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The IASB's Exposure Draft *Insurance Contracts*

Dear Ms Flores,

The European Securities and Markets Authority (ESMA) thank you for this opportunity to contribute to EFRAG's due process. We are pleased to provide you with the following comments with the aim of improving the transparency and decision-usefulness of financial statements and the enforceability of IFRSs.

ESMA has considered EFRAG's draft response on the IASB's Exposure Draft (ED) *Insurance Contracts*. ESMA supported the proposals that were reflected in the 2010 ED *Insurance Contracts*, with some exceptions. The current proposals respond to most of the concerns expressed at that time in ESMA's comment letter. However, ESMA has concerns that the mirroring approach and the accounting for changes in the current value of an insurance contract in Other Comprehensive Income (OCI) add complexity and may create accounting mismatches.

As interest rate risk is a key element of the insurance business, ESMA believes that the effects of the interest rate risk on the fair value of assets and the present value of the fulfilment cash flows for insurance contracts should both be recognised in profit or loss. We also believe that the changes in the discount rate should be presented separately from the effects of changes in other long term assumptions either in the notes or in profit or loss.

As a consequence, ESMA does not agree with EFRAG on the following points:

- With respect to the mirroring approach, ESMA does not agree with a solution that allows the use of OCI as the IASB mirroring approach lacks consistency with the fulfilment value and could impair the cohesiveness of the statements of financial position and financial

performance. Like EFRAG we believe that a solution to the accounting mismatch should start on the liability side. Yet unlike EFRAG, ESMA supports a narrow and well defined scope, should the IASB retain the mirroring approach as proposed. ESMA also believes that presenting the effects of changes in the discount rate partly in OCI and partly in profit or loss would make financial statements too complex to understand and would thus impair comparability of contracts with similar economic features;

- ESMA does not support the use of OCI and therefore disagrees with measurement of assets at fair value and recognition in OCI of the effects of revaluation other than impairment, with recycling of realised gains and losses. ESMA disagrees with EFRAG's view that the use of OCI should cover all assets involved in the asset-liability management, possibly including debt instruments that fail the contractual cash flow characteristics, equity shares and property, when it aims at matching 'stable' liabilities; and
- Should the IASB decide to retain in the final standard the approach of recognising changes in the discount rate on the OCI, we believe it is crucial that the standard requires disclosures in the notes to have a comprehensive view on the performance of insurance contracts.

In addition ESMA is concerned that the proposed standard will hamper effective enforcement as it does not provide sufficient clarity in some specific areas without relying on the Basis for Conclusions or the illustrative guidance, in respect of the following areas:

- presentation of revenue;
- determination of the discount rate ; and
- risk adjustment.

Our detailed comments on the questions in the ED are set out in appendix I. Additional comments on topics outside those questions that ESMA recommends the IASB to consider are included in appendix II.

Please do not hesitate to contact us should you wish to discuss any of the issues raised in this letter.



Yours sincerely,

A handwritten signature in black ink, consisting of a stylized 'S' followed by a vertical line and a horizontal stroke.

Steven Maijoor

Chair

European Securities and Markets Authority

APPENDIX 1 – ESMA’s detailed answers to the questions in the IASB’s Exposure Draft ED/2013/7 – Insurance contracts

Question 1

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?

1. ESMA supports the principle of unlocking of the contractual service margin (CSM) as proposed in the ED. ESMA agrees with the argument in paragraph BC 30 of the ED which states that it is inconsistent to prohibit day 1 gains and at the same time require subsequent recognition of gains on the basis of changes in estimates. This is in line with the view that the CSM represents an estimate of the profit that a contract will generate over its lifetime and that this estimate could change over time. Furthermore, this approach is consistent with principles in the forthcoming standard on revenue from contracts with customers.
2. Although the CSM includes insurance services as well as other services, ESMA agrees that the release of the CSM should relate to the coverage period as the main purpose of an insurance contract is to provide coverage for insured events over the contractual period.
3. It is ESMA’s view that in order to be consistent with the unlocking principle, changes in the share of the risk adjustment relating to future coverage should also be added to or subtracted from the CSM to the extent this part can be reliably separated and measured. Paragraphs BC36-BC37 of the ED explain that such approach was not retained as it would be difficult to disaggregate the part that relates to the future from the part that relates to the past. Although ESMA has not assessed whether this is the case, we believe that a departure from the unlocking principle should not be prohibited as it may be reliably measured.

