Association of European Cooperative and Mutual Insurers (ACME)

EXPOSURE DRAFT 5 - INSURANCE CONTRACTS

Question 1 – Scope

(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting by policyholders (paragraphs 2-4 of the draft IFRS and paragraphs BC40-BC51 of the Basis for Conclusions).

The Exposure Draft proposes that the IFRS would not apply to other assets and liabilities of an entity that issues insurance contracts. In particular, it would not apply to:

(i) assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*.

(ii) financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts (paragraphs BC115-BC117).

Is this scope appropriate? If not, what changes would you suggest, and why?

(b) The Exposure Draft proposes that weather derivatives should be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract (paragraph C3 of Appendix C of the draft IFRS). Would this be appropriate? If not, why not?

ACME response:

a) ED 5 addresses insurance contracts rather than entities. We deplore this choice since insurance is a highly regulated activity in most countries. We understand the IASB's concern about comparability, so that 2 similar contracts should be valued according to the same principles whichever entity issues them. However, the fact that several valuation options already exist in the standards removes this comparability. Furthermore, we think that the interest of a reader (or an investor) is to be able to compare the financial statements of insurance companies according to the same principles.

(b) In the draft, the IASB does not deal with the accounting of the insurance contract from the insured's point of view. Consequently there is no match between the issuer of the contract and its underwriter. The issuer could thus issue a financial instrument under the standard, and the underwriter would account for it as an insurance contract. Some fiscal problems could therefore appear. The other consequence concerns reinsurance. Seeing that the reinsurance policy is defined as an insurance contract between an insurer and a reinsurer, the record of this contract into the insurer's accounts must follow the same treatment as a direct insurance contract entered in the client's accounts. Thus, the recording in the policyholder's accounts cannot be excluded while some principles for a reinsurance contract with the cedant are not yet established.

<u>Question 2 – Definition of an Insurance Contract</u>

The draft IFRS defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary' (Appendices A and B of the draft IFRS, paragraphs BC10-BC39 of the Basis for Conclusions and IG Example 1 in the draft Implementation Guidance).

Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?

<u>Proposed ACME response:</u>

The definition of the insurance contract as it is done in ED5 raises several questions.

Some members of ACME are unhappy that the premium (or contribution) is not mentioned, which leads us to think that there could be insurance contracts without premium. According to ACME, the premium is a fundamental element in an insurance contract, as it distinguishes it from a bet on the one hand and from an endorsement or security on the other.

Another difficulty comes from the lnk between the payment by the insurer and the materialisation of an "adverse effect" suffered by the policyholder or by the beneficiary. Hence, if it is not determined ab initio that the guaranteed event will cause one or several damages, there is no insurance contract. At least a definition of what the word "adverse effect" means would be advisable, indeed a vague terminology should be avoided for such a key-word for measuring the scope given to the insurance contract by the IASB.

The insurance risk definition is defined by opposition to financial risk. It seems strange to us to define insurance risk in relation to financial risk. The insurance risk must be defined as such. We also note that there are already other definitions for the insurance: a regulatory definition for prudential needs, a fiscal definition (for tax liability). In our views, it would be desirable to harmonise all the previous definitions in order to avoid an increased complexity.

Finally we ask whether any definition will not make the IASB vary from the principle of substance over the form (the economic reality takes the lead over the legal appearance). How could one be sure that, for instance, an insurance or even a financial contract, over 10 years with an option to surrender at any time be recorded equally as a one-year contract extendible for 10 years, independent from the applied standard?

<u>Question 3 – Embedded derivatives</u>

(a) IAS 39 *Financial Instruments: Recognition and Measurement* requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:

(i) meets the definition of an insurance contract within the scope of the draft IFRS; or

(ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

However, an insurer would still be required to separate, and measure at fair value:

(i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and

(ii) an option to surrender a financial instrument that is not an insurance contract.

(paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)

Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). Is it appropriate to exempt these embedded derivatives from fair value measurement in phase I of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase I?

(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs IG54-IG58 of the draft Implementation Guidance). Are these proposed disclosures adequate? If not, what changes would you suggest, and why?

(d) Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?

<u>Proposed ACME response:</u>

We do not always understand IASB's thoughts on embedded derivatives. According to us, there are derivatives when there is a commitment to a price fixed in advance (strike price) while the underlying price stays variable. Thus in an unit-linked contract, the option to surrender at any time at the market value of the unit cannot be considered as an embedded derivative.

