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18 October 2013

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Dear Ms. Flores,

EFRAG Comment Letter on Exposure Draft: Insurance Contracts

We welcome the IASB's decision to re-expose the 2010 Exposure Draft. The revised Exposure Draft is a reasonable basis for the development of an IFRS for insurance contracts. Given the importance of this standard, we appreciate the opportunity to comment on your draft letter to the IASB.

As a global reinsurance and primary insurance group with subsidiaries in many international markets and business in almost all regions of the world, a uniform accounting standard ensuring international comparability is of critical importance. We are firmly convinced that an accounting standard for insurance contracts is necessary as we consider applying such an insurance-specific standard as being far more useful and relevant than having to rely on other IFRS, since these have not been developed with the specifics of insurance in mind.

As a member company of the CFO Forum and Insurance Europe, we support the joint comment letter of these two organisations providing feedback on your draft comment letter. However, on the basis of our broad experience with reinsurance treaties, we would like to specifically emphasize, that, in order to adequately reflect the economics of reinsurance transactions, some important changes to the Exposure Draft are necessary, which we outline in more detail in our response letter to the IASB that is attached as appendix to this letter.

We do not agree with EFRAG's conclusion in paragraph 17 of Appendix 2 that day one gains and losses on buying reinsurance should be recognised over the coverage period. Our concerns are not limited to day one gains and losses on buying reinsurance, but also comprise subsequent measurement of reinsurance contracts held.

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Furthermore we have concerns regarding the recognition of (re)insurance liabilities and the combination of insurance contracts.

Detailed arguments and proposed solutions on the topics mentioned above can be found in our response letter to the IASB.

We are committed to continue our active dialogue with you and offer our support and cooperation. We would be grateful if EFRAG would take our remarks into consideration. The Munich Re experts and we would be happy to discuss any topics where you deem this to be useful.

Yours sincerely,

Münchener Rückversicherungs-Gesellschaft



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Dear Mr. Hoogervorst,

Exposure Draft ED/2013/7 Insurance Contracts

We thank you for the opportunity to comment on this revised Exposure Draft. We fully support the Board's objective of developing one robust global accounting regime for insurance contracts and would highly appreciate a final standard being issued as soon as is practicable. As a global reinsurance and primary insurance group with subsidiaries in many international markets and business in almost all regions of the world, a uniform accounting standard ensuring international comparability is of critical importance. We encourage you to continue your ongoing efforts to develop a high quality standard for insurance contracts and offer our active support and cooperation. We are firmly convinced that an accounting standard for insurance contracts is necessary as we consider applying such an insurance-specific standard as being far more useful and relevant than having to rely on other IFRS, since these have not been developed with the specifics of insurance in mind.

We welcome the Board's decision to re-expose the 2010 Exposure Draft and appreciate the effort of the Board to take the concerns raised by constituents related to the 2010 Exposure Draft into consideration. The revised Exposure Draft is a reasonable basis for the development of an IFRS for insurance contracts.

As a member company of the CFO Forum and Insurance Europe, we support the joint comment letter of these two organisations. However, on the basis of our broad experience with reinsurance treaties, we would like to specifically emphasize, that, in order to adequately reflect the economics of reinsurance transactions, some important changes to the Exposure Draft are necessary, which we outline in more detail in our response to questions 1 and 7 attached.

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Measurement of reinsurance contracts held

A reinsurance contract is dependent on the underlying direct insurance contracts, which should be taken into consideration when measuring the corresponding reinsurance asset. Reinsurance transactions on an aggregate loss basis can be measured initially as outlined in the Exposure Draft, because those reinsurance contracts transfer a risk defined on a portfolio of underlying insurance contracts from the cedant to the reinsurer. However, where the reinsurance risk transfer is based on individual underlying insurance contracts, the cash flows of the reinsurance contract depend on the cash flows of the contracts they cover. By ceding risks to a reinsurer, the cedant replaces uncertain future results with certain future results. Consequently, the cedant is not on risk for the risks covered under the reinsurance contract. Therefore, we believe that gains or losses on reinsurance contracts written on an individual loss basis ought to be immediately recognised by the cedant. The current proposal leads to an economically and practically unnecessary deferral of such gains or losses.

Recognition of (re)insurance liabilities

Certain types of insurance contracts provide insurance cover for a number of similar or identical risks. The economics of such insurance contracts are not reflected appropriately but the proposals of the Exposure Draft lead to counterintuitive effects.

