To: Ms Françoise Flores
Chairman
EFRAG
35 Square de Meeûs
1000 Brussels

From: Economics & Finance department

Date: 25 June 2013

Reference: ECO-ACC-13-234

Subject: EFRAG consultation on long-term investing activities business models

Dear Ms Flores,

As you are aware, Insurance Europe has been highlighting the need for appropriate and consistent accounting principles for the long-term oriented business models of insurers for many years. Please find our most recent views on IFRS 4 (ECO-ACC-13-063) and IFRS 9 (ECO-ACC-13-147) attached in appendix. As the IASB does not intend to create industry specific standards, we are advocating robust and consistent solutions within the interrelated projects IFRS 9 and IFRS 4 in order to sufficiently address the needs of all industries.

Insurers' business models are such that the insurance liabilities' profile is the main driver of investment behaviour. Insurance liabilities are to a large extent long-term and predictable, with stable cash-flow profiles. Therefore, insurers are substantially able to match long-term liability profiles with investments held for the long-term. Because most insurance policies create predictable and long-term liabilities for insurers, they can invest in both long-term and illiquid assets. The insurance business model is centred around asset-liability management (ALM) in which insurance liabilities, guarantees and the related financial and non-financial assets backing them (including derivatives) are managed together.

ALM for insurers means that insurers manage assets according to the insurance liability profile in order to meet obligations towards policyholders. Because of the variety in insurance products, an insurer can have different business models and thus follow different ALM strategies. Accounting requirements that deal with individual components in isolation, separate from the overall ALM strategy, can result in different measurement and presentation that does not adequately reflect the insurance business models and may distort long-term economic decisions. Therefore, for example, the recycling for equity instruments being measured by fair value through other comprehensive income has to be permitted.

We believe that performance reporting should reflect this long-term nature and exclude the short-term market fluctuations to the extent that they are not part of the intrinsic economic performance of the insurer. Only a robust, principle-based accounting framework, which allows for transparent and consistent performance reporting, can ensure useful information for users and will not drive investment decisions by themselves.

As explained in our letters to the IASB, we strongly advocate the use of the OCI or P&L measurement and presentation categories in both IFRS 4 and IFRS 9 ('two-sided OCI and P&L approaches'), depending on the insurer's business model and the associated information needs of investors and other capital providers, This is necessary to avoid accounting mismatches and to allow the insurer to have meaningful reporting based on its long-term business model.

Although the IASB has made significant progress in recognising the essential need for a holistic approach to capture ALM strategies, we believe that further improvement is necessary in IFRS 4 to achieve an adequate long-term measurement model, including for participating contracts for which the link between assets and liabilities is the most evident.

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An approach that reflects this interaction is vital. However the current proposals that aim to address this, such as the mirroring approach, need to be developed further otherwise they would lead to significant operational complications. The industry has made proposals that address asset dependency more fully and include the notion of a "floating" residual margin.

To allow for a better understanding of the role of insurers as institutional investors we have developed a comprehensive report "Funding the future: Insurers' role as institutional investors" (June 2013) that explains in detail how European insurers invest and the benefits of our sustainable investment approach, as well as the challenges we expect to face. Please find this report in the appendix to this response (ECO-INV-13-105).

Our comprehensive report should help provide the information that the EFRAG requests. However, please find below a summary of our views.

Please do not hesitate to contact us if you would like to discuss any aspect of our comments in more detail.

Yours sincerely,

Olav Jones
Deputy Director General / Director Economics & Finance

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of more than €1 100bn, employ almost one million people and invest around €8 500bn in the economy.

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Appendix

Question 1
Would you describe your (or one of your) business model(s) as a long-term investing business model? Please explain. If so, what is its economic purpose?

Yes, predominantly the business model of insurers is long-term oriented.

