EFRAG

European Financial Reporting Advisory Group

Dr. Alexander Schaub
Director General
European Commission
Directorate General for the Internal Market

1049 Brussels

4 June 2004

Dear Dr. Schaub,

Re: Adoption of IFRS 4 *Insurance Contracts*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of IFRS 4 *Insurance Contracts* (IFRS 4) as published by the IASB on 31 March 2004.

IFRS 4 requires entities to make limited improvements in accounting for insurance contracts and provides certain exceptions to the general hierarchy of international accounting standards pending completion of a definitive standard on accounting for insurance contracts (Phase II). It also requires disclosure of information about insurance contracts issued by the entity.

We acknowledge that this is the first international accounting standard issued by IASB providing guidance on accounting for insurance contracts and we are aware that IFRS 4 is neither a rigorous nor a comprehensive standard. The urgent need to provide guidance on the accounting for insurance contracts before 2005 did not allow IASB to address broader conceptual issues. We therefore regard IFRS 4 as a stepping stone towards improvement of the widely varying insurance accounting practices in Europe and worldwide.

IFRS 4 introduces improvements to recognition and measurement principles and disclosures, without requiring extensive changes that might have to be reversed in the light of the outcome of Phase II of the project. Although IFRS 4 permits continuation of various accounting practices presently adopted in national accounting regimes which may not comply with the hierarchy normally applied in international accounting standards, we regard it as conducive to the overall aim of establishing robust accounting standards that facilitate greater confidence in the financial reporting of insurance companies, which we see as a necessary ingredient in a strong European financial market.

It is recognised, however, that concerns raised by the industry, users of financial statements, auditors, standard setters and EFRAG within IASB's due process have not been fully satisfied in the final standard. The most critical areas are:

(i) the two different measurement principles for insurance assets (fair value concept) and liabilities (amortised cost concept based on regulatory requirements), which is often referred to as the "mismatch" problem and

(ii) the deposit floor limitation for investment contracts with a demand feature, created by IASB's assumption in IAS 39 *Financial Instruments: Recognition and Measurement* that the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (IAS 39 paragraph 49).

The "mismatch" issue

The mismatch issue arises from reporting assets on a fair value basis whilst liabilities in most countries are based on historical cost. This may result in volatility in equity not purely as a result of volatility in economic conditions but also because market conditions are reflected for assets but not for liabilities. EFRAG acknowledges that this volatility in equity represents a distortion to some degree. A number of solutions to this "mismatch" issue have been discussed with the IASB but none has achieved general acceptance. One of the solutions applicable under IFRS 4 is the possibility to remeasure designated insurance liabilities to reflect current market interest rates.

However, it is important to recognise that the mismatch issue is an economic as well as an accounting phenomenon. If an insurer invests premiums received in assets whose values do not respond to the same economic influences as the liabilities to policyholders, either over the course of the insurance contract or even in some cases by the end of the contract, a mismatch arises which should be reflected in the financial statements as economic reality.

Until now insurance accounting in most countries has not recognised the economic mismatch partly because conventions were used that adjust neither assets nor liabilities for changes in market prices and partly because gains and losses were reported only when assets were realised. With the adoption of IFRS 4, we expect that management will report on the effects of the mismatch and will provide useful information in order to enhance transparency and understandability of financial statements.

The "deposit floor" issue
It is EFRAG's view that IASB's assumption of a deposit floor for demand deposits (IAS 39 paragraph 49) does not reflect the real economic situation that European financial institutions have experienced in collecting long term savings as a result of policyholders' behaviour in such circumstances. EFRAG believes that investment contracts, particularly those issued by insurance companies, are not primarily sold to serve as demand deposits but rather as long-term savings, e.g. related to pension plans. They are not regarded as savings accounts for the purpose of early withdrawals or for immediate access to cash. When we commented on ED 5 *Insurance Contracts*, we raised the concern that this assumption does not reflect real customer behaviour. We believe this issue should be reconsidered in the context of the underlying portfolio approach of the insurance business.

IFRS 4 becomes effective for annual periods beginning on or after 1 January 2005, with earlier application encouraged. The standard provides an exemption from some requirements for comparative figures for 2004 in parallel with the exemptions in IAS 32 and 39.

EFRAG has evaluated IFRS 4 and the related Basis for Conclusions. The evaluation is based on input from standard setters and market participants in accordance with EFRAG's due process.

EFRAG conclusion

EFRAG acknowledges that IFRS 4 has not been developed as a long term standard, but, rather, has to be seen as a stepping stone towards a more comprehensive and conceptually sound standard dealing with the accounting for insurance contracts that meets the needs of all stakeholders. EFRAG believes that the standard will serve the interest of Europe because it will improve existing accounting practices for insurance contracts. EFRAG therefore recommends its adoption according to Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards.

Notwithstanding EFRAG's endorsement advice, EFRAG urges IASB, in consultation with the main stakeholders, to start developing immediately as Phase II of this project, a conceptually sound, long-term solution to improve the accounting for insurance contracts significantly, particularly in the areas we described and the general treatment of discretionary participation features. EFRAG will be particularly keen to see these issues addressed on a coordinated basis with the IASB's further work on financial instruments.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman