

# Rådet för finansiell rapportering

The Swedish Financial Reporting Board

RFR-rs 2007:5

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

Dear Sirs,

We appreciate the opportunity to respond to the International Accounting Standards Board's Discussion Paper *Preliminary Views on Insurance Contracts*. This letter represents the views of the Swedish Financial Reporting Board.

We strongly oppose implementing a standard, based on the measurement model proposed, before other important IASB projects have been finalised. Our main arguments are the following:

- We do not support the rationale of using transfer values as a measurement basis for insurance contracts. Such a model will be based on several hypothetical parameters, which will be difficult to validate against actual market transactions and, as a consequence, there is a high risk for fundamental estimation errors.
- We consider that a measurement model using actual cash flows as a starting point will be superior to the model proposed.
- We consider that day-one-profits should normally not occur in insurance business activities.
- We consider that only changes that are motivated by the unique characteristics' of insurance contracts should precede the implementation of other projects. As a consequence it is essential that the radical proposals in the DP, if implemented, will not subsequently be changed as consequence of the finalisation of other important IASB projects.

We also note that the approach of accepting day-one-profit is in total disagreement with the guidance in the recent IFRIC Draft Interpretation D 21 Real Estate Sales.

## General remarks

We recognise the need for a new IFRS on insurance contracts due to the wide difference in practices today. A new IFRS for insurance contracts will necessarily address many of the fundamental questions that are under discussion presently. Given some of the radical changes proposed in present practices and the large impact they may have on the insurance industry, it is important that any new standard, as a result of this project, will not subsequently be revised as consequence of the finalisation of other important IASB projects. Therefore it is essential that IASB ensures that no major changes are implemented that are not consistent with the direction proposed for related projects. Only differences that are motivated by the unique characteristics' of insurance contracts and the business models used in the insurance industry should motivate that IASB implement changes affecting the areas of measurement at fair value, revenue recognition, recording of day-one-profits, recognition and measurement of liabilities and other important areas including the work relating to phase D of the Conceptual framework project,

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**The Swedish Financial Reporting Board**

Box 7680 103 95 STOCKHOLM

Tel: +46-8-50 88 22 79 Fax: +46-8-32 12 50

[www.radetforfinansiellrapportering.se](http://www.radetforfinansiellrapportering.se)

# Rådet för **finansiell rapportering**

before work in the area has been completed, the reason being that many of the issues discussed in the paper may have far reaching implications on other, non-related areas of

financial reporting. It must be avoided that principles suggested in this DP for insurance liabilities will be spread to all liabilities without an in-depth analysis of the impacts.

Our understanding is that one fundamental building block of the DP is that all insurance contracts should be measured at fair value, with this value derived at using hypothetical counterparts, cash flows and prices and that day-one-profits at initial recognition and the expensing of all direct acquisitions costs are natural.

We believe that the model has been chosen as a result of a misguided belief that if the methodology works in the financial markets it should therefore also work for insurance contracts. However, we hold the view that this is a weak starting point even for financial contracts. A liquid market is more an exception than a rule even in the financial markets. The last months have shown how difficult it is to accurately model a fair value when there is no reference market to use as a starting point. Transferring that methodology to an industry where there normally is no secondary market at all is fundamentally incorrect and must be questioned. This is especially the case when non-entity specific parameters are to be used. There is a high probability that a model for measurement of insurance liabilities that is based on certain components will arrive at a value that is far from representing a fair value. This risk is especially high when there is no requirement to calibrate the model to the initially observed transaction price. A model that requires the preparer to only identify certain components of an insurance contract will not be able to identify all unique components that is part of the transaction price. This obvious risk for constructing a model where different components are not accurately estimated is much higher than the risk of not identifying when the customer has paid too much or too little. Therefore we consider that the initial transaction price best represents the fair value and that day-one-profits normally should not occur. Our preferred approach is a model that uses fair value for certain components and where others are amortised during the remaining life of the contract.

