Committee of European Banking Supervisors

Tower 42
25 Old Broad Street
London EC2N 1HQ
United Kingdom

t + 44 (0) 20 7382 1770
f + 44 (0) 20 7382 1771

www.c-ebs.org

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Peter Clark
International Accounting Standards Board
30 Cannon Street,
London EC4M BXH
United Kingdom

Dear Mr Clark

Discussion Paper - Preliminary views on Insurance Contracts

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union, welcomes the opportunity to comment on the Discussion Paper Insurance Contracts (DP) issued by the IASB.

Banking supervisory authorities and central banks have a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

While this discussion paper deals only with accounting issues for insurance liabilities, CEBS believes that considering its important interactions with some of the Board's other projects, this DP may have implications for other areas of non-insurance accounting. Notwithstanding in particular the potential and conceptual similarities between insurance contracts and financial instruments that use fair value measurement approaches, we believe that there are differences on how insurance contracts and financial instruments are measured in practice. Therefore, CEBS would encourage the Board to extend the useful inputs that the work on insurance contracts may generate to financial instruments only after careful consideration.

In this response, rather than answering each of the specific questions raised in the discussion paper, we intended to focus predominantly on issues raised in this discussion paper which are of particular relevance and importance from a banking supervisor perspective and notably those that could have consequences for financial reporting in the banking industry through IASB's conceptual framework and financial instruments long-term projects.

The comments hereafter have been prepared by one of CEBS' expert groups, the Expert Group on Financial Information (EGFI), chaired by Mr. Arnoud Vossen, in charge of monitoring any developments in that area and of preparing positions to be taken by CEBS. The development of our comments on this Discussion Paper was coordinated by a Subgroup of EGFI under the direction of Mr. Patrick Amis.

If you have any questions regarding our comments, please feel free to contact Mr. Arnoud Vossen (+31.20.524.3903) or Mr. Patrick Amis (+ 33.1.4292.6032).

Yours sincerely

Danièle Nouy
Chair, Committee of European Banking Supervisors

Appendix

Links with the conceptual framework project and other relevant IASB projects

CEBS welcomes the efforts of the IASB on the insurance contracts project and its strong commitment to propose a revised accounting model for insurance contracts, in constant dialogue with the industry and insurance supervisors.

While we support adoption of a revised standard for insurance contracts, we note that the Discussion Paper (DP), when dealing with issues relating to the measurement of insurance liabilities, raises questions about general principles of recognition and measurement: for example when discussing measurement based on an exit value model approach, recognition of revenue and classification of discretionary participation features under equity or liability (and related issues of consistency with IAS 32 and the current conceptual framework). Considering the potentially significant implications of the DP on recognition and measurement concepts, we would encourage that the links between this DP and the conceptual framework project and other relevant IASB projects are properly identified and considered, in order to ensure consistency as regards the general principles being developed.

Definition of the current exit value

The DP proposes a current exit valuation model for insurance liabilities which presents many similarities, conceptually, with the definition of fair value that is embedded in SFAS 157 as well as the definition that is defined both in the context of the conceptual framework project (milestone I of phase C: Measurement) and in the preliminary work on the redefinition of a standard on financial instruments. However, having regard to the detailed definition that is provided in the paper, we notice that there may be some differences between this measurement approach and the one that is provided in the Fair Value Measurements project that the Board should further explore.

For example the building blocks approach in the insurance contract discussion paper includes an explicit risk margin which is compensation for bearing risk. This concept which allows risks and uncertainty associated with the liability to be taken into account is relevant for mark-to-model measurement in a broader context and should be considered in the measurement project, when dealing with the redefinition of fair value. On the contrary, the SFAS 157 definition is not explicit regarding the incorporation of similar building blocks in the fair valuation determination process.

The current exit value concept also refers to the market participant view when determining the transfer value of the liabilities at each stage of the building blocks. In the insurance project, a market participant is assimilated to an entity holding an identical obligation, i.e. a peer or another reporting entity which is allowed to hold insurance liabilities and has the same knowledge as the reporting entity about the characteristics of the contract whereas there seems to be a need of clarification on this issue under the Fair Value Measurements project.

Transfer versus settlement

The current exit value is based on the concept of a “transfer value”, which would be assessed from the perspective of transactions between market participants rather than from the perspective of the entity itself. However, we assume that transfer values of insurance contracts will usually be largely influenced by the cash flows resulting from the settlement of the contracts’ obligations.

