the IASB's effort in considering the complexities of



the insurance business model, by requiring that under the fulfilment value approach, a distinction is made between the effects of short-term market fluctuations (in OCI) and long-term profitability (in P&L).

We acknowledge that the use of OCI to mitigate the effect of non-economic volatility in P&L represents a valuable attempt. However, the requirement to use the OCI may need to be revised to ensure that no accounting mismatches arise (nor in P&L or in OCI) if the assets backing insurance contracts are not eligible for the FVOCI category.

In fact, the use of OCI to mitigate the effect of volatility represents a valid solution only to the extent that the eligibility criteria for the FVOCI category under IFRS 9 effectively take into account the needs of the insurance business model. In this respect, we recall that in our comment letter on the *Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9* we made the following considerations: *"we understand that the IASB objective in introducing such a new portfolio was to solve the issue of the accounting mismatch for insurance companies that apply IFRS 4. Perhaps, in the insurance sector there is another business model (i.e. other than that considered when dealing with banks' liquidity portfolios), which requires the use of the FVTOCI (i.e. without this portfolio the accounting representation would be "mismatched", while risk management of assets and liabilities is coordinated). If the modification proposed in the ED does not solve the insurance sector issue, we believe that the IASB should further investigate this issue, adequately adopting the definition of business model that should be more closely linked to asset-liability management strategies."*

We remark that it is important to have a holistic view when considering the business model of the insurance industry. In this respect, we would suggest that the insurance business model should be considered not only in the context of the *Classification and Measurement* project, but also in the developments of all other financial instruments-related projects such as impairment and hedge accounting.

Analysts interviewed on this topic remark that it is important to consider the matching between insurance liabilities and the underlying assets; they believe that the use of OCI provides an effective means to reflect this matching in a way that is transparent, but at the same time helps sterilising the effect of short-term fluctuations.

Although we support a limited application of OCI, we note that the proposed use of OCI leaves unaddressed other accounting mismatches with respect to several asset classes (eg investment properties and equities).

The OIC strongly suggests that any definition of the contents of the FVOCI category be done within the financial instruments standard, instead of providing a specific measurement category for financial instruments held by insurers. At the same time, we would firmly disagree with an approach that carves out the definition of the FVOCI category from the financial instruments standard and leaves it for future decisions, with the result that the insurance industry is not able to solve the matter of accounting mismatches.

## **EFFECTIVE DATE AND TRANSITION**

### **Question 5**

**Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?**

**Why or why not? If not, what do you suggest and why?**

The transitional provisions represent a significant improvement compared to the 2010 proposals and the OIC supports the introduction of a limited retrospective application, in line with the "spirit" of the IAS 8 framework.

In terms of effective date, the OIC would support an approach where (i) the effective dates of both the revised IFRS 4 and IFRS 9 are aligned; and (ii) the early adoption is encouraged for both standards, in light of the expected introduction starting from 2016 of the new Solvency II requirements.

We disagree with the EFRAG proposal "that for all entities where insurance forms significant part of the entities' activities [...] the effective date of IFRS 9 should be deferred until the effective date of the new insurance standard". In fact, we disagree on transitional requirements that are specific for insurance companies or for IFRS adopters that issue a significant number of insurance policies. Such a transitional requirement, if implemented, would undermine the principle that accounting standards should not be industry-driven.

## **THE LIKELY EFFECTS OF A STANDARD FOR INSURANCE CONTRACTS**

### **Question 6**

**Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?**

**How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?**

**Please describe the likely effect of the proposed Standard as a whole on:**

- a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and**
- b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis**

The OIC in conjunction with EFRAG, IASB and NSSs of France, Germany and the UK is completing the analysis of the results of the field test conducted with interested entities in Europe. The detailed findings are under examination and will be made public in aggregated form once the analysis has been completed.

## **CLARITY OF DRAFTING**

### **Question 7**

**Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB?**

**If not, please describe any proposal that is not clear. How would you clarify it?**

While we confirm our previous comments, we note that the exact components of the insurance contracts revenue are not clearly indicated. If the IASB will retain this concept, further clarifications are needed. We suggest that a more detailed example than that indicated in parr. IE 12-IE 15 of the ED is added to clarify the insurance revenue calculation (especially when more complex contracts are considered).

More specific comments may be sent after the completion of the analysis of the field test.

## **OTHER ISSUES – Disclosures**

We are surprised that an important area such as disclosures is not considered as part of the main consultation.

In fact, disclosure requirements and their correct application are fundamental to the success of the revised IFRS 4. Even if it is difficult a complete evaluation of this topic at this stage (because some important ED principles are still under discussion), the theme of disclosure should still be discussed. The increase of company board judgments in the evaluation of insurance contracts may determine some complexities in the comparison of financial statements due to the number of assumptions underlying booked amounts.

Although the ED proposes a great number of disclosures on reconciliations, assumptions and valuation methods used, this huge granularity in the information requested risks to impair the ability of users to focus on the key information on judgements that are significant to explain the overall measurement model.

Also, some disclosures may provide little benefit with significant effort: this is the case of the requirement to disclose the confidence level-equivalent, which is regarded by our constituents as being too onerous.

Furthermore, it is important to analyse the relationship between IFRS 4 and IFRS 7, also referring to disclosure requirements to avoid both separated information in the case of a mix of insurance and financial risk and duplication of data. Only relevant information should be given in the financial statements to avoid an excess of information that affects effectiveness of the information provided.

As a result of above comments, we strongly recommend that the IASB, once it has finalised the measurement model, launches a public consultation that focuses on the disclosure requirements, to ensure that only key messages are conveyed to stakeholders and any excess of information is avoided.