Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

16 October 2014

DP/2014/1: Accounting for Dynamic Risk Management: a Portfolio Revaluation approach to Macro Hedging

Dear Mr Hoogervorst

We are taking this opportunity to comment on your Discussion Paper “Accounting for Dynamic Risk Management: a Portfolio Revaluation approach to Macro Hedging” (the “DP”) which describes the Portfolio Revaluation Approach (PRA). This letter has been drafted by the European Insurance CFO Forum, a body representing the views of 21 of Europe’s largest insurance companies, and Insurance Europe, the European insurance and reinsurance federation which represents 95% of the premium income of the European insurance market. Accordingly it represents the consensus view of a significant element of the European insurance industry, including their global operations.

A better alignment of risk management and financial reporting is a desirable objective.

We appreciate the IASB’s efforts to investigate how companies’ dynamic risk management (DRM) approaches can be addressed in IFRS accounting. We believe it is essential to reflect such practices in financial reporting as it will provide more decision useful information to users about the management of risk in the organisation. Defining appropriate accounting measures which reduce or eliminate accounting mismatches in profit or loss would result in a better depiction of an entity’s business model in financial statements. Hence, we question the IASB’s concern that the application of the PRA would lead to a lack of comparability between companies. Different risk management activities lead to different financial results which should be made transparent. We note however, that the DP does not address reflecting DRM for insurance business in IFRS accounting. A relevant DRM approach for insurance business should take account of insurance contract liabilities and the interaction with the measurement of the backing assets. These elements of insurance business are not addressed in the current DP.

Risk management of an open portfolio is a key activity for insurance companies in managing policyholder liabilities.

We do not agree with the DP’s approach which seems to be a banking specific amendment to IFRS 9, which itself is not an industry specific standard. The IASB’s macro hedge accounting project should also develop a view on the application of risk mitigating techniques for industries beyond banks to maintain consistent requirements for transparent accounting / disclosure of risks.

Insurers manage portfolios of insurance contract liabilities, which are open portfolios where new insurance contracts are added and existing policies expire or lapse on a regular basis. Insurers carry out open portfolio risk management through asset liability management (ALM). In ALM the policyholder liabilities and backing assets are managed together to meet policyholder obligations as they fall due. The exposures are, therefore, often managed on a net exposure basis. Hedging instruments are also often used by insurers to manage their risk exposure. However, the ability to use hedge accounting principles under the newly issued IFRS 9 will still be limited for insurance companies, in particular as it is based on a single risk perspective which is not reflective of how insurers manage risks from insurance portfolios.

Dynamic Risk Management (DRM) is part of the insurance business model. The DP proposals should be developed alongside IFRS 4 Phase II in order that the macro hedge accounting principles, when combined with IFRS 9, are relevant to insurance business.

Consistent accounting principles between insurance contracts' liabilities and underlying assets are crucial to reflect insurers' ALM practices and the long-term nature of our business model to allow for meaningful presentation of financial results. Consequently, accounting solutions to reflect such dynamic risk management practices are critical to our industry.

As the insurance contracts standard (IFRS 4 Phase II) is still under development, the requirements for the measurement of insurance contracts liability portfolios are not finalised. It is not yet clear the extent to which the interaction between IFRS 4 Phase II and IFRS 9 will provide a suitable basis to fully reflect insurers risk management practices. Therefore, it is challenging to assess and comment at this stage on the appropriateness and application of the PRA to the insurance business model. We would encourage the IASB to develop the macro hedge accounting principles alongside IFRS 4 Phase II so that the combined requirements are relevant to the insurance business model.

It is very important that the final combined requirements on IFRS 4 Phase II "Insurance Contracts" and IFRS 9 "Financial Instruments" provide an adequate basis for insurers to report their core financial performance and meet the information needs of users. Macro hedge accounting should supplement those standards on the core financial performance for the insurers' use of macro hedging risk management practices.

A macro hedging accounting solution must be relevant to insurance business, taking account of insurance contract liabilities and the measurement of backing assets and wider risks beyond interest rate risk.

We believe it is unlikely that the PRA as drafted would provide a suitable macro hedge accounting basis for insurers. Whilst there may be some limited elements which are relevant, the proposed PRA needs to be significantly adjusted and further developed to be able to deliver a suitable approach for insurers' business models. We appreciate that the IASB clarifies that the illustration in the DP has been developed around the banking industry; stabilising net interest income for banks is an understandable objective, considering the amortised cost approach for core lending activities. However, whilst the PRA is provided as an example model, it is solely designed to address specific issues around amortised cost accounting.

The IASB's insurance contracts project requires a current fulfilment measurement for insurance contracts liabilities, thus insurers will be required to use current valuation for its core business activity. The DP's PRA puts emphasis on the interaction between amortised cost and interest rate risk. It would not seem appropriate to apply such a model if liabilities are measured at current fulfilment value and the underlying assets will be either valued at amortised cost, at fair value through other comprehensive income or at fair value through profit or loss.

Limiting the risk exposure to interest rate risk and the use of derivative financial instruments in the PRA would not capture the vast majority of risk management practices used by insurers. Insurers manage a greater variety of risks in their insurance liability portfolios beyond interest rate risk, hedging risks such as duration, longevity and liquidity. A macro hedge accounting solution will need to adopt a broader approach to risk exposures than set out in the DP to be relevant to the insurance industry.

Furthermore, the definition of risk management instruments in the DP refers only to derivatives whereas insurers carry out their ALM and manage the risk exposure of policyholder liabilities with a wider variety of asset classes. In addition, the benefits provided to policyholders are usually long duration, but the assets, including derivative instruments, used to back these liabilities are shorter duration and so this adds complexity to dynamic management of risk for insurers.

Optional use would be most appropriate although it is too early to finally conclude.

We note that the IASB is interested to learn whether the PRA should be mandatory or optional. It is our view that solutions which lead to extensive disclosure requirements and tracking efforts should not be mandatory. This is especially relevant if an industry wide approach is developed, optional application could be more suitable if the end user benefits do not outweigh the implementation cost. However, we believe it is too early at this stage of the process to consider whether the final outcome should be mandatory or optional.

PRA through other comprehensive income needs to be further explored.

We believe that the application of macro hedge accounting when changes in the insurance contract liabilities due to discount rate changes are presented in OCI should be further considered in the next steps of the project. In addition, consideration should be given to the interaction with the unlocked contractual service margin which forms part of insurance contract liabilities under IFRS 4 Phase II. The unlocking of the contractual service margin could often incorporate changes in underlying liability cash flows that are partially or wholly matched by hedging instruments.

We will continue to monitor the progress made with this DP and consider its potential impact alongside developments in IFRS 4 Phase II. In developing the future exposure draft, we would ask the IASB to take into consideration the insurance dynamic risk management approach and the interaction with the final requirements of IFRS 4 Phase II.

Yours sincerely,

Olav Jones
Deputy Director General
Director Economics & Finance
Insurance Europe

Gérald Harlin
Chair
European Insurance CFO Forum