CFOFORUM

The European Insurance CFO Forum
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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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18 May 2010

Dear Sir David,

Response to Exposure Draft: Measurement of liabilities in IAS 37

We are taking this opportunity to comment on your exposure draft - Measurement of Liabilities in IAS 37 (the “ED”). This letter has been drafted by the European Insurance CFO Forum, which is a body representing the views of 20 of Europe’s largest insurance companies. Accordingly, it represents the consensus views of a significant element of the European insurance industry.

We have prepared this response letter in the context of the implications of the proposals in the ED primarily in relation to non-financial liabilities held on our balance sheet but also with regard to the potential implications for the insurance contracts project given the likelihood that aspects of the ED proposals may influence the insurance contracts project.

We welcome the release of the ED as an important step to providing an appropriate basis for the valuation of non-financial liabilities. We support the high level principle in the ED of the valuation of liabilities and anticipate that aspects would also be applicable to insurance contracts. However, we have significant concerns with the application of the fulfilment model with regard to service obligations.

We support the use of building blocks and believe that they are an effective means of measuring a fulfillment value but they must be appropriately defined

We support the use of three building blocks for the IAS 37 fulfilment model at a high level but have some concerns about the detailed definitions in the proposals.

We agree that the estimated outflows of resources should form the first building block in the measurement of the liability. However we have concerns about the requirements in paragraph B5(b) that estimates shall be consistent with observable market prices, if available. We believe that entity-specific information in line with the expected cost to fulfil the obligation should be the primary source of information, and take into account observable market prices, where relevant.

We support the use of probability-weighted cash flows to calculate the estimated outflows of resources but reinforce the importance of paragraph B4 which recognises that calculating a probability-weighted average for all possible outcomes is not necessary or practical in all cases. We encourage the Board to make it clear in the final standard that a stochastic model is not prescribed.

We agree with the second building block, that the present value of the resources required should take into account the time value of money. We do not believe that any further prescription is required with regard to the discount rate beyond that in the exposure draft.

We support the inclusion of the third building block, the risk adjustment, and support the objective in paragraph B15 which states that a risk adjustment measures the amount, if any, that the entity would rationally pay in excess of the expected present value of the outflows to be relieved of this risk. We agree that the expected outflows of resources should be adjusted for uncertainties in the cash flows. We believe that the most persuasive argument in support of this position revolves around the example of two obligations each with two equally possible outcomes, in the first case 49 and 51, and in the second case, 1 and 99. In both scenarios the expected present value is 50. However, given the different risk profiles of the two obligations, it is appropriate that their valuation would differ.

We believe that it is important to include a risk adjustment for the obligations in the scope of IAS 37 to take into account the risks associated with the uncertainties around the cash flows. Conceptually we believe that there should be an explicit risk adjustment. However, for simpler non financial liabilities we believe that it may be appropriate to use simplified methodologies as a suitable proxy for the calculation of the risk adjustment. We would note, however, that an explicit risk adjustment will, in our view, always be required for obligations where the risk adjustment is an important component of the liability from the perspective of users of the financial statements, such as insurance contracts. We do not believe that the approach to determining the risk adjustment should be prescribed as each liability will vary in level of complexity and uncertainty.

We support the principle that valuation should reflect a “rational cost of exit” but do not believe that this principle is reflected in the proposed treatment of service obligations

We support the high level proposals that an entity should measure a liability at the amount that it would rationally pay to be relieved of the present obligation (“rational cost of exit”). We understand that there are a number of ways that the rational cost of exit valuation can be met and believe that in most cases, fulfilment cost would be the most appropriate measurement. However we do not believe that the underlying detail of how to measure the present value of the resources required to fulfil an obligation set out in Appendix B is consistent with the concept of rational cost of exit, notably with regard to service obligations.

The ED sets out what the relevant future outflows are expected to be for both cash and service obligations. For cash obligations, we believe the inclusion of all expected cash payments is appropriate and we support the inclusion of both direct and indirect costs in building block one.

However, in terms of service obligations, the ED proposals do not appear to apply a rational view of minimum cost of exit given the need to look to, or estimate external contractors’ prices for service obligations and hence include profit margin in liability value. We do not believe that a payment to a contractor should be hypothecated if there is no plan to use an external contractor. The rational least cost of exit should reflect the entity’s expected cost of exit from the obligation upon the basis of how it expects to fulfil the obligation. We therefore do not consider the liability should include an expected third party profit on the presumption of outsourcing.

In essence this approach is introducing a transfer concept into a fulfilment measurement. In this respect we agree with the alternative views set out in paragraph AV2 and AV4 that the liability should be measured at the expected cost to fulfil the obligation and therefore exclude a profit margin.

The Phase II insurance contracts valuation model should be built up in a consistent manner with aspects of the IAS 37 proposals

As insurance companies, our principle concern with regard to the measurement of liabilities is with insurance contract liabilities. We note that the exposure draft to be issued for insurance contracts (insurance contracts ED) is not expected to refer explicitly to IAS 37 and also that insurance contracts are scoped out of the IAS 37 proposals. We agree with this approach because of the revenue generating nature of insurance contracts and the resulting proposal for a residual margin that is expected to be included in the insurance contracts ED. However we believe that the measurement of liabilities within the scope of IAS 37 and the measurement of insurance contract liabilities excluding the residual margin should follow consistent principles. We are still assessing the significance of potential differences between IAS 37 and the insurance contracts project, particularly as the insurance contract proposals are still under development.

We therefore support the building block concept in both models and, in particular, believe that the risk adjustment building block is an appropriate one in both the IAS 37 and insurance contracts projects for the reasons set out above.

However, as noted above we believe aspects of the IAS 37 proposals should be amended, notably in relation to the measurement of obligations fulfilled by undertaking a service which we do not believe should include a profit margin. The amended approach should then be consistently applied to insurance contracts.

We agree with exemption for onerous insurance contracts set out in the IAS 37 ED but do not want this to preclude what will be discussed in finalising the insurance contracts project.

If you have any queries or questions that you would like to raise in relation to the matters raised in this letter, please feel free to contact me.

Yours sincerely

Dieter Wemmer

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