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INSURANCE SWEDEN comment on EFRAG draft Comment letter on IASB Insurance Contracts ED/2013/7

Insurance Sweden appreciates the EFRAG initiative of encouraging us to comment on the EFRAG draft comment letter to the IASB regarding Insurance Contracts ED/2013/7.

Insurance Sweden is the industry organization for insurance companies in Sweden. About 40 Insurance companies are members of Insurance Sweden and together they account for more than 90 per cent of the Swedish Insurance market.

This letter is intended to serve as an addition to the Insurance Europe and the European Insurance CFO Forum comment letter to EFRAG, of which drafting we have taken part.

Introduction

In general, Swedish insurers apply a very active asset management strategy, comprising well diversified portfolios and the use of derivatives. Their portfolios include a large amount of equities, in average more than 30% of the investments, according to our latest statistics from June 2013. For many insurers the asset management is regarded to be an equally important part of their core business, as the performance of the underwriting business.

When Sweden joined the European Union in 1995, fair value measurement was introduced according to EU regulations in the Accounting directives. Fair value measurement was quickly accepted in Sweden and appreciated for its transparency and comparability for users of financial reporting.

Fair value measurement is still the most common measurement method for investment portfolios of Swedish insurers.

However, the preferred measurement category varies across Swedish insurers and also within portfolios of the same insurer. Measurement categories like amortized cost and available for sale are more suitable for some business models and the proposed third measurement category in IFRS 9, Fair Value through Other Comprehensive Income (FVOCI) is also well advocated by certain insurers.

Insurance Contracts Exposure Draft ED/2013/7

In the following, we comment on three specific areas in the ED; OCI, Mirroring and Unbundling. These comments, which we hope you will find useful, constitutes our feedback on the EFRAG draft comment letter.

Our main messages are:

1. We disagree with the IASB proposal for a mandatory OCI.
2. Mirroring is needed for mutuals, but need some further deliberations. "The Alternative Approach" has to be further investigated and developed before it can be launched as the sole alternative to Mirroring.
3. The criteria for unbundling are too narrow.

The above mentioned areas are the same as the ones we plan to comment on, in our response letter to the IASB, due on 25 October 2013.

1. Interest expense in Profit or Loss

We disagree with the IASB proposal for a mandatory OCI.

There can be reasons for reporting the effects of changes in the insurance liability due to discount rate changes in both OCI and/or P/L in order to be consistent with the insurer's different types of products, business models and asset liability management strategies.

Regardless of where the effects of discount rate changes are presented - in P/L or in OCI - we are deeply concerned about the requirement to recognize in P/L a calculation of interest expense using the discount rate that applied at the date when contracts were initially recognized, in an attempt to calculate an interest expense on an amortized cost basis.

The complicated calculation of such interest expense at amortized cost would bring about fundamental changes of the IT-systems as a consequence. If the proposals for an interest expense at amortized cost would be introduced, it should be necessary to store numerous discount rate curves; the current discount rate and the discount rate at inception, for each and every contract (or possibly a group of contracts). That would be extremely burdensome.

For non-life insurers applying the simplified approach in paragraphs 35-40, there is also a further and significant complication. Though they will probably not discount the liability for the remaining coverage, they still have to discount claims reserves. Since many non-life insurers don't register contract date in their claims systems, using discount rates at contract inception would be impossible without extensive system changes.

The costs related to all these changes of the IT-systems would be huge without any certain benefits of increased information of the entity's financial performance.

Whilst we support the Boards view, that segregating underwriting performance from the effects of the changes in the discount rates would provide relevant information that faithfully would represent the entity's financial performance, we believe that the 'definition' of effects of changes in the discount rate need to be changed, moving away

from the demand of storing discount rates at inception.

We suggest the following modification:

- recognizing, in profit or loss, the interest expense determined using the discount rates that applied at the beginning of the financial year; and
- recognizing, in profit or loss or 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 beginning of the financial year.

In our view, this modification would result in information that is at least equally as good as the information that would be the result of the ED proposal – and at a cost that is dramatically lower.

2. Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items – “Mirroring”

Mirroring is needed for mutuals.

Mutual entities may be required to apply IFRS standards. It is therefore of essential importance that the characteristics of mutual entities are taken into account. Mutual entities cannot be listed, but may have issued debt securities that are listed. However, not only European companies listed in an EU securities market, but also companies whose only listed securities are debt securities, are requested to prepare their consolidated financial statements in accordance with IFRS. As a consequence, mutual entities may be required to comply with the IFRS-regulation. Further, there are also jurisdictions in which the IFRS are mandatory for insurers regardless of whether the entities are listed or not. This is the case in Sweden. The consequences of the proposed standards for mutuals entities must therefore also be carefully analyzed and considered

We support the mirroring approach set out in paragraphs 33-34.

We deem it necessary for mutual entities, given the statement made by IASB in its Basis for Conclusions, BCA 59 e) i) and BCA 62 where no equity would be reported in the accounts of the issuing entity if policyholders have rights to participate in the whole of any surplus of the entity in question.

If the mirroring approach cannot be applied there will be situations where an accounting mismatch will occur, for instance if the entity has assets in the accounts that are not measured at fair value or fair value option is not applicable by IASB standards. For a mutual entity ultimately all payments to policyholders are to some extent dependent on the returns on all assets of the entity. For that reason, accounting mismatches are unavoidable on a company level if the mirroring approach is not applied.