Question 2

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

- (a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?
- (b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?
- (c) recognises changes in the fulfilment cash flows as follows:
 - i. changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items
 - ii. changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and
 - iii. changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

- 4. ESMA does not support the 'mirroring approach' proposed in the ED as the measurement of the liability may not faithfully reflect the fulfilment cash flows as the latter will partly reflect the carrying amount of the underlying items held by the insurer. ESMA considers that the proposed approach adds significant complexity to preparers and users to understand and implement the standard. Additionally, due to the narrow scope of contracts to which the 'mirroring approach' could apply, only some but not all accounting mismatches will be prevented.

5. ESMA believes that the IASB should develop a solution to prevent accounting mismatches based on the measurement of the fulfilment cash flows of the insurance liability for both the participating and unit-linked contracts.
6. Nevertheless, if the IASB were to decide introducing the mirroring approach, ESMA supports the narrow scope defined and recommends the IASB to clearly describe the principles, provide guidance and more examples as to when and how this exception shall be applied.

Question 3

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

7. ESMA agrees that revenue presented in the statement of comprehensive income should depict the transfer of promised services arising from the insurance contract in an amount that reflects the consideration to which the entity expects to be entitled. Especially as revenue will be recognised when services are provided which is aligned with the revenue recognition principles in the forthcoming standard on revenue from contracts with customers.
8. ESMA is concerned that the presentation and allocation of 'promised services' in paragraph 56 of the ED is not well defined and may lead to diversity in practice. ESMA believes that the IASB should ensure that any application guidance and illustrative examples provided are aligned with those robust principles without replacing the latter. We are concerned that illustrative example IG7 may result in confusion whilst it may not be needed to understand the principle as currently worded.
9. With respect to separation of the investment component, ESMA notes that paragraph 10 of the ED requires unbundling of investment components unless they are so highly interrelated that the entity is unable to measure one without considering the other and the benefit to the policyholder depends on both. ESMA believes that the unbundling principle should drive the revenue recognition, as requiring a separation for presentation purposes only may result in complex and judgemental separation of the additional investment component and impair comparability. Therefore, we consider that the unbundling principle should be applied to both the presentation and the measurement consideration as we believe that, if an entity is unable to unbundle for measurement purposes, it is unlikely that it would be able to present the investment component separately.

Question 4

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

- (a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and**
- (b) recognising, in other comprehensive income, the difference between:**
 - (i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and**
 - (ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows**

Why or why not? If not, what would you recommend and why?

10. ESMA does not agree with the proposals in the ED to recognise the interest expense determined using the discount rate applied at the inception of the contract in profit or loss and to recognise the difference with the interest rate at the reporting date in OCI. ESMA agrees with the alternative view set out in paragraphs AV2- AV4 of the ED as we believe that applying the proposed principle will not result in reflecting adequately the performance of an entity.
11. Although ESMA acknowledges that 'performance' is a concept not yet defined in IFRS, we believe that the effect of changes in the discount rate in conjunction with the changes in fair value of assets held are relevant aspects of the performance of the insurance activity. Management of both the interest rate risk and changes in fair value of assets are key to the insurance business and thus we believe they should both be reflected in profit or loss. In addition, the proposed approach will result in accounting mismatches in cases where the assets that are backing the insurance liability are measured at fair value through profit or loss.
12. Should the IASB choose to retain this proposal in the ED, ESMA believes the standard should require disclosures in the notes that enable users to have a comprehensive view on the performance of insurance contracts, including the effects of recycling from OCI to profit or loss.

13. ESMA understands that some insurers wish to present the effect of changes in the discount rate separately from the effects of changes in the other long term assumptions that are used in the measurement model. ESMA believes that such information is useful and could be presented either in the notes or in profit or loss based on the principle included in paragraph 85 from IAS 1 – *Presentation of Financial Statements* which provides sufficient flexibility to enable insurers to reflect separately the impact of the changes in discount rate.

