The European CFO Forum
Comite Europeen des Assurances

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28 February 2008

Dear Karel,

As you will be aware we attended a call with Ben, Evelyne, Teresa and Jung-Duk on 15 February to continue our discussions around accounting and regulatory reporting developments. We found the call useful and have, as requested on the call, obtained the CEIOPS QIS 4 background document: Guidance on the definition of the reference entity for the calculation of the Cost of Capital. We have, at this stage, conducted only a high level review of the document and have some observations that we would like to bring to your immediate attention, reflecting both political and technical concerns.

We are concerned that the background document offers evidence of the apparently increasing level of reference to the IASB discussion paper on insurance contracts accounting in the development of Solvency II. Whilst we support consistent frameworks in regulatory and financial reporting we are concerned that elements of the IASB's discussion paper do not represent an economic approach to valuation of insurance contracts and this concern appears to be shared by a wide range of commentators based on response to the discussion paper. There are signs that the IASB staff, having heard the level of dissent to some of the proposals, are looking to consider alternative measures in certain areas. Accordingly, we wanted to bring to your attention the most recent developments within the IASB in these areas to highlight our concern that regulatory reporting is moving towards an apparently shifting accounting position. We have identified four areas which potentially fall into this category:

i) Guaranteed insurability
We have already commented on the inclusion of the guaranteed insurability criteria in the QIS 4 draft technical specifications both in our letter of 29 January and in the CRO Forum and CEA responses to the draft specifications. In this regard we would highlight recent papers submitted to the IASB board meeting in February by Peter Clark, the insurance contracts project manager. In the summary of responses to the discussion paper it was noted:

- "Many respondents argued that the discussion paper artificially constrained the cash flows by excluding ... some future premiums and other aspects of policyholder behaviour"
- "Many respondents opposed the guaranteed insurability test"

As a result of this opposition, Peter Clark has prepared a paper for IASB discussion that considers in more detail a suggestion made by several respondents, notably the adoption of an approach that considers recognition at a "whole contract" level rather than as individual rights and obligations attaching to a contract. Such an approach, advocated by the CFO Forum/CEA, argues that an economic approach to the valuation of insurance contracts will reflect all expected cash flows from existing contracts rather than creating artificial limits based on the IFRS definitions of assets or liabilities. It is still recognised that criteria must be established to distinguish new and existing contracts and the European insurance industry has agreed to continue working in this area to try to develop such criteria. The CFO Forum and CEA welcome the fact that the IASB appear prepared to re-open this debate to try to arrive at a more appropriate basis for recognising future premium income.

ii) Measurement attribute
Both the IASB discussion paper and the Draft Solvency II Framework Directive refer to the valuation of insurance contracts (or technical provisions) as a "current exit value" concept focused around an immediate transfer to another entity. Whilst some respondents supported current exit value as an appropriate measurement attribute (although very few, if any, respondents appear to have offered full support for all the IASB proposals) Peter Clark's summary of responses notes that "many suggested that the Board explore a notion tied more directly to the fact that insurers generally expect to settle their liabilities over time by paying benefits to policyholders as the benefits fall due rather than transfer their liabilities to a third party." Accordingly, another paper prepared by the IASB staff for discussion at a future Board meeting is entitled "Settlement value as a candidate measurement attribute: Some preliminary thoughts". Peter Clark has also referred to alternative measurement attributes that have been suggested by respondents such as "a transfer to a mirror image entity"; he considers that such a position would potentially allow use of entity specific expense assumptions as a matter of principle rather than as a proxy for unavailable market data, reflecting another view expressed by discussion paper respondents. Whilst the CFO Forum/CEA did not unequivocally support either a transfer or a settlement approach and did not set out a proposed measurement attribute, it is important to note that this remains an area of discussion within the IASB.

iii) Diversification benefits
Peter Clark has also indicated that the discussion paper's position on allowance for diversification benefits in the calculation of the risk margin (which restricts such allowance to diversification benefits within portfolios) has been widely challenged in responses. A shift in this position to, for example, either allow entity-wide diversification credit or assume a transfer to a well diversified market participant, and hence take wider credit, would not be consistent with the "empty" reference entity as set out in the background document. Again it is important that accounting developments are monitored in this area.

iv) Participating contracts
The QIS 4 draft technical specifications on distribution of extra benefits (TS.II.D.24) refer to usage of the constructive obligation concept stating that "By a constructive obligation is meant IFRS definition ...". It should be noted that this definition, as included in the current IAS 37 Exposure Draft, is under consideration by the IASB and could be redefined on a more restricted, or legalistic, basis. This matter was referred to in Peter Clark's summary of responses as follows:

"The discussion paper proposed that, for participating contracts, the cash flows for each scenario should include an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date. Some respondents felt this test could provide an appropriate answer in their circumstances (though not necessarily in other environments), but reported concerns that the financial liabilities project (to amend IAS 37) might narrow the definition of a constructive obligation to the point where it would not deliver an appropriate answer for them. However, most respondents indicated that the measurement of a participating insurance contract should include all cash flows from the contract."

This issue is another that could potentially be solved by adoption of the "whole contract" approach referred to above rather than restricting the recognition of obligations attached to contracts to those that meet the definition of a liability under the final IAS 37.

I hope that you find this information useful in the continuing development of Solvency II reporting requirements. Moreover, we would reiterate our willingness to provide you with any technical accounting advice about adjustments to be made to the IFRS balance sheet in order to get an economic balance sheet for solvency purposes (eg deferred tax adjustments) if you believe that could be helpful.

Please note that we have copied this letter to Thomas Steffen and other CEIOPS personnel given the relevance of the content to CEIOPS' ongoing work.

Please feel free to contact me if you wish to discuss any of these matters further.

Yours sincerely,

Jacques Le Douit, on behalf of the CFO Forum and the CEA

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