Committee of European Banking Supervisors

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Dear Madam, dear Sir,

Exposure Draft ED/2010/8 Insurance contracts

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union, welcomes the opportunity to comment on the IASB's Exposure Draft on the Insurance Contracts (ED/2010/8).

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

CEBS welcomes the opportunity to comment on this exposure draft although it deals only with accounting issues for insurance contracts. Indeed, CEBS contains members who supervise large banking groups that include insurance entities and which require an overall supervisory assessment of the combined group's financial position and risk profile.

CEBS has reviewed the exposure draft from a banking supervisory perspective and has focused predominantly on issues which may have implications for other areas of non-insurance accounting or could impact banks' financial statements

More generally, CEBS would like to urge the IASB, when adopting standards for products or contracts that are relevant for different economic sectors, to apply consistent principles and accounting methods, that minimise differences in outcomes and thus the scope for arbitrage. Particular attention should be given to achieve consistency regarding the following aspects and concepts: unbundling and bifurcation, risk adjustments for uncertainty and value adjustments, non-performance risk, own credit risk as well as recognition of credit risk losses.

The comments put forward in this letter and in the related appendix have been coordinated by CEBS's Expert Group on Financial Information (EGFI) chaired by Mr. Didier Elbaum (Deputy Secretary General, Autorité de Contrôle Prudentiel) - in charge of monitoring any developments in the accounting area and of preparing related CEBS positions - and in particular by its Subgroup on Accounting under the direction of Mr. Michel Colinet of the Belgian CBFA.

If you have any questions regarding our comments, please feel free to contact Mr. Elbaum (+33.1.4292.5801) or Mr. Colinet (+ 32.2.220.5247).

Yours sincerely,

Giovanni Carosio

Chair, Committee of European Banking Supervisors

Appendix

Unbundling

We note that the IASB's ED proposes unbundling of components of an insurance contract if the components are not closely related to the insurance coverage. In principle, CEBS supports a comprehensive approach for the valuation of rights and obligations resulting from insurance contracts. The unbundling of not closely related elements is consistent with this overall approach and is further consistent with our view. Consistently with its comment letter on the exposure draft "Financial Instruments: Classification and Measurement", CEBS believes that when various components of a hybrid instrument are not closely related, bifurcation is the best way to represent the nature and cash flows of the instrument and results in more decision-useful information for users by increasing transparency and comparability. Comparability will be further enhanced when unbundled non-insurance elements are accounted for in the same way as similar stand-alone contracts accounted for under the revenue or financial instruments standards.

CEBS also believes that criteria on when unbundling would be required should be consistent between IFRS 9 and the insurance contract standard.

The Board should clarify what is meant by 'closely related' and provide more guidance. Furthermore, the notion of "account balance" mentioned in the paragraph 8 (a) of the Exposure Draft should be clarified.

Liquidity premium

The IASB proposes to take into account a liquidity premium in estimating the discount rate used to measure insurance liabilities.

CEBS understands that this proposal is rather controversial among insurance supervisors and therefore needs further in depth debate. Additionally, because of the significant judgment involved, the final standard should also require clear disclosure of this item.

Accounting mismatches between assets and liabilities

CEBS has concerns that the model proposed in the ED may potentially introduce additional volatility in the income statement as a result of the current measurement and re-measurement of insurance liabilities, concurrent with the remeasurement for financial assets. A large part of the insurance business is, in essence, managed on a long term basis due to the long duration of many insurance liabilities. In respect of these liabilities, insurers manage investments with a view to meeting their long term insurance commitments in terms of both risk versus return and duration. It is questionable whether the long term business model of insurers is, in terms of annual performance, fairly reflected by a P&L approach that is sensitive to changes in the value of assets and insurance liabilities as a result of short term movements in financial markets and assumptions.

This volatility is indeed linked to how performance should be defined and presented. As stated in its comments on the ED "Presentation of Items of Other Comprehensive Income" (ED/2010/5), CEBS thinks that profit or loss is a key metric to assess the performance of entities. Therefore, CEBS believes that a debate regarding the definition and presentation of performance is urgently needed.

We urge the IASB to make sure that the information conveyed through insurers' primary financial statements is relevant and reflective of their business models.

Risk Margin

The CEBS agrees with the inclusion of an explicit risk margin in the measurement model for insurance liabilities. From a banking supervisory perspective, CEBS considers that taking into account uncertainties linked to the amount of future cash flows is prudent and conveys decision-useful information to users. This is consistent with previous comments made by CEBS notably in its comment letter on the ED fair value measurement (ED/2009/05), where CEBS encouraged the IASB to « *strengthen disclosure requirements on valuation techniques to encourage entities to disclose information on valuation processes as well as adjustments applied to reflect model risk and other valuation uncertainties* ».

Financial guarantees

The ED proposes to treat financial guarantees that are not derivatives as insurance contracts (rather than financial instruments) whereas other credit protection contracts, that do not meet the definition of an insurance contract, would continue being treated as derivatives.

As a preamble CEBS would like to stress that the accounting model for financial guarantees should be such that it (i) reflects economic substance, (ii) results in robust and relevant measurement and (iii) ensures consistency at an appropriate level.

While we do not express a view on whether financial guarantees should be treated as insurance contracts or as financial instruments, we would nevertheless like to make a few observations that the IASB should consider.

Financial guarantees share many of the features of insurance contracts and it would for that reason be appropriate to scope them in IFRS4. However, some reasons for maintaining such contracts within the scope of IAS39/IFRS9 have also been identified. Thus, it can be argued that 'credit risk' is a very relevant financial risk that banks and financial intermediaries face in their activity (as evidenced not least by the financial crisis) and that a product which transfers 'credit risk' from an entity to another should be considered as a financial instrument. As such, it could be reasoned that the framework deals consistently, in one standard, with all financial guarantees. Furthermore, having a comprehensive standard for such contracts would eliminate opportunities to arbitrage between standards through structuring of financial products

In that context it is noteworthy, that from a prudential point of view, issued financial guarantees are considered and treated as direct credit substitutes. Moreover, IFRS9 is a more familiar reference framework for the banking industry - which is the main provider of financial guarantees - and for banks' supervisors.

Having said that, CEBS acknowledges that drawing the line between products is very hard in a principles-based framework and determination of the relevant applicable standard risks to be arbitrary in cases like financial guarantees. CEBS therefore believes that ensuring consistency in treatment and language throughout the standards is far more important and will eliminate the risk of arbitrage between standards through inventive structuring of financial products.

We observe that the treatment under IFRS4 could result in a more robust provisioning model (based on actuarial estimates) for financial guarantees than the current combination of IAS39 and IAS37 (currently based on an incurred loss approach). Irrespective of the retained choice, it is important for CEBS that the treatment of financial guarantees results, whether accounted for under IFRS 4 or under IAS 39 lead to the same results. Therefore, CEBS would strongly encourage the IASB to pursue the revision of impairment for financial assets (under IFRS 9) and the measurement for provisions (under IAS37) based on a concept of expected losses to achieve comparable outcomes and thus eliminate scope for arbitrage.

Notwithstanding the above discussion on measurement, CEBS recommends the following disclosures to be mandated :

- Distinction between liabilities for financial guarantees that are "doubtful" and liabilities for other financial guarantees, in order to have information on the total amount of "provisions" for credit risk.

- Separate information on the exposure to credit risk that arises from financial guarantee contracts, in order to have information on the total exposure to credit risk of the reporting entity.

- Fees received from financial guarantee contracts should be disclosed separately, in order to have information on the reporting entity's activities with financial guarantees.