Question 5

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

14. ESMA agrees with the proposed approach regarding the transition period and expects that many entities have information enabling them to estimate the remaining contractual service margin. However, ESMA believes that sufficient time should be allowed for proper implementation of these proposals.
15. Although ESMA sees merit in aligning the effective dates of the final standard on Insurance Contracts and IFRS 9 – *Financial Instruments*, we believe that that IASB should finalise and set the effective date of IFRS 9 as soon as possible with the appropriate transition guidance being included in IFRS 4. If IFRS 9 is applied before the final standard on insurance contracts is issued, insurers should be allowed to modify their IFRS 9 classification when after a final standard on insurance contracts is issued.

Question 6

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?

How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:

- (a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and**
- (b) the compliance costs for preparers and the costs for users of financial statements to**

understand the information produced, both on initial application and on an ongoing basis

16. ESMA believes a standard on insurance accounting is long overdue and the IASB should exert maximum efforts to consider and finalise the new standard as soon as possible.

Question 7

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?

17. ESMA is concerned that the proposed standard does not provide sufficient clarity in some specific areas without relying on the Basis for Conclusions or the illustrative guidance, for example in respect of the following areas:
- presentation of revenue;
 - determination of the discount rate; and
 - risk adjustment.

APPENDIX 2 – ESMA’s additional comments on the IASB’s Exposure Draft ED/2013/7 – *Insurance contracts*

Discount rate *Illiquidity adjustment*

1. In its comment letter to the 2010 ED¹, ESMA did not support including the liquidity premium in the discount rate without a clear rationale and detailed guidance on implementation.
2. Paragraph B70(a) of the ED provides guidance on assessing the appropriate discount rate for insurance contracts based on market rates for (specified) assets. Paragraph B70(a)(iii) states that in using the top down approach no adjustment needs to be made for remaining differences between the liquidity characteristics of the insurance contract and the assets in the portfolio. ESMA believes that such application guidance is inadequate as those ‘remaining’ differences may result in discount rates that do not properly reflect the characteristics of the insurance liability and may have a significant and material impact, especially in times of stress when liquidity premiums on assets increases.
3. As currently drafted, the requirement in paragraph B70 (a) may result in significant diversity in practice and insufficient disclosures to assess the impact of (changes in) discount rate and the impact of the liquidity premium thereon.
4. The IASB states in BCA 83 that the requirement to disclose the discount rate used (as included in paragraph 85) should alleviate some of the concerns raised about comparability that result from the inability to eliminate all parts of the observed credit spread that relate to credit risk. ESMA believes that in addition to this disclosure the IASB should require an entity to provide that level of granularity in disclosures, which would allow users to assess the impact of the liquidity adjustment on the discount rate. It is our view that these disclosures should also include a sensitivity of the insurance liability to changes in the discount rate and illiquidity premium.

Dependence of fulfilment cash flows on the asset rate

5. Paragraph 26(a) of the ED includes a requirement that, to the extent that cash flows for insurance contracts depend, wholly or partly, on returns from underlying items, the characteristics of the liability should reflect that dependence in the determination of the discount rate. ESMA recommends the IASB to clarify the determination of the discount rate and indicate whether, for example, the reinvestment’s assumptions should be included in the discount rate used for participating contracts.

¹ CESR/10-1540 http://www.esma.europa.eu/system/files/10_1540.PDF

Financial guarantee contracts

6. Financial guarantee contracts issued by insurers are included in the scope of this ED. All other non-financial guarantees are measured at the value of the consideration received and subsequently in accordance with IAS 18 – *Revenue* or IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets*.
7. ESMA believes that all financial guarantee contracts should be in the scope of this ED except for parent-subsidiary guarantees for which the actual accounting treatment (IAS 18/IAS37) should be maintained.

Level of aggregation and diversification benefits

8. ESMA agrees with the IASB's conclusion that measurement at a portfolio level gives the same result as at contract level when the measurement is based on a probability weighting of expected cash flows as articulated in paragraphs B36-B38 of the ED. However, there is no guidance in the ED to determine the level of aggregation as acknowledged in BCA 113 of the ED Insurance contracts. This would apply also to the level of aggregation for risk adjustments to reflect the diversification benefits as stated in paragraphs BCA103-BCA104. The diversification effects between portfolios as proposed in this ED can have a huge impact on the risk adjustment related to insurance contracts. ESMA believes that the IASB should make sure that the levels of aggregation and diversification benefits reflect faithfully the economic benefits that can be realized by the entity and not undermine unduly the comparison between entities.