Moreover, in most cases, the options proposed are not separable from the contract to be bought or sold separately. Hence there is no possibility for arbitrage on these options. They are not negotiable. It is thus difficult to understand the need to cut the contract in small pieces. To us, the mere presence of the loss test on the entirety of the contract is enough to assure that all commitments are included in the balance sheet.

<u>Question 4 – Temporary exclusion from criteria in IAS 8</u>

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy for an item if no IFRS

applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for:

(i) insurance contracts (including reinsurance contracts) that it issues; and

(ii) reinsurance contracts that it holds.

(paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions).

Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?

(b) Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:

(i) eliminate catastrophe and equalisation provisions.

(ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies.

(iii) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC58-BC75 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you propose, and why?

<u>Proposed ACME response:</u>

(a) We regard the exemption as appropriate given the current state of the Board's development of phase II of the project on insurance contracts. However taking the self-proclaimed objectives for phase I into account, it would be adequate and wise to maintain the exemption until a complete standard exists.

(b) We have mixed feelings as far as the provisions for equalization are concerned. We note that under § IG 47 the IASB acknowledges that when the company undergoes events like catastrophes (low frequency, but high losses) the result is likely to mislead and consequently requires that information be disclosed in the annexe. We suggest that in phase I, the companies, which are allowed by the jurisdiction of their respective States to maintain their equalisation reserves, be given the possibility to keep them accounted as currently and regard them as a component of the liabilitites (while in the meantime being accepted as a component of the solvency margin). We also would like to stress, with regards to phase II , that we see those provisions as part of the "fair value liabilities".

<u>Question 5 – Changes in accounting policies</u>

The draft IFRS:

(a) proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).

(b) proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of

financial assets that are measured at fair value, with changes in fair value recognised in profit or loss (paragraph 35 of the draft IFRS).

Are these proposals appropriate? If not, what changes would you propose and why?

Proposed ACME response:

We believe that the proposals in (a) and (b) are appropriate. However, in order to assure some comparability between two companies within one country who could, according to the IASB provision, adopt different accounting policies, a paragraph that indicates and assesses the changes operated in relation to the current local standards should be disclosed.

Question 6 – Unbundling

The draft IFRS proposes that an insurer should unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet (paragraphs 7 and 8 of the draft IFRS, paragraphs BC30-BC37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).

(a) Is unbundling appropriate and feasible in these cases? If not, what changes would you propose and why?

(b) Should unbundling be required in any other cases? If so, when and why?

(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

Proposed ACME response:

(a) We regard the current proposal in paragraph 7 of ED 5 as an improvement to previous draft proposals, as it recognises that unbundling is required only when the bundled nature of the plan obscures the proper accounting for obligations.

However, ACME does not favour the unbundling of insurance contracts in principle, except in cases where the structure of the contract is clearly artificial. This is because insurance contracts are, in general, designed, priced and managed as packages of benefits and, in consequence, any unbundling required solely for accounting purposes would necessarily be artificial.

Where the structure of a contract does obscure the accounting for the deposit element, and unbundling of the insurance and investment components may be required, we believe the criterion should be that "the cash flows of the insurance component and the investment component do not interact" rather than the current one-sided proposal to test if "the cash flows from the insurance component do not affect the cash flows from the deposit component". This change would lead to a more balanced approach and leave bundled a number of traditional products, where the one-sided test might apply unnecessarily.

(b) We do not believe that unbundling should be required in any other cases and we agree that surrender values should not be unbundled from traditional life contracts.

(c) Subject to the comments made under (a), we believe it is clear when unbundling is required during phase I.

<u>Question 7 – Reinsurance</u>

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).

Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?

<u>Proposed ACME response:</u>

ACME would like to stress that it favours a definition of the reinsurance contract which is similar to the insurance contract.

In particular, with an identical insurance risk level we would see a clearer separation between traditional reinsurance activities and financial reinsurance which ought to lead to a more transparent accounting for contracts taken as reinsurance contracts, but which constitute in fact an activity of alternative financing. More specifically, we are in favour of the type of presentation as presented under *IG Example 3 Unbundling* for the type of contracts like *"Spread loss cover*" using an "*experience account".*

Likewise ACME is in favour of the general principal of non-offsetting of the reinsurance assets and the insurance liabilities.

