Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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30 November 2010

Dear Sir David

We are a group of users of insurance company accounts who meet under the auspices of the Corporate Reporting Users' Forum (CRUF), and include individuals from both buy- and sell-side institutions. We are pleased to have the opportunity to comment on the key aspects of the Insurance Contracts Exposure Draft (ED) published in July 2010.

In general, we are supportive of the aims of the IASB in seeking to establish a coherent framework for insurance accounting based on a fair value approach. We believe that the existing patchwork approach to insurance reporting has a number of considerable flaws, and this materially impedes consistent evaluation of insurance company performance. We also believe that the building blocks approach proposed by the IASB in the ED is, in overall terms, a sensible and workable basis for calculating insurance liabilities.

However, we believe that the ED focuses too much on the balance sheet, with little attention paid to the implications for income statement presentation. It is vital that insurance accounting includes analysis of operating earnings that clearly distinguishes between short-term movements, especially those that are market related, and underlying elements. Another key concern we have with the ED is the lack of guidance, in a number of fundamental areas, as to how the rules would be applied in practice. While the IASB may view this as consistent with a principles based approach, we believe that this would be very likely to lead to materially different interpretations of the accounting rules between companies that would significantly undermine the consistency of reporting. Such an outcome would be likely to exacerbate existing accounting issues, not solve them. We expand on these and other key issues in more detail below.

I. The 'cost option' and earnings volatility (Questions 1 and 13)

We understand that some European insurers are concerned that implementing the ED would create significant volatility in earnings, and, with the abolition of the AFS option under IFRS 9 proposals, want to return to a book value approach for invested assets and seek to develop a 'cost option' for insurance liabilities.

While we have sympathy with the desire of the industry to minimise volatility in earnings, we are opposed to a 'cost option' for insurance liabilities. We believe that allowing historical cost accounting would significantly undermine comparability of performance between insurers just at the point that we might achieve a standardised approach globally. It is also inconsistent with the likely direction of regulatory reporting.

In addition, we believe that it is unrealistic to expect investors to ignore market movements simply because assets are valued at cost by those companies electing the cost option approach. In adjusting assets to market values without the capacity to make similar adjustments to liabilities, there is the risk that investors and analysts inadvertently re-introduce the accounting mismatches that the companies seek to avoid with a standardised approach to assets and liabilities.

Nonetheless, we do have sympathy with insurers' desire to reduce short-term volatility in results when using a fulfilment model and believe that this can be achieved by one of three methods: 1) the inclusion of an 'operating profit' figure half way down the P&L account to counteract the focus on a volatile net income figure; 2) the P&L account only includes an operating profit with below the line volatility included in a reconstructed OCI statement; 3) The use of an 'asset yield minus explicit credit default' approach to discounting liability cash flows.

Of the three, the last is not acceptable – it is tantamount to allowing a 'cost option' approach. We are agnostic about which of the first two approaches is taken, albeit the retention of a reconstructed OCI has some challenges as to how 'exceptional' gains/ losses are recycled out of OCI.

Where we do have a strong opinion is that a tightly defined and consistently applied calculation of 'operating profit' must be incorporated into the standard. Our expectation is that this would be the key focus of results, with clear differentiation between volatility that arises from variances between expected/current experience and that which results from the impact of market volatility on potential future profits.

Given the uncertain nature of many of the IASB proposals within the ED we have not attempted to formulate a detailed set of suggestions as to precisely what would, or would not, be included within the operating profit figure. However, we believe it is crucial that the IASB involves the users of accounts in developing these principles.

II. Changes in estimates (Questions 1 and 13)

The ED proposes that changes in the estimates of future cash flows underpinning insurance profitability should be recognised in full in the current income statement, with the original residual margin continuing to be recognised on the basis of initial assumptions.

However, in our view, this proposal would create additional unnecessary volatility in earnings, and it would mean that the operating results reported by the insurers would become less reflective of underlying economics.

For example, in the event of a negative re-evaluation of profitability on a specific contract or portfolio, it would mean recognising an immediate loss even when the business is still expected to remain profitable overall. In addition, since future year earnings would continue to reflect the ‘unwind’ of the residual margin based on original pricing assumptions, results would simply resemble the returns that insurers expected to happen rather than what has actually occurred. Since it is more or less inevitable that there will be some changes between inception and the ‘actual’ outcome, this would make profit margins less and less relevant over time.

As users of the accounts, we are far more interested in understanding the actual contribution from in-force business to current free capital generation, based on the latest information available to the insurance company, rather than what was expected when the policy was first written. As such, we recommend that insurers be required to recalibrate the expected residual margin at each reporting date, based on the latest information. While we acknowledge that this is a complex area, in principle this would mean that any reduction in future expected profitability would initially be offset against unrecognised margins on that business, with positive changes also used to rebase the residual margin (a ‘shock absorber’ approach). The exception to this would be for the impact of changes in discount rates on insurance liabilities; we believe that this area of volatility should be linked to the change in the valuation of insurance assets.

A criticism of this approach is that it could allow insurers to ‘bury’ bad news. However, this could be overcome by requiring insurers to disclose where liability estimates have changed, particularly where such recalibrations have been absorbed by unrecognised margins, and to be clear as to the impact this is expected to have on future earnings. This would also need to be linked to the ‘vintages analysis’ of life earnings that, as referred to below, we would like to see included as a mandated disclosure.

III. Illiquidity premium (Question 3)

In the context of wider industry debate, there is acceptance that an illiquidity premium is a valid part of the discounting of insurance reserves under certain financial market circumstances, and subject to tight restrictions. In this context, any illiquidity premium should be set with reference to the profile of the liability, and should be independent of any asset risk that a company chooses to assume.