Insurers receive premiums in return for a promise to pay policyholders when specified events occur. To be able to honour these commitments, insurers invest the premiums they receive. Thus, the primary role of an insurer is to provide protection from risks in exchange for a premium, as well as to manage policyholders' savings. These premiums need to be invested in order to pay claims and benefits on insurance policies as well as to cover operating and capital costs. The insurers' business models are such that the liabilities' profile is the main driver of insurers' investment behaviour. Insurance liabilities are to a large extent long-term and predictable, with stable cash flow profiles mainly as a result of mutualisation, ie, pooling of risks. Therefore, insurers are substantially able to match long-term liability profiles with investments held for the long-term. Because most insurance policies create predictable and long-term liabilities for insurers, they can invest in both long-term and illiquid assets.

ALM (asset-liability management) for insurers means that insurers manage assets according to the liability profile in order to meet obligations to policyholders. Because of the variety in insurance products, an insurer can have different business models and thus follow different ALM strategies.

Question 2
What are your long-term investing activities driven by (e.g. the need to back long-term liabilities)? What is the nature of your long-term commitments? How do you distinguish between assets held to back long-term liabilities and other assets? Are you also involved in trading activities? If so, to what extent and for what purpose?

There are three main drivers of insurers' investment strategies:

- the profile of their liabilities (duration and predictability),
- the risk/return profiles of available assets, and
- a range of framework conditions such as prudential regulation, accounting requirements and taxation.

Insurance liabilities are generally illiquid. Depending on the type of products that insurers write, their management adopts different investment strategies and asset allocations. For example, life insurers typically provide long-term products that give them predictable long-term liabilities. Lines of services which are less predictable, such as catastrophe insurance, are often combined with a portfolio of more predictable claims. The unpredictable losses of individual policyholders become more predictable or measurable when aggregated or pooled. In addition, insurance companies often buy reinsurance to provide cover for unpredictable claims or to rebalance over-exposure. Having predictable long-term liabilities allows insurers to invest in both long-term and illiquid assets without incurring liquidity risk.

On the whole, insurers are not every-day traders. Insurers' investments are meant to back up policyholders' claims and benefits.

Question 3
What are the different types of assets you invest in?

Insurers invest in a wide range of assets to meet the needs created by the variety of insurance products they provide. Insurers aim to match their insurance liabilities by using well-designed investment strategies.

More than three quarters of insurers' assets are represented by corporate bonds (36%), government bonds (28%) and equities (15%) (see figure 6, page 19 in the investment report "Funding the future: Insurers' role as institutional investors", June 2013, attached), in addition, insurers make use of derivatives and property investments. Insurers generally favour these asset types because their risk and term profiles satisfy the demands created by their liabilities. However, the investment mix varies between companies and countries within Europe and at company level. Typical factors that need to be taken into account for the optimal investment mix are: duration and nature of the liabilities, liquidity needs, risk/return appetite, availability of financial instruments and market conditions.

Question 4
How is your long-term investment strategy established and how do you report on it, for both transparency and stewardship perspectives? How do you ensure that your current or potential shareholders can make the link between how you report your investment long-term strategy and the information provided in your financial statements? Could such a link be improved? How?

As described in our response to _Question 3_, the investment decisions are linked to a large number of variables, which differ across Europe and between companies. But they all have in common the inherent link to the liability profile, thus the ALM-aspect incorporated into the main insurers' objective: to provide insurance-protection.

Insurers disclose and explain their investment strategies and their results in detail in accordance with disclosure requirements in the relevant financial reporting framework (local GAAP or IFRS accounts) They also give more information on a non-mandatory basis (e.g. sustainability reports). Insurers are in favour of transparent disclosures that are effective and helpful for users to understand the insurers' business model. If accounting requirements are inconsistent or not appropriate for ALM, financial reporting is distorted and does not allow the faithful presentation of performance. In such cases, insurers are forced to undertake greater efforts when communicating the results to users and may encounter difficulties in doing so adequately.