Combination of insurance contracts

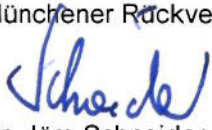
We appreciate that the term "otherwise interdependent" has been replaced by a more detailed description by referring to the wording of ED/2011/6. At the same time, we think slight specification would further increase clarity when assessing the significance of insurance risk.

Beyond the issues briefly described above, the Exposure Draft requires amounts relating to investment components that are not unbundled to be disaggregated from the revenue presented in profit or loss. Conceptually, this is inconsistent with the proposal not to separate these components from an insurance contract.

We would be grateful if the Board would take our remarks into consideration. The Munich Re experts and we would be happy to discuss any topics with the Board or the staff where you deem this to be useful.

Yours sincerely,

Münchener Rückversicherungs-Gesellschaft


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CFO


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Response to questions 1 and 7 of the 2013 Exposure Draft

Question 1—Adjusting the contractual service margin

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows 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?

Measurement of reinsurance contracts held

Accounting of reinsurance contracts held has changed significantly comprising both changes of the measurement model for reinsurance assets (e.g. at initial recognition now deferral of all gains and losses, apart from losses of retroactive contracts) and the newly introduced requirements for adjusting the contractual service margin. Since the measurement of reinsurance contracts held is affected by the requirement to adjust the contractual service margin, we provide our comments as part of our response to Question 1.

We fully agree with paragraphs 51 and 63 of the ED that in essence propose a gross presentation of business assumed and ceded in the statement of financial position and in the statement of comprehensive income.

However, for reinsurance contracts held we would like to draw your attention to the issues of the determination of the contractual service margin at inception (paragraph 41 (c)) and the subsequent release of the contractual service margin (paragraph 41 (d) (ii)) as well as to the subsequent adjustment of the contractual service margin (paragraph 41 (d) (iii)).

We also agree with the conclusion in BCA 143 that the contractual service margin for business assumed (i.e. for insurance liabilities) is different to that for business ceded (i.e. for reinsurance assets). While the contractual service margin on the liability side defers uncertain future expected profits not yet earned, the reflection of uncertain future results is not the purpose of the contractual service margin on the asset side. Rather the contractual service margin of reinsurance contracts held needs to be determined in such a manner that the reinsurance asset reflects the effects generated by the release from risk provided under a reinsurance contract. Hence, the measurement of the contractual service margin of reinsurance contracts held is still a major concern.

Reinsurance transactions on an aggregate loss basis can be measured as outlined in the ED, because those reinsurance contracts transfer a risk defined on a portfolio of underlying insurance contracts from the cedant to the reinsurer. However, we do believe that in other cases reinsurance transactions (where the risk transfer is based on individual underlying insurance contracts) should not be measured as outlined in the ED. As a consequence, the assumption in paragraph 41 (c) (i) of the ED that "the entity shall recognise any net cost or net gain on purchasing the reinsurance contract as a contractual service margin" is not appropriate under certain circumstances.

As outlined in BCA 128 and mentioned in paragraph 41 (b) the cash flows of a reinsurance contract held depend on the cash flows of the contracts they cover. In particular, from an economic perspective, a reinsurance contract on individual loss basis is fully dependent on the underlying direct insurance contracts. This fact should be taken into consideration when measuring the corresponding reinsurance asset, both at inception and subsequently. When ceding risks to a reinsurer, the cedant replaces uncertain future results with certain future results. Consequently, the cedant is not on risk for the risks covered under the reinsurance contract. This should be reflected in a strong link between the evolution of the contractual service margin of the reinsurance contract held and the contractual service margin of the underlying business. The current wording can lead to significant divergence between those margins and provides room for accounting arbitrage.

In contrast to the economic effects outlined above the current proposals in paragraph 41 (c) and 41 (d) for determining the contractual service margin of reinsurance contracts held lead to inconsistencies to the contractual service margin of the underlying direct insurance contracts both at inception and subsequently. This has two consequences which we consider not being in line with appropriate measurement and presentation:

- Since the contractual service margin of reinsurance contracts held is neither at inception nor subsequently linked to that of the underlying insurance business, this would facilitate accounting arbitrage (this comment refers to paragraphs 41 (c) and 41 (d) (ii) of the ED).
- The core function of reinsurance as measure to mitigate losses from insurance risk is not reflected appropriately by the concept of paragraph 41 (d) (iii) of the ED dealing with the subsequent adjustment of the contractual service margin. In a situation of unfavourable changes in future cash flows of the underlying insurance contracts exceeding the contractual service margin on the liability side, the cedant would suffer a loss from the incoming business. Although covered by a reinsurance contract held, according to the current proposals in the ED this loss cannot be compensated by a respective change of the value of the reinsurance asset. This is caused by paragraph 41 (d) (iii) requiring in such a situation to reduce the contractual service margin for a reinsurance contract held and even allowing for a negative contractual service margin.