After initial recognition subsequent measurement should be based on a model that replicates the value at initial recognition. Such, by us, preferred approach should be based on the expected cash flows that the insurance contract is expected to generate, contractually enforceable or not. Market data should only be used for those components of an insurance liability where there is a liquid market.

We also hold the opinion that fair value is not always the most relevant measurement basis for financial reporting. The relevance is dependent on the business model of the entity. If the entity's business model is such that fair value is of no interest for the estimation of future cash flows and the changes in fair value are unrealised, the value of the fair value information when presenting the financial reports must be questioned. The fair value may be especially irrelevant in the income statement if the entity's business model is to earn revenue through the servicing of a contract until its final maturity.

Regardless of the relevance; if an entity's other assets and liabilities are measured at fair value, there might be a need to use some kind of methodology which captures corresponding value changes in the components of the insurance liability that are directly or indirectly connected to/dependent on other assets and liabilities of the entity. E.g. if an entity uses assets and liabilities to mitigate changes in the value of the insurance liability and those assets and liabilities are measured at some kind of current value, and/or the size of the insurance liability is directly dependent on value changes of these assets or liabilities being measured at some kind of current value, then those components of the insurance liability should be measured using the same measurement methodology.

# Rådet **för** *finansiell rapportering*

To conclude, we believe that actual transaction prices best represent the fair value of an asset or liability, since such methodology best captures all the factors that are considered when a buyer and seller reach an agreement on a transaction price. Using valuation models that seek to replicate a transaction price by measuring single components will normally fail to identify all relevant parameters. Therefore we consider that day-one profits normally should be a misrepresentative presentation of a transaction at initial recognition. Consequently, a measurement methodology should be used for subsequent measurement that replicates the price at initial recognition.

## **Question 1**

**Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?**

If IFRS should have the same recognition and derecognition criterias for both financial instruments and insurance contracts has to be decided based on the available evidence. Our general opinion is that there is no obvious rational for having exactly the same detailed principles if the circumstances are different. However as a general rule, if all important attributes are the same, the recognition and derecognition requirements should apply regardless if IAS 39, IAS 37 or IFRS 4 are applied.

## **Question 2**

**Should an insurer measure all its insurance liabilities using the following three building blocks:**

- (a) **explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,**
- (b) **current market discount rates that adjust the estimated future cash flows for the time value of money, and**
- (c) **an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?**

**If not, what approach do you propose, and why?**

We prefer an indirect measurement methodology for initial recognition based on the actual transaction price. I.e. the model should replicate the initial value at initial recognition. The same measurement model should thereafter be used for subsequent measurement.

The implication of an indirect measurement methodology is that there is an assumption that the transaction price agreed between two counterparts represents a true fair value.

Having that basic presumption as a starting point, we consider that:

1. The estimated cash flows based on the expected behaviour of the customer should be estimated
2. The estimated cash flows should be discounted, when relevant
3. Certain embedded options and other non-linear risk should be measured using some kind of measurement methodology, and finally
4. The difference in value between the transaction price and the value generated from the valuation exercise should be presumed to be the best representation of all the factors that have not been captured in the theoretical measurement of the value at initial recognition. (The effect of that

# Rådet **för** finansiell rapportering

methodology is that the "unspecified parameters" will be amortised using the effective yield methodology during the expected life of the insurance liability).

That said we believe that IASB needs to recognise that there may be a lot of different models used for estimating the fair value of an insurance liability and that there may be a lot of nuances in the insurance agreements that make the methodology proposed to be too prescriptive and unbalanced.

For example the insurance agreements may be divided into separate components being priced separately (e.g. administrative cost compensation, insurance risk compensation, compensation for embedded financial guarantees and finally compensation for initial transaction costs).

Different measurement methodologies may be relevant for estimating the fair value of those different components, other than what is indirectly proposed by stating "probability-weighted and current estimates". We believe for instance that other methodologies may be better suited to capture non-linear risks and the correlation between the different components of expected cash flows that the insurance agreement may be expected to generate and which are therefore used as the basis for pricing the insurance contracts.

We therefore instead propose a more general and principle based approach that should identify the attributes that should be considered when measuring the value of an insurance liability.