However, we are concerned that the ED gives insurers very wide discretion as to how the illiquidity premium is calculated and applied in practice. In order to ensure consistency between companies we believe that it is very important that any insurance accounting standard provides clear and precise guidance as to the basis of calculation and size of illiquidity premium, as well as how would this change in different market circumstances. The standard also needs to mandate comprehensive disclosure on this topic.

IV. Margin measurement (Questions 4-6)

The CRUF accepts that analysing margins between a 'risk' and 'residual' component has a number of theoretical advantages, and would tie in with how many insurers assess technical pricing. However, we have reservations about the approach proposed in the ED given the very high likelihood that this will lead to material inconsistencies in how different insurers calculate the risk adjustment; in other words, we believe that the results could well end up as wholly incomparable. This problem would be further compounded by the fact that the residual margin is simply a balancing figure, eliminating a 'day one' gain, which would be recognised in earnings on an entirely different basis to the profit recognition of the 'risk adjustment'.

Given the inherent limitations of the composite margin approach we remain of the view that the two margin approach is the best option. However, in order to counter-balance these significant practical issues we recommend that a) a single basis of calculation is mandated, preferably the 'cost of capital' approach, since this is fairly straightforward to apply and is well understood; b) only a low level of credit is given for diversification, in line with existing ED proposals; and c) in order to minimise potential differences in calculation, and to prevent companies 'gaming' the rules, we believe that the residual margin should be released into earnings on the same basis as the risk adjustment. The one exception to this should be for short duration contracts, where we believe that the unearned premium approach proposed in the ED is very sensible (providing that the adoption of this approach is mandated, and is not an option).

Nonetheless, we would like to make it clear that users remain confused by the practical consequences of the different margin alternatives. We believe it is critical that the IASB sets out clear and detailed illustrative examples of how the margin rules would be applied in practice, and exactly how changes in assumptions would be presented in results, before we can make a fully informed judgement on the preferred approach.

V. Free capital generation (Question 14)

There is increasing focus amongst analysts and investors on free capital generation – defined as the emergence of free surplus, after reflecting changes in required capital (based on the higher of economic and regulatory capital to iron out fungibility issues). While existing accounting standards require rudimentary disclosures around capital to be provided, this information is not sufficient to be able to understand the link between current operating performance and how free capital is generated.

As such, we would like to see mandatory comprehensive disclosures built into accounting for insurers, with a clear reconciliation from IFRS operating earnings to free capital generation, on a segmental basis consistent with that described below.

VI. Other disclosures (Question 14)

The presentation and lay-out of accounts are crucial to the user, including what appears in the primary section and what is given in the notes. Credibility of this standard is most likely to be a result of what the user sees.

In this respect, for insurers, the 'front page' of the income statement tends to be considerably less important than the nature of segmental disclosures, particularly for those companies which write both life and non-life business. As such, we see no particular problem in the event that premiums and claims data is not shown on the face of the P&L itself. However, what we do believe is critical is that any accounting standard mandates segmental disclosures built around product types, in addition to the disclosures mandated under IFRS 8; this analysis should include relevant information about profit drivers and sensitivities that would enable a third party to make an informed assessment of financial performance – for example asset management charges, premium loadings, spread income, risk profits within life products and investment returns on shareholder capital.

Another area where we believe that disclosure could be improved is in relation to understanding changes in the profitability of different 'generations' of policies. While such information is, to some extent, available for non-life insurers by way of reserve 'triangles', we would like to see this broadened out to include life insurers too. For both life and non-life insurers, we would like to see the format for these disclosures to be mandated, in order to ensure that a consistent approach is adopted.

We would welcome the opportunity to be involved in this aspect of standard setting.

VII. Reinsurance (Question 16)

The ED states that insurers should factor in an expected reinsurance default rate into margin analysis. However, no insurer is likely to buy cover from a reinsurer that it does not expect to meet its obligations and, in our view, this simply adds complexity without improving reporting practice. We suggest moving to an incurred loss model, whereby losses on current or possible future reinsurance recoveries are recognised when there is objective evidence that the asset is impaired.

We are also concerned that the ability for a cedent to generate a 'day one' profit by the use of reinsurance could be used to 'arbitrage' the accounting rules. We believe that this should not be allowed within the accounting standard.

VIII. Transition (Question 17)

We believe that the current proposals regarding the transition to the new accounting rules need to be redesigned. We believe that the basic principle should be that business in force at the date of adoption of any future standard should be accounted for in exactly the same way as future new business. However, we do also recognise that certain approximations will need to be made, particularly for some life contracts that were originally written in the 1990s or before, in order to avoid placing an undue burden on the industry in terms of time, cost and effort, for no real benefit to the users of accounts.

IX. Practical matters (Question 18)

We are well aware that the June 2011 deadline for completion of this project is extremely ambitious given the need for areas of the ED to be revisited, and the complexity of these proposals for the entire industry; the fact that this is happening at a time when many European insurers are faced with significant regulatory changes is not the problem of the IASB, but it does introduce further practical constraints as well.

We do not want to see the IASB timetable used as a reason to abandon the insurance accounting project, but neither do we believe that is in the interests of any party to push through a complex series of changes which have not been fully thought through. While the core principles of insurance accounting will need to be agreed upon by June 2011, room needs to be left to allow for 'field testing' of the proposals, and for iterative changes to be incorporated into more detailed implementation guidance.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB and FASB.

CRUF participants come from all around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

We sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum (www.CRUF.com) and not as representatives of our respective organizations. The views expressed are those of individual CRUF participants and do not necessarily reflect the views of the respective organizations where we are employed.

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