For mutual entities where the policyholder has a right to participate in any surplus of the entity as a whole there will be no economic mismatch. The wording in paragraph B84 is somewhat unclear and seems to imply that mirroring would not be possible for mutual entities, since it may be possible to avoid economic mismatches on a contract level. For a mutual entity the underlying items are the assets and liabilities of the entity as a whole which clearly is in line with the requirements of paragraph 33. The wording in paragraph B84 should be amended in order not to restrict mutual entities from applying the mirroring approach, for instance by including a provision in the Application guidance that clearly states that the criteria in paragraph 33 is met if the underlying items are the assets and liabilities of the entity as a whole.

Consequently the application of the mirroring approach for mutual entities will have to be made according solely to paragraph 34a) and not paragraph 34b). The value of cash flows that vary directly with underlying items will be measured on a company level, not on a contract level and there will be no bifurcation of cash flows.

Since there is no economic mismatch borne by a shareholder there is no need for bifurcation of cash flows as requested in paragraph 34.

The guidance to paragraph 34 should be amended to clarify the use of the mirroring approach at company level for mutual entities, in order to avoid misinterpretations. Since the standard often refers to the contract level, it is important to clarify situations when it shall be applied at company level. For instance paragraph B85 could be supplemented with a point c) that states that for mutual entities where the policyholders have rights to participate in the whole of any surplus of the entity, there is no need to bifurcate the cash flows as described in paragraph B85a) and B85 b).

The Alternative Approach

In the context of Mirroring; Insurance Sweden is aware of the so called Alternative Approach that some European and other global insurers are developing. We recognize that the Alternative Approach aims at addressing the concerns raised by some parties regarding the bifurcating cash flows, as included in the mechanics of the mirroring approach.

However, it is somewhat challenging to understand the full details and effects of the specific Alternative Approach since it is not tested for all products. To our understanding it does not work for mutuals. The Alternative Approach needs to be further investigated and developed, before it can be launched as the sole alternative to mirroring.

3. Unbundling

We believe the criteria in the ED for unbundling are too narrow and not principle based.

The basic principle in the ED seems to be that there is an insurance contract at the core of the product and then some services or other attachments added. However, referring to the Swedish insurance market, for several companies (unit-link companies) the business model is rather a savings contract with an insignificant insurance coverage. In most contracts there is often an option added to add significant insurance coverage, such as waivers of premium. The profit driver for the insurer is fees charged for the savings product and not the insurance risk taken on. In a principles based standard the relevant criteria for unbundling should be that the separate components are distinct. A distinct component is one that is easily separated either by pricing principles, separately sold product, and/or is reviewed by management either separately or together with similar components. On top of that the cash-flows related to the investment component must be possible to measure reliably. This would allow for the different business models of insurers to be captured in the financial statements.

To illustrate how the unbundling criteria in the current draft could affect the accounting in different ways, although the product is more or less the same, depending on how the insurance component is put together with the savings product:

- Unit linked contract where the policyholder has chosen to invest the whole premium in an equity fund. The policyholder pays a fee. The insurer pays 101% of the fund value in the case the policyholder dies or 100% at maturity/surrender. There are no guarantees in the contract. This contract would be measured using IAS 39/IAS 18 since there is no significant insurance risk.
- The same unit linked contract but with a waiver of premium if the policyholder becomes sick. The policyholder pays the same fee as for the other unit linked contract, with an addition of an insurance premium for the health insurance. The insurance risk is considered to be significant in this case. The investment component is distinct since it is sold as a separate product but the insurance component is inter-related with the investment component since it will terminate when the savings component terminate. Thus the contract will be measured using IFRS 4.
- The same unit linked contract but with a separate waiver of premium contract sold by the same or another insurance company. The unit linked contract will be measured using IAS39/IAS18 and the insurance contract will be measured using IFRS 4.

In a unit link insurance company the exactly same products will be measured and accounted for differently depending on whether the insurance wrapper is added or not. When applying the unbundle criteria for the asset management service component some of the cash flow could be derived and measured through IAS 18. We believe this is an artificial split that does not reflect the business model. The only component that is relevant to account for under IFRS 4 is the waiver of premium, which is easy to separate as it is sold separately and thus priced and followed up separately.

As the waiver of premium can be sold separately and terminated separately the

contract would move between IFRS 4 and IAS 39/IAS 18 as the policyholder chooses to pay for the waiver of premium or not. We understand this constitutes a modification that would require the insurer to derecognize the contract and recognize a new contract, although the basic functionality is unchanged. This will affect both revenue recognition models (IAS 18 vs. IFRS 4) and the presentation in the balance sheet, as the investment component will move between insurance liability and financial liabilities. Again, we believe this creates an artificial split of the cash flows of the product and will add to the complexity in accounting for this relatively simple instrument. The administrative burden to monitor and account for such contracts will be overly complex without any identified benefits.

A suggested rewording of the unbundling criteria could be:

B31 Paragraph 10(b) requires an entity to separate a distinct investment component from the host insurance contract. Unless highly interrelated, an investment component is distinct if:

- (a) A contract with equivalent terms is sold, or could be sold, separately in the same market or same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity shall take into account all information that is reasonably available in making this determination. The entity need not undertake an exhaustive search to identify whether an investment component is sold separately; and
- (b) The investment component, whose operating results, separately or together with other components beside insurance components, are regularly reviewed by the entity's management; and
- (c) The cash-flows related to the investment component can be measured reliably.

B32 (a) – keep as is

- (b) – delete the whole paragraph

We would like to again thank EFRAG for the opportunity to share our comments with you. Please feel free to contact us to discuss any matters raised in this letter.

Yours sincerely,



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