International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

DIA comments on ED on Insurance Contracts

25.10.2013

Danish Insurance Association
Philip Heymans Allé 1
DK-2900 Hellerup
Phone +45 41 91 91 91
Fax +45 41 91 91 92
fp@forsikringogpension.dk
www.forsikringogpension.dk

Helle Gade

Dir. +4541 91 90 91
heg@forsikringogpension.dk

Vores ref. HEG
Sagsnr. GES-2008-04591
DokID 328075

The Danish Insurance Association (DIA) welcomes the opportunity to comment on the targeted consultation of the Exposure Draft on Insurance Contracts (the ED).

The DIA appreciates that the IASB has included many changes for the better in the present ED based on the comments that we provided to the 2010 ED. However, we do not believe that the IASB has yet found the right solutions particularly on the following very significant issues (Q3-5).

In particular we have strong concerns on the changes to the recognition of interest expense, which now includes a mandatory recognition of interest expense in OCI. There may be severe consequences of requiring the use of OCI. Worst case it may:

- jeopardise incentives to perform good risk management in insurance companies
- obscure the economic results of the period and
- reduce the attractiveness of investments in shares and property from an accounting perspective although they may be quite attractive investments from a policyholder and a general economic perspective.

We therefore urge the IASB to reconsider the mandatory use of OCI and in particular what should be the general principle for recognition of interest expense (P/L or OCI).

We believe that the OCI-model included for recognition of interest expense should not be the general recognition principle for interest expense. The general principle for recognising all changes to the fulfilment value of insurance contracts including interest expense should remain profit or loss as suggested in the 2010 ED. We think there could be an OCI-option in IFRS 4 to classify a contract at initial recognition to be recognised in OCI only in the case where it reduces an accounting mismatch arising from the use of FVOCI or amortised cost in classifying financial assets under the coming IFRS 9. This should be combined with an option in IFRS 9 to use FVOCI. However, in a Danish context we do not see a particular need for an OCI-model.

If it is not possible for the IASB to decide on a general principle for recognition of interest expense in IFRS 4 based on recognition in profit or loss then there is a need for a P/L-option to be included in IFRS 4. The option should correspond to the IFRS 9 option for financial liabilities and allow entities at initial recognition to irrevocably designate a portfolio of insurance contracts to be measured at fulfillment value through profit or loss, when it reduces an accounting mismatch or is in line with the management and performance evaluation of the insurance contracts.

Question 4 - A current value through profit or loss should remain the general recognition principle

The ED requires - for cash flows that does not vary directly or indirectly with returns on the underlying items - that insurers recognise in OCI the difference between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the discount rates that applied at the date that the contract was initially recognised. In P/L the interest expense is recognised based on the discount rate applied at initial recognition.

This suggested OCI recognition principle for interest expense assumes in reality that all assets corresponding to the insurance contracts are measured at FVOCI.

The DIA strongly disagrees that financial statements will provide relevant information if entities are required to use a recognition principle of interest expense based on the OCI-model required in ED2013/7 (60(h) and 64).

This point is also very well explained in the alternative view of Stephen Cooper, which we support except for the solution presented therein. However, we would like to stress a few points in relation to this.

Business model of Danish life insurers

In Denmark the accounting principles of life insurers has for many years now been based on a current value principle with all changes in values through P/L. Life insurers in Denmark are not using the principle of held to maturity for accounting purposes. Danish life insurers have a business model that would be inadequately presented using the principle of held to maturity (amortised cost/FVOCI).

A few words on the business model of Danish life insurers. Danish insurers measure insurance liabilities at a market consistent value. This means that the value of insurance liabilities are dependent upon interest rate levels through the use of a discount curve, which reflects market information for as long as the information is a faithful representation and otherwise relies on a mark-to-model approach.

In order to limit the interest rate risk, many companies have an independent hedge portfolio. The objective of this portfolio is to obtain a high degree of assurance that the insurer will be able to honour the pension commitments. The interest rate risk on pension obligations is largely hedged by using derivative financial instruments as interest rate swaps and swaptions.

The result of the investment strategy is measured by the overall return of the investment portfolio and the hedge portfolio. This return is compared with de-

velopments in provisions for pensions as a result of interest rate changes – the so-called adjusted return.

Investments by insurers are managed on a risk/return basis taking into account the (insurance) liabilities that the company has. An example provided by a Danish insurer: Investments are made taking into account the run off of the portfolio, the guarantees provided to policyholders and the expected market return.

In terms of volumes of trades, those factors which result in the highest volumes of trades are the risk management as well as the tactical investment decisions based on market movements and not the liquidity needs.