We express some doubts however as to the scope of the concept as developed in para BC90

i) should this paragraph encompass the entirety of insurance contracts, it is not applicable to traditional reinsurance. Indeed, in most countries of continental Europe, it is not right to state that the non-proportional reinsurance premiums reflect the current value of technical provisions, the latter representing the future burden of past claims. The reinsurance premium is determined on the basis of reinsurer's estimate of the cedant's future claims, whose past losses represent inevitably only a poor approximation, in particular for the low frequency and high amounts risks (catastrophe reinsurance); to this estimate a loading is added, which is in principle proportional to the reinsurer's risk capital. In proportional reinsurance, if the evidence given in BC 90 were correct, except for the impact triggered by the discounting of the reserves, the reinsurer would constantly register a null technical profit, which is of course not the case.

ii) if, on the other hand, this paragraph only covers the sole financial reinsurance, we understand that it refers in fact to the development risk of the provisions for claims such as "*Loss portfolio transfer*" (LPT) or "*Adverse Development Cover*" (ADC) .

For other types of financial reinsurance contracts we are not certain that the risk as mentioned under BC 90 is the main risk to control and hence, that the solutions proposed by the IASB are relevant.

Consequently to the question on the real scope of the chapter *"Accounting by a cedant for reinsurance*", we also wonder whether paragraph 18 covers solely financial reinsurance or also traditional reinsurance. Should the latter be the case, we do not understand the principles contained in para 18b) to e) for phase I. These indeed seem to be a matter for a prospective approach in fair value given that we don't see how in most of the countries of continental

Europe, it would be possible to enter a profit from the coming into force of a reinsurance contract.

Lastly we question heavily the real scope of paragraph 19. The latter refers to IAS 36 *Impairment of Assets*. Should it be referred to this Standard, it is foreseen under n° 36.558 that an impairment loss should be recognised whenever a recoverable amount is below carrying amount. Referring to the definitions of this Standard, it appears that the concept of "*recoverable amount*" is defined like its *"value in use*", in the case where a "*net selling price*" cannot be determined - which is the case in the insurance sector where there is no transparent and liquid market. This notion of "*value in use*" implies, as in n° 36.26, to estimate the in- and outflows updated at an appropriate discount rate.

Consequently, paragraph 19 comes in the end to systematically discounting the reinsurer's part in the technical provisions, because this discounted value is necessarily lower than its non-discounted value. This provision causes problems because, in phase I, the non-life technical provisions won't be discounted in most countries of continental Europe.

Question 8 – Insurance contracts acquired in a business combination

IAS 22 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 *Business Combinations* proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and

(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. Its subsequent measurement would need to be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.

The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you suggest and why?

Proposed ACME response:

We regard the proposals as appropriate.

Question 9 – Discretionary participation features

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.

Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?

Proposed ACME response:

We support the temporary exemption for contracts with discretionary participating features as an interim solution until the implementation of phase II and we agree that an intermediate category, neither liability nor equity, should not be permitted for the unallocated surpluses associated with discretionary participating features in insurance contracts (paragraph 24 (b)).

We understand that the exemptions mentioned at § 24 & 25 are complete. They cover at the same time valuation methods and the recording of premiums as revenues (and not as deposit).

Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).

Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?

Proposed ACME response:

The “fair value” (FV) of insurance contracts (or of with-profit investments) does not seem to be stable yet. Does each individual contract have to be considered or a portfolio of contracts? Is it the matter of a transaction with the policyholder, in which case it is easy to comprehend why this FV cannot be less than to the sum payable on demand?

Is it question of a transaction with another insurer? In this case, since there is no market, how are the practices, the parameters, the hypothesis to be harmonised in order for the figure displayed to bear a real significance?

Are contract renewals to be allowed for? If not, the value of a contract - even long maturity but to be surrendered at any time- would only be slightly different from a short-term contract.

With these problems needing clarification, it seems premature to require that the companies publish any figure which would not have the same significance for two competitors. ACME notes that the IASB has come to the same conclusion concerning the PML (probable maximum loss) at § IG46.

Question 11 –Other disclosures

(a) The Exposure Draft proposes requirements for disclosures about the amounts in the insurer’s financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance

contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of the draft Implementation Guidance).

Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.

To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.

(b) The proposed disclosures are framed as high level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements.

Is this approach appropriate? If not, what changes would you suggest, and why?

(c) As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS (paragraphs 34, BC134 and BC135).

Should any changes be made to this transitional relief? If so, what changes and why?

ACME is convinced of the merits of an improvement to the current published annexes. Hence we broadly approve the proposed device.

However, we feel that requirements should be ranked. For instance, we do not understand why the key figures mentioned under §IG 59 are optional. They provide a first level of comparability while being easily produced. These ratios could be made mandatory. However, some information could be deemed strategic by management, so it is undesirable to require their publication. Hence, § IG 37 f, which requires information on the financing of long-term commitments when capital is needed, extends beyond the reporting system and falls within the remit of prudential supervision. Likewise, we do not see the point of § IG 47 on the past losses from low frequency and high severity risks, which is only a poor approximation of future loss.