Question 5
Do you believe the business model described above justifies a specific financial reporting treatment? If so, what should it be? Please explain how it brings relevant information to investors. Are there circumstances in which you would argue that fair value is not an appropriate measure? What other measurement attribute would you suggest and why (i.e. where a measurement basis in existing IFRS does not properly reflect the business model as described by you)? How should measurement uncertainty be dealt with in a 'long-term investment activities' business model?

Insurance Europe firmly believes that investments with long-term horizons require a different treatment than, for example, pure day-to-day trading activities. The IASB has already recognised and acknowledged this: the new IFRS 9 standard introduces a mixed measurement model for financial instruments, which we explicitly support. Depending on the nature of the insurance products and the related assets, there is a clear need for different classification possibilities including "amortised cost", "fair value through other comprehensive income" and "fair value through profit and loss".

In particular, a significant proportion of insurers' investments are in bond and bond-like assets with fixed maturity values. Where insurers have long-term liabilities and can hold assets to maturity, they are not exposed to volatility in the current market value due to changes in credit spreads, but are only exposed to actual defaults. This is very different from a situation where assets are traded on a daily basis.

As described earlier, the insurance business models manage the assets and insurance liabilities together. Therefore accounting requirements should reflect this interaction rather than dealing with assets and liabilities in complete isolation. Therefore, we are also supportive of the IASB's recognition in IFRS 9 to allow matching of the financial assets with our insurance liabilities by introducing a third classification category, fair value through OCI (FVOCI), based on a defined business model ('to hold and to sell'). We see the proposed definition as a pragmatic approach to address the needs of the insurance industry. However, in line with our previous explanation for the measurement treatment in IFRS 4, the use of profit or loss presentation should be allowed depending on the nature of the relationship between assets and liabilities and the needs of users, and so it is essential that the OCI category should not be mandatory in IFRS 4.

Respecting the conceptual decision of the IASB not to create industry-specific solutions, we support the decision of the IASB to address the concerns of the insurance industry within the IFRS 9 standard. However, we continue to argue that the scope of the new FVOCI category is too narrow, being only limited to simple debt instruments. While insurers do use simple debt instruments in order to match insurance liabilities, the asset strategy is often more complex, for example, involving the use of derivatives in order to diversify credit exposure and manage interest rate risk. Other asset classes may include investments such as equities, investment property, mortgages and other loans. Hence, for FVOCI to be appropriate for all types of insurance business, eligible assets must be extended to cover all asset classes.

Particularly, under the current IFRS 9, the accounting requirements for equities might negatively impact long-term investments in equity. It is essential that for equity investments at fair value through OCI, 'recycling' should be allowed so that gains or losses are recognised in income statements.

While we acknowledge that current measurement in the balance sheet represents useful information to investors, there is a specific need for the use of OCI or profit and loss to present changes in these current values in the performance statement appropriately, depending on the nature of the insurance products and related assets and related users' needs. In this respect Insurance Europe has welcomed the IASB's recognition to allow the use of OCI in IFRS 4 that will captures the volatility due to discount rate changes. However, as noted before, depending on the nature of the insurance liabilities and the related assets backing these liabilities fair value information could provide more useful information. Therefore, we continue to advocate that the IASB considers OCI an optional approach.

Furthermore, a robust solution for participating contracts in IFRS 4 is key to achieving a high quality standard that provides useful information to users. The current proposals under the mirroring approach would lead to significant operational complexities. The industry developed a more practical approach to implementing the mirroring approach of the IASB using the concept of 'floating residual margin'.

Question 6

If you are an investor in entities that are involved in long-term investment activities, what is the information that is the most relevant to you? How does IFRS financial reporting contribute to those needs today? Please explain.

We refer largely to our response in *Question 5*. Insurers as investors expect that suitable accounting requirements ensure a faithful presentation and a proper reflection of the business model of the entities in which they invest. Important sources of information are: the current value of the assets (for example, when sales are a realistic alternative) and the predictability of future cash flows from the investment (when holding is a realistic alternative).