To document this, a Danish life insurer has analysed the transactions in 2012 in the total bond portfolio of the insurer. In 2012, 11% of the total value of the bond portfolio was redeemed, while investments and divestments amounted to 72% of the value of the total bond portfolio. Therefore, investments are based on a *Held for sale* principle.

Further, performance is calculated based on current/fair value measurement basis, a fair value return and benchmarked against a fair value return. This picture is representative of all Danish life insurers.

Mismatch and incentives
The introduced OCI recognition principle in the ED assumes in reality that all assets corresponding to the insurance contracts are measured at FVOCI.

The OCI recognition principle for interest expense should be seen in the light of the introduction of a new FVOCI measurement category in IFRS 9. Both requirements will, however, as presently drafted result in substantial accounting mismatches for Danish insurers. There are a several reasons for this.

First, even with the limited amendments to IFRS 9 proposed in 2012, which suggested introducing a new measurement category (FVOCI), not all assets will be measured at FVOCI. This will result in a mismatch. The new measurement category in IFRS 9 (FVOCI) is for financial assets that are both simple debt instruments and where the business model is *held to collect and for sale*. However, Danish insurers also hold shares and other investments such as investment property to back the insurance liabilities thereby supporting business and property development. The measurement of these investments will be fair value through profit or loss. The requirement in the ED to recognise part of the interest expense on the insurance liabilities in OCI will therefore result in an accounting mismatch. From an accounting perspective this may reduce the attractiveness of such investments although they may be quite attractive investments from a policyholder and a general economic perspective.

Second, many Danish insurers (including non-life insurers) use financial instruments (derivatives) to hedge for example interest rate risk inherent in the insurance liabilities. Derivatives will according to IFRS 9 be measured at fair value through P/L (FVPL). The introduction of FVOCI will result in an unnecessary accounting mismatch in P/L if the (interest rate) risk in insurance liabilities is hedged. Worst case insurers may be incentivized to reduce the use of derivatives, which is usually considered good risk management, if they find it necessary to reduce the accounting mismatch.

Third, even if all assets could be measured at FVOCI it would not eliminate the accounting mismatches. As mentioned earlier Danish life insurers actively manage for example bond portfolios and when doing so the amount recognised in OCI will be recycled to profit or loss. However, the amounts recycled on the assets sold will not be matched by the corresponding amount on the liability side as in most cases the liability will not be derecognised. Therefore, a principle to recognise gains or losses on assets in OCI may obscure the economic results of the period when specific assets are sold and amounts in OCI are recycled to P/L. This may affect the comparability of performance measurement.

The DIA therefore does not believe that a recognition principle for interest expense as suggested in the ED will result in relevant information for the readers of financial statements.

Complexity issues
The requirement in the ED to recognise part of the interest expense on insurance liabilities in OCI will increase complexity in the financial statements both for readers to assess and for preparers to produce the information required.

Further, we do not see the relevance of recognizing interest expense in P/L based on the initial discount rate. Many insurance contracts are of a long duration and therefore it is not relevant basing interest expense information on interest rates from 20-30 years ago or more. It may obscure the current development in accounting results.

For preparers we believe that the costs of the administrative burden will be substantial as in reality preparers have to keep track of separate measurements, one for the recognition in profit or loss and another one for OCI. In the Danish market, current values in measuring insurance liabilities have been used since 2004 in combination with a required use of FVPL. This principle has the advantage of the companies being able to recalculate the interest rate on a current basis with no requirements to keep track of the portfolios at initial recognition other than for CSM purposes. In the current proposal, any subsequent change in expected cash flows to be allocated to a specific portfolio at initial recognition needs to establish a link to a specific interest rate curve/discounting rate.

The IASB has concluded that this operational complexity is justified because segregation of gains and losses that are expected to unwind over time from other gains and losses would enable users of financial statements to understand the underwriting and investing performance of an entity that issues insurance contracts. However, this is also possible when the recognition of interest expense is only through P/L either by separating underwriting and investing performance directly in P/L or by including a specification in the notes. Thereby the mismatch and incentive effects could be avoided.

Suggestions for changes
The DIA believes that the general principle for recognising all changes to the fulfilment value of insurance contracts including interest expense should remain profit or loss as it was suggested in the 2010 ED.

Given the many disadvantages that the OCI-model causes for both readers of financial statements and for preparers, we believe the OCI-model should at most be an option. We think there could be an OCI-option in IFRS 4 to classify a con-

tract at initial recognition to be recognised at fulfilment value through OCI only in case where it reduces the accounting mismatch arising from the use of FVOCI or amortised cost in classifying financial assets under the coming IFRS 9. This should be combined with an option in IFRS 9 to use FVOCI. However, in a Danish context we do not see a particular need for an OCI-model.