Some attributes that should be considered are:

- The expected future premiums (contractually enforceable or not)
- The expected future outgoing cash flows
- Direct cash-flows that have arisen when generating the insurance liability
- The time-value of money
- Other factors in aggregate which add up to the initial direct cash-flows (ingoing premiums and outgoing cash-flows for the creation of the insurance contract).

These principle based paragraphs could be complemented with items that normally should be considered (e.g. insurance risk, financial guarantees, administrative expenses, fees to insurance brokers' e.tc.)

To conclude; we consider that more than one model may be used when modelling the fair value of an insurance liability. There are existing alternatives other than those proposed when separating the measurement of the insurance liability in the three components proposed and that we also believe that the transaction price normally is the best estimate of the fair value wherefore theoretical cash-flows which have no connection with the one's expected to occur between the two parties in the transaction are irrelevant when estimating the value of the insurance liability. Therefore "market consistent" should to be replaced with "entity specific".

The main rational for this comment is that:

1. Insurance liabilities are not normally transferable and therefore it is the entity specific cash flows that should be of interest when measuring the value of an insurance liability
2. When there is no liquid or standardised market, estimating market consistent prices of different kinds is a highly subjective an arbitrary exercise. The additional value of such an exercise may be questionable since the values calculated will never be materialised into actual cash flows.

Finally, it is important to have a principle based and open approach when discussing what the current "risk-free" interest rate actually is. When studying the yield curve it is often the case that it drops at the longest maturity traded. The reason for this is that there is a lack in supply of long government bonds which are used to hedge long life insurance/pension liabilities. Therefore an

# Rådet **för** finansiell rapportering

IFRS on insurance contracts must allow adjustments to be made to the price quoted when extrapolating the yield curve into even longer periods than what is traded.

## **Question 3**

**Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?**

We refer to the comments made when answering question 2.

We would also like to make some specific comments.

- (a) A specific comment is that the last part of E28 (b) is unclear. It is stated that an entity should consider the specific terms for settlement. At the same time the basic message in the exposure draft is that the insurance liabilities should be measured based on a theoretical transfer value. Then, if the contractually terms in an insurance agreement are that the contract is not transferable, but instead that a settlement value should be calculated if the policy holder moves to another insurance company, should the settlement value be used instead? If yes, should it be the settlement value as at the balance sheet date, or a value in the future calculated based on the expected maturity of the contractually relationship?
- (b) Paragraph F3(e) states that the margin used should be as consistent as possible with observed prices. We do not believe that it is relevant to recalculate the risk margin just because the pricing in the market of exactly the same risks have changed. The rationale for this statement is that if there is no intention to transfer the insurance liability the subjective estimate of a current risk margin will not reflect a good estimate of future cash flows. The cash flows are still expected to be the same. However, if the risks actually have changed, it is reasonable to do a recalculation because the expected cash flows then are expected to change.

## **Question 4**

**What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.**

(a)

The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.

(b)

There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?

(c)

The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.

# Rådet för **finansiell rapportering**

(d) Other (please specify).

We prefer alternative a based on the reasoning given when answering question 2.

## **Question 5**

This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.

(a)

**Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?**

No. We do not consider an exit value to be an appropriate measurement attribute. Most insurance liabilities are not transferable and most common is that it is only possible to settle the liability. Due to a lack of possibility to transfer the liability and the fact that there are no common standardised insurance agreements we fail to understand the rationale in basing the measurement of an insurance liability on other than entity specific parameters for those parameters not observable in the market place. Furthermore, since it only in exceptional circumstances is possible to transfer the insurance liabilities the prevailing business model is to manage the insurance agreement during the life of the contract and not to engage in short term profit taking. When such a business model exists the best estimate of future cash-flows is the one being based on the expected cash-flows of the insurance entity.

The most essential flaws with the proposed methodology are:

- It will be highly subjective and arbitrary for entities to try to "invent" a theoretical counterpart.
- It will be very arbitrary for entities to estimate what that theoretical counterpart would require as compensation for taking over the insurance liabilities.
- Transfer value is based on an expected maturity of the contract based on contractual cash flows. To restrict the calculation to contractual cash flows may be highly irrelevant compared with the entities own assumptions regarding the expected cash flows.