We support the Board's approach in paragraph 41 (a) for recognition of reinsurance contracts held and would like to follow this approach for the measurement. For recognition, a differentiation is made between

- reinsurance contracts providing coverage for the aggregate losses of a portfolio of underlying contracts (here referred to as 'reinsurance contracts on aggregate loss basis') and
- all other reinsurance contracts (i.e. reinsurance contracts providing coverage for the loss of individual underlying insurance contracts, here referred to as 'reinsurance contracts on individual loss basis').

For reinsurance contracts on aggregate loss basis, we support the Board's approach outlined in paragraph 41 (c) (i). The contractual service margin of the reinsurance asset should be solely based on the reinsurance contract. This implies a calibration of the contractual service margin to the reinsurance premium at inception. This approach refers to the reinsurance contract, which is consistent with the requirements for recognition of the reinsurance asset.

For reinsurance contracts on individual loss basis the principle of following the fortunes is decisive and consequently should be reflected in accounting. Based on this, the contractual service margin of the reinsurance asset should reflect the reinsurer's share in the risk of the underlying business. This is best reflected by the proportion of the risk adjustment of the reinsurance asset to the risk adjustment of the liability of underlying contracts. This approach refers to the underlying primary insurance contracts, which is consistent with the requirements for recognition of the reinsurance asset.

For subsequent measurement, the adjustment of the contractual service margin of reinsurance contracts held should be restricted as follows. With the exception of reinsurance contracts on aggregate loss basis where the contractual service margin at initial recognition is negative, the contractual service margin should not be negative. In the case of reinsurance contracts on aggregate loss basis where the contractual service margin at initial recognition is negative the contractual service margin should not be less than the contractual service margin at initial recognition including interest accreted on the contractual service margin.

For the sake of clarity, we further propose the following two amendments:

- The word “only” should be inserted in the first sentence of paragraph 41 in order to make clear that there is always a link between business assumed and business ceded.
- As a general rule a favourable (or unfavourable) change in the future cash flows of reinsurance contracts held is generated by an unfavourable (or favourable) change in the future cash flows of the underlying insurance contracts. Hence, in order to reflect the logic on how this should be calculated, “minus” and “plus” should be exchanged at the beginning of paragraph 41 (d) (iii).

As requested in the invitation to comment please find below wording proposed for the future standard for insurance contracts.

Proposed wording: Reinsurance contracts held

- 41 An entity that holds a reinsurance contract pays a premium and receives reimbursement if it pays valid claims arising from underlying contracts, instead of only receiving premiums and paying valid claims to the policyholder. Consequently, some of the requirements in this [draft] Standard are modified to reflect that fact, as follows:
- (a) the recognition requirements of paragraph 12 are modified so that an entity shall recognise a reinsurance contract held:
 - (i) from the beginning of the coverage period of the reinsurance contract, if the reinsurance contract provides coverage for the aggregate losses of a portfolio of underlying contracts; and
 - (ii) when the underlying contracts are recognised, in all other cases.
 - (b) in applying the measurement requirements of paragraphs 19–27 to estimate the fulfilment cash flows for a reinsurance contract held, the entity shall use assumptions that are consistent with those that are used to measure the corresponding part of the fulfilment cash flows for the underlying insurance contract(s). In addition, the entity shall, on an expected present value basis:
 - (i) treat cash flows, including ceding commissions, that are contingent on the occurrence of claims of the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract;
 - (ii) treat ceding commissions that it expects to receive that are not contingent on the occurrence of claims of the underlying contracts as a reduction of the premiums to be paid to the reinsurer;

