

Vienna, 16 November 2007

Mr. Peter Clark
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Comments on the Discussion Paper – “Preliminary Views on Insurance Contracts”

Dear Mr. Clark,

the Austrian Actuarial Association (AVÖ) represents the actuarial profession in Austria.

The insurance market in Austria is not very large. There are approximately 50 insurance companies active in the market, some pure life insurance companies, some pure non-life insurance companies and the most are composite insurers, some of them providing long-term health insurance. There are only 4 companies (2 of them are Austrian groups, the other 2 belong to international groups) with a premium income of more than 1 billion Euros. Many of the Austrian insurers are part of an international group and have to fulfil all the requirements necessary for the group accounting. This gives pressure also to the smaller Austrian-based companies to implement IFRS-like measures which they just need for competition purposes.

The AVÖ therefore is very grateful to have the opportunity to comment on the Discussion Paper. It is a very interesting paper written on a high level and with many new ideas. But sometimes we feel the arguments and solutions are far away from the real business of insurance companies. We want to give attention to the costs arising in implementing systems as presented. Some of our insurance companies would be kicked out of the market just because of expenses resulting from consulting and software-tools. The other thing we would like to mention is the necessity of auditability and comparability of the methods presented.

Maybe we should also mention our concerns regarding the influence of capital markets in the valuation models. We are aware of financial economics and the mathematical methods behind that, but we also see the limits of this theories. There have been many attempts to transfer insurance risks to capital markets, but non of these concepts was successful. That gives a hint that terms as market-consistency should not be the overruling principle for contracts like insurance contracts and we recommend to give up, what you called ‘current

AKTUARVEREINIGUNG ÖSTERREICHS (AVÖ)

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exit value'. We would prefer terms like 'actuarial value' because this is best describing the method necessary for determining cash-flows and risk margins.

We thank you again for having the opportunity to provide you with our comments and offer you a helping hand whenever you need it. We can imagine how difficult it is to have the thankless task of writing an accounting standard for a heterogeneous worldwide industry and hold in high esteem the work you have done.

Yours faithfully,

Dr. Klaus Wegenkittl
President

Mag. Christoph Krischanitz
Chairman
"Accounting, Solvency and Risk Management"

Comments on the Discussion Paper on the “Preliminary Views on Insurance Contracts”

Some general remarks

In Austria there is a clear understanding of the concept “insurance contract”. An insurance contract is unique because of some important properties which perfectly fit together:

- Insurance contracts are ‘to compensate the policyholder if a specified uncertain event adversely affects the policyholder’ (taken from the definition in IFRS 4). This adverse event cannot be managed by the policyholder himself until the object of risk vanishes. That forces the policyholder to fulfil the contract until it matures. In economic language that would mean cancelling the insurance contract without releasing from the underlying risk will decrease the ‘utility’ of the policyholder.
- Insurance contracts have a specified maturity on which the policyholder and the insurance company agree in advance. This agreement has not only a legal character but also an economic character because at the same time the policyholder agrees to pay commission in advance depending on the maturity of the contract. In Austria it is common that for long-term contracts the commission is a percentage from the total sum of premiums (that is the sum of all annual premiums over the agreed premium-payment-years). Thus, the policyholder has to deal with the question of maturity very seriously. So after agreement the policyholder feels impelled to pay all the premiums until the end of the contractual period otherwise a material part of his investment would be lost.
- Because management of insurance risk only works on portfolio level, every change in one single contract has an impact on all other contracts in the portfolio. Therefore insurance companies are either allowed to deduct a substantial penalty in case of surrender or (as it is the case of life-long health insurance contracts) are not required to pay any surrender value at all to the policyholder. Economically that can be seen as transaction costs. There are possibly other transaction costs regarding to tax repayments. Thus, moving insurance contracts from one insurer to another never can produce profits for the policyholder. If he is rational he would suspend premium payments only in case of emergency.

In our point of view this arguments make clear that there is a strong need for recognising future premiums of every insurance contract at least for the contractual maturity.

Answers to the questions

Q1: Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

An insurance contract usually has three beginnings. First the legal beginning when the contract is signed from both parties. Second the technical beginning, which is the date defined in the contract when the insurance coverage should start. The third beginning is the economic beginning when the first premium is paid and the insurance coverage becomes active. When a contract has agreed on December 30, xxx0 with a technical begin on January 1, xxx1 there is no coverage given on December 31, xxx0. The commission usually is paid with the first premium, which would be in this example somewhere in the beginning of January xxx1. So in principle it would not make sense to account for such a contract on December 31, xxx0. Also we see some danger to open opportunities to manipulate revenues in accounting for fictitious contracts with legal beginning in the end of December and withdrawing them automatically after time limit for the first premium payment.