(b)

**Is 'current exit value' the best label for that measurement attribute? Why or why not?**

No. Current exit value is a highly misrepresentative label on the proposed measurement methodology. Since the proposed measurement methodology is based on theoretical cash flows with theoretical counterparts, they do not faithfully represent the financial resources necessary to exit a present insurance liability. The most faithful representation of such value is the contractually agreed value that the entity needs to release the entity from its obligation. That value is the current settlement value.

However, our statement should not be seen as a proposed methodology for measuring insurance liabilities.

## **Question 6**

**In this paper, beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the**

# Rådet för **finansiell rapportering**

insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:

- (a) incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?
- (b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?
- (c) not recognise them? Why or why not?

We believe that this question is not easily answered since it can not be seen in isolation from the treatment of initial direct transactions costs.

As mentioned previously in the comment letter, we believe that the best method of estimating the insurance liability is the indirect method. There should be an assumption that the net of the initial premium and the direct acquisition costs, is the best representation of a fair value since that value is based on actual transactions between independent counterparts.

Using that presumption as a starting point we believe that expected positive and negative cash flows should be considered as well as the expected maturity of the insurance liability at initial recognition and that changes in the parameters used when calibrating the value of the insurance liability should be reflected in subsequent measurement. As regards the presentation issue, we are of the opinion that all cash flows necessary for the generation of the insurance liability should be presented net in the balance sheet.

If IASB continues to hold the view that transaction costs should be expensed at initial recognition that needs to be reflected at initial recognition of the insurance liability.

## **Question 7**

A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?

- (a)  
Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.
- (b)  
All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?
- (c)  
All cash flows that arise from those terms of existing contracts that have commercial substance (ie have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).
- (d)  
Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.

# Rådet **för** finansiell rapportering

(e)  
No cash flows that result from beneficial policyholder behaviour.

(f)  
Other (please specify).

We believe that this question is not easily answered since it can not be seen in isolation from the treatment of initial direct transaction costs. Please see our answer on question 2.

## **Question 8**

**Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?**

No. Since we are in favour of the indirect measurement methodology it is natural to include the initial acquisition costs at initial recognition.

## **Question 10**

**Do you have any comments on the measurement of assets held to back insurance liabilities?**

It is essential to have uniform measurement methodologies for assets and liabilities if they are closely linked to each other. If the liabilities are measured at some kind of current value it is also natural to measure the assets at current value.

However when measuring the insurance liability it is important not to include parameters that are directly linked to the performance of the assets if the expected changes in value of the assets is not considered when measuring the value of the assets. To exemplify: if the insurance contract grants the policy holder a right to a certain percentage of the future return on the assets, that value should not be considered when measuring the value of the liability. However if the insurance contract also guarantees that a certain amount will be paid in the future, that future amount must be included in the measurement of the liability. It is therefore essential to be consistent in the measurement of assets and liabilities and to not include potential future liabilities if not the same potential future assets are included; one component can not exist without the other.

Furthermore, we believe that there exist sound arguments for including the entities on shares in the fair value of the assets if the value of the insurance liability is directly related to a change in value of the entity's own share. An alternative would be to use the "Shadow accounting" methodology that is used in IFRS 4 and reduce the value of the insurance liability instead of changing the treatment of the holdings of own shares. The reason for our position is that it is not actually the entity that has the right to the return on the assets if there is an insurance agreement that grants the policyholder the right to the return.

The same arguments could be used for large holdings of mutual funds where the liability is directly linked to the return on those mutual funds (i.e. it is not uncommon with large percentage of ownership in funds solely created for an unit linked business. If these funds are index funds and the insurance company is listed, the entity is forced to invest in its own share without having any right to the return of the share).

## **Question 11**

**Should risk margins:**

(a)  
**be determined for a portfolio of insurance contracts? Why or why not?  
If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts**



# Rådet för **finansiell rapportering**

that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?