- (iii) apply the requirements of paragraph 21 so that the fulfilment cash flows reflect the risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes; and
 - (iv) determine the risk adjustment required by paragraph 27 so that it represents the risk being transferred by the holder of the reinsurance contract.
- (c) the requirements of paragraph 28 that relate to determining the contractual service margin on initial recognition are modified so that, at initial recognition the entity shall recognise a contractual service margin measured at an amount that:
- (i) ~~the entity shall recognise any net cost or net gain on purchasing the reinsurance contract as a contractual service margin measured at an amount that is equal and opposite to the sum of the amount of the fulfilment cash flows and pre-coverage cash flows for the reinsurance contracts providing coverage for the aggregate losses of a portfolio of underlying contracts; unless~~
 - (ii) is equal to the proportion of the risk adjustment of the reinsurance asset to the risk adjustment of the liability of underlying contracts applied to the contractual service margin of the liability of underlying contracts, in all other cases not cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the reinsurance contract, in which case the entity shall recognise such a cost immediately in profit or loss as an expense.
- (d) the requirements of paragraphs 30–31 that relate to the subsequent measurement of the contractual service margin are modified so that the entity shall measure the remaining amount of the contractual service margin at the end of the reporting period at the carrying amount that was determined at the start of the reporting period:
- (i) plus the interest accreted on the carrying amount of the contractual service margin to reflect the time value of money (the interest accreted is calculated using the discount rates specified in paragraph 25 that applied when the contract was initially recognised);
 - (ii) minus the amount recognised relating to services that were received in the period (in particular, for reinsurance contracts not providing coverage for the aggregate losses of a portfolio of underlying contracts the pattern of transfer of services is based on the underlying primary insurance business); and
 - (iii) ~~plus/minus~~ (or ~~minus/plus~~) a favourable (or unfavourable) change in the future cash flows if that change arises from a difference between the current and previous estimates of the future cash flows that relate to future coverage and other future services. With the exception of reinsurance contracts on aggregate loss basis where the contractual service margin at initial recognition is negative, the contractual service margin should not be negative. In the case of reinsurance contracts on aggregate loss basis where the contractual service margin at initial recognition is negative the contractual service margin should not be less than the contractual service margin at initial recognition including interest accreted on the contractual service margin. Changes in the expected present value of cash flows that result from changes in the expected credit losses of the reinsurer do not relate to future coverage or other future services and shall be recognised immediately in profit or loss.
- 42 Other requirements of this [draft] Standard apply to a reinsurance contract held. For example:
- (a) an asset that arises under a reinsurance contract may be regarded as comprising both the expected value of the recovery that relates to the remaining risk coverage and the expected value of the recovery that relates to incurred claims. An entity may simplify the measurement of the expected value of the recovery that relates to the remaining coverage using the approach set out in paragraphs 38–40 if:
 - (i) doing so would produce measurements that are a reasonable approximation to those that would be produced by applying the requirements in paragraph 41; or
 - (ii) the coverage period of the reinsurance contract is one year or less.
 - (b) disclosure requirements apply to reinsurance contracts.

Rationale based on Framework

The differentiation between types of reinsurance contracts is consistent with the differentiation already introduced for recognition.

The approach described above supersedes any differentiation between prospective and retroactive contracts. Such a distinction does not appear appropriate from an economic point of view, since it would imply a different treatment of the ceded liability for incurred claims depending on the nature of the reinsurance contract (i.e. prospective or retroactive).

For reinsurance contracts including both prospective and retrospective features, which are common in practice, the Board's approach would result in two separate contractual service margins for one reinsurance contract. The contractual service margin for the "prospective portion" of the reinsurance contract would be released over the coverage period, while the contractual service margin for the "retroactive portion" of the reinsurance contract would be released over the settlement period. This would be both confusing for users and impracticable for preparers.

Non-performance risk is appropriately reflected when applying paragraph 41 (b) (iii). Since the contractual service margin is not calibrated to a premium in the approach proposed above, the impact of non-performance risk on the fulfilment cash flows is not offset by an increase in the contractual service margin. By contrast, under the ED approach non-performance risk would not result in any impact on the total reinsurance asset (i.e. the sum of the fulfilment cash flows and the contractual service margin).

The proposed approach is easy to apply in practice and easy to understand.

It enables users to identify and understand similarities in, and differences among, reinsurance assets for different types of contracts. In particular, the approach for reinsurance contracts on individual loss basis enables users to identify the reinsurer's share in the underlying business. Beyond that, users can identify more or less favourable reinsurance conditions.