Although a market participant view is defined quite clearly on a theoretical point of view in the discussion paper we believe that it is not clear enough on how a market participant view could be applied when there is no available market data, as this is the case for insurance products and can also be the case for some financial instruments. This might request assumptions on market participants’ behaviours and on hypothetical transactions between hypothetical market participants and, hence entail higher subjectivity and a variety of approaches in the practical implementation of the standard. Therefore we believe that this issue could give rise to reliability issues in those cases and hence requires further examination. As regards liabilities, either insurance or financial instruments, we believe that the transfer value should be influenced by the settlement values, in the absence of market data in particular.

Profit at inception

As already mentioned in our 4th May 2007 comment letter on the *Fair Value Measurements Discussion Paper*, we are concerned that the recognition of day-one profits or losses at initial recognition could give rise to reliability issues when relying on valuation techniques that incorporate important unobservable inputs. Strong risk management and valuation controls are necessary to ensure the rigorous determination of fair values, especially when there are not established valuation techniques or where inputs to the valuation process are not observable. We believe that this topic merits additional examination in the context of future work on measurement, revenue recognition and financial statements presentation.

Own credit risk

We understand that the creditworthiness of the insurer would be reflected in the measurement of its insurance liabilities. We believe that own credit spread variations should not be incorporated in the fair value of liabilities. Doing so would imply the recognition of gains when a reporting entity’s credit quality deteriorates, which may not result in information which is useful for users of financial statements. It may even lead to misleading information for users of financial statements, as the debtor in many instances has to settle its contractual obligations in full on a going concern basis.

Beneficial Policyholder behaviour

Consideration of policyholder behaviour introduces concepts that could be problematic in a mixed attribute measurement model framework. The discussion paper states explicitly, in paragraph 142 that the IASB does not intend to extend the model beyond insurance contracts as it would indeed be inconsistent with the existing requirements under IAS 39 (e.g. deposit floor).

Incorporation of expected future cash flows resulting from beneficial policyholder behaviour in the current exit value of insurance liabilities is consistent with the idea that cash flows incorporating all future outflows under a contract should also include all future inflows that are integral to the fulfilment of obligations of that same contract. However, due notably to the intangible nature of the concept, we would not support the extension of this model to financial instruments. Assumptions would have to be made to estimate the value of generated intangible assets from a transaction which might introduce subjectivity in valuation and may lead to various practices in terms of recognition and measurement of intangible assets. Moreover, we are not convinced that the concept of guaranteed insurability is clear enough and we wonder whether this treatment could not lead, in certain cases, to the recognition of insurance assets, instead of liabilities, when applied to profitable entities.

Unbundling

We note that the IASB requires unbundling of deposit components except in cases where components are difficult to separate or value, or where the components are highly interdependent. We fully support unbundling of deposit elements in insurance contracts which would meet the definition of a financial instrument as we believe that an entity should account in the same way for the deposit component of an insurance contract as well as for the issuer of a separate, but otherwise identical financial instrument. We also believe that criteria on when unbundling would be required should be consistent between IAS 39 and the insurance contract standard.

However we are aware that in cases where components can be measured separately on a basis that is not arbitrary, the insurance component would be measured as the difference between the measurement of the whole contract and the measurement of the deposit component. Therefore inconsistencies may exist as an insurance component may not receive the same accounting treatment as a separate insurance contract. We would encourage the IASB to consider this issue further.

Treatment of financial guarantees

We are of the view that contracts that have similar economic characteristics and are managed in the same way should be treated in a consistent way, regardless of differences in legal form, in order to enhance comparability and consistency among entities notably insurers, bankers and financial conglomerates.

However we have noticed that in the current situation there is not a clear distinction between the definition of a credit insurance contract according with IFRS 4 and the definition of a financial guarantee contract according to IAS 39, and hence we are concerned that this could raise arbitrage issues. Therefore we would encourage the Board to further explore this issue and to ensure that when a financial guarantee contract meets the definition of an insurance contract, both contracts should have the same accounting treatment.

Service margin

While not opposing the idea of a service margin, we are not sure that this concept is sufficiently defined in the discussion paper. We believe that it needs further clarification, notably regarding the way it articulates with other IFRS, especially with IAS 18 (see paragraph 13 and paragraph 13 of the appendix in particular).