But on the other hand if we have a contract consisting of an investment part and an insurance part and we have to unbundle them it would cause some troubles when the investment part has a different beginning according to IAS 39 than the insurance part.

So we suggest a compromise. For recognition purposes IAS 39 and IFRS 4 should be consistent, that is a contract has to be recognised when it is agreed despite of a later technical beginning. But for measurement purposes an insurance contract which is agreed but contains no technical coverage at the accounting date should be valued with zero.

Q2: 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?

Every measurement rule of insurance contracts can be written in a form consisting with the structure of the three building blocks. So principally we are in favour of this structure.

We want to comment on the details of the building blocks.

We fully agree that cash-flows should be explicit, unbiased, probability-weighted and current in the sense we understood from the discussion paper. But we have some reservation against the concept of 'market-consistent' in connection with insurance contracts. Market-consistency requires the existence of a market which trade cash-flows that are similar or comparable to the cash-flows to be valued. Otherwise you wouldn't have any evidence for modelling or parameterization. But such a reference market does

not exist for insurance contracts. The risks and durations of insurance cash-flows cannot be replicated on any real market. There were some attempts to bring insurance risks into the financial markets, like ‘survivor bonds’, ‘cat bonds’ or weather-derivatives, but these products got no liquidity because investors are not used to deal with these kinds of risk. Furthermore pricing of such a product will be done following actuarial principles rather than financial principles. So we suggest to omit the term ‘market-consistent’. It would be very important to make clear that ‘unbiased’ and ‘probability-weighted’ lead to estimates consistent with actuarial principles.

We principally support the idea of risk-free interest rates in connection with risk-neutral valuation techniques because that is consistent with financial theory. But we face the big problem that nothing like a risk-free interest rate exists in reality and least of all for durations more than thirty years. So there is a need for a clearer convention regarding the use of interest rates.

We found the big range of suggested risk margin techniques is comprehensive enough, there is no need for further concepts. But it should be clear to the Board that all these risk margin techniques follow different ideas and are therefore not comparable. Some of the risk margins allow for diversification whereas others do not. There is no idea about prudence and calibration. Comparability between companies cannot be obtained when everything is free to choose.

If the idea of calibrating the risk margin to the premium would become widely accepted the concept of risk margins becomes meaningless and can be omitted from the building blocks.

We are not able to comment on the service margin because we do not understand this concept. Please make it more apparent.

Q3: 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 would expect more guidance on cash-flows like premiums (which part of the premium can be recognised) and costs (what exactly are maintenance costs, what about the overhead costs, etc.).

Q4: 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.**
- (d) Other (please specify).**

We support the idea of an actuarial value to be accounted. That would give in most cases positive results (a asset or a negative liability) at inception of the insurance contract. We would not allow to show this amount immediately as a profit but we also would not show it in the 'insurance liabilities'. We would recommend to introduce a 'liability for future profits' which can be realised during the maturity of the contract. In normal cases, where we have an economical gain at inception we would therefore show a negative 'insurance liability' and a positive liability of the same size, so that in total an insurance contract has no value. One year later after receiving the first premium we have produced an asset due to the invested premium and a liability due to the revaluation of the present value of future cash-flows.

There is no natural way to distribute profits over the lifetime of a contract, but there are some concepts already available. One can be taken from IAS 19 and the way actuarial gains/losses are dealt with. Another concept stems from the FASB. They introduced the concept of 'estimated gross margins'. From an actuarial point of view such concepts make sense, but should be refined for IFRS purposes.

Q5: 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?

(b) Is ‘current exit value’ the best label for that measurement attribute? Why or why not?

When the Discussion Paper refers to ‘current exit values’ it is meant ‘price’. Why not state what it is? Values and prices have different properties in an economic perspective. The Discussion Paper wants to have a price that is comparable with other prices and follows the usual market rules. But as there is no market there are no market rules. Insurance contracts are abstract products. Transferring them means at least transferring insurance files, data and money. In many cases also IT-systems, know-how and staff have to be transferred. That depends on the structure of the portfolio, the specific insurance products and the purpose of the transfer. If the buyer of the portfolio has similar products and a well-working IT-system, the transfer can have the background of enlarging its business, stepping into new customer segments or throwing a competitor out of market. If the purchaser does not have an appropriate infrastructure, the purchase can target staff members, knowledge or IT-systems. If the buyer was not active in the purchased business line before, the purchase targets the entry in a new line of business or in new client relationships etc. There is no ‘typical’ market participant and estimations for cash-flows as for instance costs (maintenance costs) and the calibration of a risk margin are strongly dependent on the different possible purchase objectives.