Different knowledgeable and independent observers can easily reach consensus, although not necessarily complete agreement, that a particular depiction of a reinsurance asset is a faithful representation. In particular, the proposed reference to the underlying insurance liability for contracts on individual loss basis allows an easily verifiable measurement of the reinsurance asset.

The approach described above provides relevant financial information capable of making a difference in the decisions made by users. When applied to reinsurance contracts on individual loss basis the reinsurance asset exactly reflects the reinsured portion of both income (i.e. premiums) and expenses (i.e. claims) of the underlying business. This is the most relevant information enabling users to assess the economics of the reinsurance contract. By contrast, for reinsurance contracts on aggregate loss basis, where such a direct relation between the underlying primary insurance business and the reinsurance coverage does not exist, a calibration to the reinsurance premium provides more relevant information. Hence, the approach fully reflects the economics of the reinsurance transactions. Consequently, it is relevant and faithfully represents what it purports to represent.

Recognition of (re)insurance liabilities

Since the recognition of (re)insurance liabilities is affected by the requirement to adjust the contractual service margin, we provide our comments as part of our response to Question 1.

Certain types of insurance contracts provide insurance cover for a number of similar or identical risks. In general, the number of these insured risks is unknown at the beginning of the coverage period of these insurance contracts. The insurance premiums are directly linked to the number of underlying insurance risks which are finally covered. This is common for certain types of reinsurance contracts, which are typically on individual risk basis, and for primary group insurance contracts, e.g. the insurance of a fleet of cars of a leasing company.

In such cases, the initial measurement of both the fulfilment cash flows and the contractual service margin would be based on an estimate of underlying insurance risks that are expected to be concluded in future. In subsequent periods the fulfilment cash flows are adjusted to reflect the actual business volume. The contractual service margin is adjusted for changes in estimated cash flows resulting from changes in business volume, but changes in the risk adjustment resulting from changes in business volume are recognised in profit or loss. Consequently, changes in business volume have an artificial impact on profit or loss. That means, the economics of such insurance contracts are not reflected appropriately but lead to counterintuitive effects.

We support the Board's approach in paragraph 41 (a) of the ED for recognition of reinsurance contracts held and would like to follow this approach for the recognition of reinsurance liabilities. For recognition of reinsurance contracts held, a differentiation is made between

- 'reinsurance contracts on aggregate loss basis' and
- all other reinsurance contracts (i.e. 'reinsurance contracts on individual loss basis').

For the measurement of an insurance contract which itself covers one or more underlying insurance risks an entity shall take into account cash flows resulting from underlying insurance risks at the same time when the underlying insurance risks (i.e. the individual underlying insurance contracts) are recognised. For 'reinsurance contracts on individual loss basis' this would be consistent with recognition requirements for reinsurance contracts held outlined in the ED.

Alternatively, the counterintuitive effects described above could be avoided by adjusting the contractual service margin for changes in the risk adjustment relating to future periods.

Question 7—Clarity of drafting

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?

Combination of insurance contracts

During the May 31 to June 2 2011 meeting the Board tentatively decided that contracts entered into simultaneously for the same risk, or contracts that are otherwise interdependent “should be considered a single contract for the purpose of determining risk transfer”. We appreciate that the term “otherwise interdependent” has been replaced by a more detailed description in the ED by referring to the wording of ED/2011/6. At the same time, we think slight specification would further increase clarity when assessing the significance of insurance risk.

- Paragraph 8, which belongs to the “Scope” section of the ED seems to indicate that insurance contracts shall also be combined for recognition and measurement, if certain criteria are met. This would deviate from the Board’s tentative decision during the May 31 to June 2 2011 meeting. We suggest clarifying that paragraph 8 needs to be applied when assessing the significance of insurance risk rather than when recognising or measuring an insurance contract.
- In accordance with paragraph 8(a) two contracts have to be combined whenever they are “negotiated as a package with a single commercial objective”. For insurance contracts the concept of a “single commercial objective” is quite ambiguous since any contract has the objective to compensate the policyholder if an insured event adversely affects the policyholder. Hence, in a broad interpretation, any two insurance contracts have the same commercial objective. On the other hand, the “single commercial objective” is present if protection is provided against the same insured event, i.e. the contracts “relate to the same insurance risk” which is already covered by paragraph 8(c).

We suggest clarifying this by either deleting paragraph 8(a) or by specifying under which circumstances not covered by paragraphs 8(b) and 8(c) a combination of insurance contracts which are “negotiated as a package” is required.