(b)

reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?

The insurance business, with regards to insurance risk, is built on the law of large numbers, meaning that the pricing of the contracts is based on expected and not on unexpected losses. In our opinion a direct answer on the questions raised would be too black or white. The right answer is that it depends on the circumstances and for different insurance contracts it may be more or less relevant to have a narrow or a wide view on the portfolio definition which should be used to calculate the risk margin. To exemplify, there is a very high negative correlation between insurance policies for long-livety risk and mortality risk insurance. In some cases these two risks are covered in the same insurance agreement; in other cases they are sold separately. Due to the strong negative correlation between these two quite opposite risks, the market price for these two risks are based on this strong negative correlation and they should therefore be considered in parallel when using the accurate risk margin for measuring the value of an insurance agreement. In other cases (e.g car insurance and credit insurance) there might be strong diversification effects as well, however the market prices for these two risk factors are not considered in parallel in pricing and therefore the risk margins used should be independent of the diversification effects between the two.

The conclusion from this is that risk margins should be determined based on the relevant portfolio size and take into account those diversification benefits that are used in pricing different insurance contracts.

## **Question 13**

**If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?**

A standard for insurance contracts should as long as possible be consistent with other IFRSs. The present requirements in IAS 39 do not require an instrument to be unbundled if the whole instrument is measured at fair value. Such unbundling is however not forbidden.

Therefore we believe that its should be allowed to use unbundling whenever there is a clean deposit and/or service component whose cash flows are not interdependent with other components in the insurance contracts.

## **Question 14**

(a)

**Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?**

No. An exit value may be either a transfer value or a value that eliminates the present obligation.

Furthermore we believe that the credit characteristics of a life insurance company is of a very low interest, especially in those jurisdictions where there is a requirement to hold assets which are pledged directly for the insurance liabilities and subsequently protected from the default of the entity.

(b)

**Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?**

# Rådet för **finansiell rapportering**

See our answer on question 14 (a).

Furthermore we believe that a possible credit margin is something that would be arbitrary to identify separately. Instead the possible credit margin is one of several different components that all should be included in the calibration factor at initial recognition to derive at a value to use at initial recognition that does not create a day-one profit or loss. That calibration factor should thereafter be held constant in subsequent measurement and thereby be allocated to earnings as part of the revenue for servicing the policy holder.

## **Question 15**

**Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?**

If IFRS should have the same recognition and derecognition criterias for both financial instruments and insurance contracts has to be decided based on the available evidence. Our general opinion are that there is no obvious rational for having exactly the same detailed principles if the circumstances are different. However, as a general rule, if all important attributes are the same, the recognition and derecognition requirements should apply regardless if IAS 39, IAS 37 or IFRS 4 are applied.

## **Question 16**

(a)

**For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?**

Regardless of if there is a legal or a constructive obligation, if the value of the liability is linked to the value of the assets, it would be inconsistent to recognize the value of the liability when the corresponding increase in the asset value is not recognised.

## **Question 17**

**Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?**

(a)

**Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).**

Yes, see our comment on question 10

(c)

**Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).**

Yes, see our comment on question 10.

# Rådet för **finansiell rapportering**

## **Question 19**

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

This question could not be answered in isolation. Instead it should be handled within the Financial Presentation Project.

## **Question 20**

Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

This question could not be answered in isolation. Instead it should be handled within the Financial Statement Presentation Project.

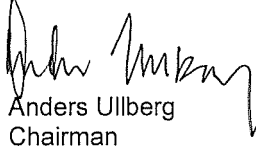
## **Questions not answered**

We have chosen not to respond to the following questions: 9, 12, 16 b, 17 b and d, 18 and 21.

If you have any questions concerning our comments please address our Executive member Carl-Eric Bohlin by e-mail to: [carl-eric.bohlin@radetforfinansiellrapportering.se](mailto:carl-eric.bohlin@radetforfinansiellrapportering.se).

Stockholm November 28, 2007

THE SWEDISH FINANCIAL REPORTING BOARD



Anders Ullberg  
Chairman