If it is not possible for the IASB to decide on a general recognition principle for interest expense based on profit or loss then there is a need for an option to recognise all changes in the fulfillment value of insurance liabilities in profit or loss. We understand that the IASB is hesitant to allow options. However, such an option will eliminate several accounting mismatches as well as some very undesirable incentives for Danish insurers - if the OCI-model suggested for IFRS 9 is also made optional. Further, certain conditions could apply to the use of the option.

We believe such an option in IFRS 4 should correspond to the option in IFRS 9 to designate a financial liability at fair value through profit or loss (4.2.2). The option should allow entities at initial recognition to irrevocably designate a portfolio of insurance contracts to be measured at fulfillment value through profit or loss when doing so result in more relevant information because either:

(a) it eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch)
(b) a portfolio of insurance liabilities is managed and its performance is evaluated on a fulfillment value basis in accordance with a documented risk management or investment strategy

Since Danish insurers generally use fair value (current value) through profit and loss on the asset (and liability) side, this option will result in elimination of the accounting mismatch that would otherwise result from the suggestion in ED2013/7 (60(h) and 64).

Question 3 - Presentation of insurance contract revenue and expenses should allow a summarized margin method for life insurance

For non-life we agree that the presentation of insurance contract revenue and expenses will provide relevant information that reflects how the business is managed. However, for life insurance and pensions business we do not agree.

In Appendix B (B31-B32) it is determined that investment components shall be separated from the host insurance contract unless the investment components are highly interrelated. An investment component and insurance component are highly interrelated if the entity is unable to measure the one without considering the other or the policyholder is unable to benefit from one component unless the other is also present. We agree that this is a suitable criterion for separating elements or not.

In those cases where the investment component and the insurance component of a contract are not separated according to B31-B32, it is still required that the elements are separated for the statement of profit or loss (and other comprehensive income) according to paragraph 58 of the standard.

This is not in all cases meaningful for life insurance contracts where risk premiums are determined for the duration of the contract and therefore the revenue amount that would result from separating the two elements may not provide meaningful information and would not reflect a measure that is used by the company for the economic management of the life business. Further, the actual separation of elements will be a heavy burden both to calculate and to administer in practice.

Therefore, we think that for life insurance business the summarized margin approach, which was suggested in the ED Insurance Contracts published in 2010, should be available as well. As life insurance contracts often are a mix of savings and insurance, which is closely interrelated, the unbundling proposal for the statement of profit or loss (and other comprehensive income) may not provide meaningful information and does not reflect how the business is managed.

Question 5 - Effective date and transition

The DIA is pleased that the IASB has stated in C6 that in applying the transition requirements in relation to estimating the remaining contractual service margin for already issued insurance contracts, an entity need not undertake exhaustive efforts to obtain information but shall take into account all objective information that is reasonable available.

However in C6 it is also mentioned that an entity shall:

(a) estimate the expected cash flows at the date of initial recognition at the amount of the expected cash flows at the beginning of the earliest period presented, adjusted by the cash flows that are known to have occurred between the date of initial recognition and the beginning of the earliest period presented;

This will be a huge task for which 3 years may not be enough. We urge the IASB to consider a wording that allows also more pragmatic approaches where cash flows do not have to be estimated in line with the intention of not having to undertake exhaustive efforts.

Regarding the effective date, we find it important that the effective date of IFRS 4 and IFRS 9 are aligned so that it is possible for insurers to avoid two major changes in their financial statements in short succession. Further, we would suggest that early adoption is permitted in IFRS 4.

Question 7 – Interpretation of "directly attributable costs"

The DIA understands the ED such that "directly attributable costs" can include also discounts as explained below that will be recognised as a reduction of "directly attributable costs".

There are cases where an insurer forms a collaborative agreement with an investment fund manager, where the insurance entity receive a fee based on the size of the total investments of the (unit-linked) contracts placed in the investment funds administrated by that manager. The fee stems directly from the investment of each single (unit-linked) customers account balance. The fee is paid from the investment fund to the insurance entity and represents a discount to

the fee that the customers have already paid for asset management services provided by the investment fund manager.

We understand the ED such that the portion of the fee income (discount) paid to the customers can be included in the fulfillment cash flows of the portfolio as a reduction of the "directly attributable costs" i.e. it can be considered inside the contract boundary.

Yours sincerely,

Helle Gade