It would be impossible to find a unique price, because in incomplete markets (when they exist) prices are not unique. Due to high transaction costs and long-term management objectives the pricing concept can not be generalized and leads to confusion.

So we would prefer the concept of a value instead of a price. This value should be based on actuarial principles and reflect the role of the portfolio within the insurance company. That has to do with maintenance costs, diversification effects between portfolios and products, customer relationships, reinsurance, asset management etc..

So we are not able to understand and apply a concept like ‘current exit values’ in context with insurance business and would therefore recommend a value which could be called ‘actuarial value’.

Q6: 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 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?**

Every cash-flow expected during the lifetime of an insurance contract should be taken into account, as we argued in our introduction. They should not be a matter of recognition but of measurement. In finding realistic probabilities for different policyholder behaviour we incorporate insurance life and create a true and fair view on what is going on in the contracts. A future standard should not differ between beneficial and non-beneficial behaviour.

Q7: 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.**
- (e) No cash flows that result from beneficial policyholder behaviour.**
- (f) Other (please specify).**

As there is no alternative to insurance coverage, customers are very interested in fulfilling the contract's conditions, see our introduction. Thus we do not see any need for the concept of 'guaranteed insurability'.

We prefer option (b) having in mind the principle of materiality. Existing contracts are contracts with active insurance coverage at the reporting date. We see no need for taking into account future renewals.

Q8: Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

Direct acquisition costs (as commissions) are a compensation for the effort salespersons made to purchase an insurance contract. Their job is done after receipt of the first premium. The acquisition cost has to be paid out at that moment. But it is an expense compensated by the income of future premiums. Because all the future premiums should be taken into account for the calculation of the insurance liability (as we argued in the introduction) the acquisition costs and every other cost are covered by the present value of future cash-flows. Thus expenses of acquisition costs are distributed among the lifetime of the contract and not shown separately.

Q9: Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

The comments to question 5 apply.

Q10: Do you have any comments on the measurement of asset held to back insurance liabilities?

No comment.

Q11: 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 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?

(a) Yes, risk margins should be determined for a portfolio of contracts. Insurance risk can only be managed on a portfolio level, thus the risk of a contract depends on the risk of the portfolio.

(b) Diversification effects between portfolios should be taken into account if this diversification effects can be economically materialised in reality. So they have to be managed in linked entities with no transfer prohibition.

Q12:

(a) Should a cedant measure reinsurance assets at current exit value? Why or why not?

(b) Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?

(i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.

(ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.

(iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

(a) 'Current exit values' do neither apply to direct insurance nor to reinsurance. See comments to question 5. An 'actuarial value'-concept has to be applied.

(b) (i) and (ii) are not only a consequence of 'current exit values' but also of other concepts based on economic or actuarial principles. (iii) This discussion seems to be far from reality and will not occur in reasonable models. But it seems to be the consequence of 'current exit values'.

Q13: If an insurance contract contains deposit or service components, should an insurer unbundled them? Why or why not?

We would favour an approach where unbundling is only necessary for umbrella products with different providers in the background.

Q14:

(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?

(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?

We cannot see any credit risk for the insurer in an insurance contract. The insurer receives the premiums in advance and if he agrees on monthly payment then he is allowed to deduct the missing premium from the insurance loss to pay out. Thus the issuer of an insurance contract never faces credit risk! If the insurance contract should be transferred to another insurance entity then again the new owner of the contract faces no credit risk. The only one who is facing credit risk is the policyholder, but he is not in the scope of the discussion paper. So this discussion is meaningless even for the 'current exit value' approach.

Q15: 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?

No comment.

Q16:

- (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?*
- (b) *An exposure draft of June 2005 proposed amendments to IAS 37. Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?*

In principle every cash-flow that has to be expected should be incorporated in the valuation. This cash-flows should at least include all legal and constructive obligations.

In Austria there is no need for further guidance on constructive obligations.

Q17: 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).*
- (b) *Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).*
- (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).*
- (d) *Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).*

No comment.

Q18: Should an insurer present premiums as revenue or deposits? Why?

Premiums do not belong to the policyholder! They are not used for the fulfilment of the own contract of the single policyholder, but are used to fulfil the insurance obligation for a whole portfolio. Premiums are distributed among all existing and even future customers. So premiums never can be deposits.

Q19: Which items of income and expense should an insurer present separately on the face of its income statement? Why?

No comment.

Q20: Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

To be consistent with the answer to question 4 the income statement shall also include changes of what we called 'liability of future profits'.

Q21: Do you have other comments on this paper?

No comment.