Question 12 – Financial Guarantees

The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS 39 *Financial Instruments: Recognition and Measurement* to a financial guarantee that it gives to the transferee in connection with the transfer (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or liabilities.

Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

Proposed ACME response:

We agree with the Board's proposal of a clear distinction between financial guarantees given by a transferor of non-financial assets or liabilities and a credit insurance given by a credit insurer. As a result, the genuine activities of credit insurance, which meets the definition of insurance, will be covered by the proposed IFRS on Insurance Contracts and will therefore be treated as other insurance contracts. Similarly, financial guarantees provided by industries other than the insurance industry, i.e. banks, would also be treated as insurance contracts, if they meet the definition.

Question 13 – Other comments

Do you have any other Comments on the Exposure Draft and Implementation Guidance?

1. **Some thoughts on phase II**

The model chosen for phase II is an asset/liability model. In this case, the liabilities stemming from the insurance contract would be valued in fair value. On the other hand, in a competitive situation like the one prevailing currently, no profit would be recognised at inception. Moreover, the presence of a loss test could entail the entry of losses at the time of underwriting. ACME notes that such a model is not symmetrical. The prohibition from making a profit (theoretical and uncertain) from the underwriting is not an issue to us, since this is what is currently done in Europe. Should the IASB want to introduce an asset/liability standard restricted by prudential considerations, we would advise going back to a "deferral and matching" standard which, on the one hand, fits with the idea that insurance is a service contract (not a financial negotiable contract) and which, on the other hand, would give much the same results as the model mentioned above.

For ACME, the key is whether or not the IASB identifies the immediate capitalisation in the balance sheet of future gains generated internally by insurance contracts. It seems that in other industries this identification is prohibited, since similar intangible assets are only recognised by the buyer when a transaction is done (cf. IAS 38 introduction, §4). Why would a special case be made for insurance in this layout?

ACME is also astonished to see how the measurement of a liability, be it at fair value, could take into account the own solvency risk of the person who enters it. Thus, the more insolvent a company becomes, the more its debts loses some of its value. And if it is still possible to get rich by borrowing on higher interest rates, this immediate gain is, in fact, artificial since it will be compensated by higher interest charges. For ACME, the taking into account at present value of an asset or a liability by systematic comparison between the internal return on assets or on liabilities and its present return makes no sense. We illustrate it in the paragraph below.

2. **A new method to evaluate the bonds**

ACME cannot but share the objections made by EFRAG over the fact that the distinction HTM-AFS is not adapted to the financial management of institutional investors. The conditions classified as HTM, and the consequences in the event that these conditions are not respected, are so heavy that no insurance company will bear the risk of classifying the bonds as HTM but write them in AFS, hence will value them as fair value.

Which fair-value for the bonds ?

IAS 39 lays the principle that the fair-value of a bond (listed or not) is its market value, i.e., the selling price to the seller and the purchase price to the buyer. The mutuals and cooperatives of ACME question the validity of this analysis, which ends up disconnecting the selling price of the fixed revenue bonds from the developments of the interest rates. Indeed the capital gain from the selling of bonds is the immediate and mathematical compensation for a fall of interest rates, as much as the depreciation from the sale carries a rise in interest rates as automatic compensation.

Since the conditions of a fixed-rate bond are known since its purchase, the evolution of its market value does not constitute a plus or minus of its intrinsic value, but the break-even point between its initial value and its interest income.
With a view of pursuing the activity of an insurance company, it is not logical to enter immediately the capital gain or loss, be they latent or realised; the capital gain or loss should be spread on the residual maturity of the bond so as to compensate the loss, or the gain, of expected income.

Let's take an example to illustrate our purpose.
Imagine that an insurer proposes a 5- year savings contract with a fixed rate of 5%, to a policyholder. It is not possible for the latter to exit before the term of the contract. As for the insurer, he has invested the received premium on a zero-coupon bond, at a 5-year maturity yielding 5%. Neglect the other charges. Economically, the insurer's only role is to be a broker, he works without margin, hence the profit or loss over the period as well as the implications on the own funds should be nil over the whole duration of the contract. According to IAS it is far from being the case.

Let's conduct an analysis with a premium of 1,000 and supposing that the rates drop to 4% from the 2nd year.

	Bond market value[1]	**Financial liabilities**	**Profit and Loss**	**Total equity**
From the start	1,000.00	1,000.00	0.00	0.00
Year1	1,090.97	1,050.00	40.97	40.97
Year2	1,134.61	1,102.50	-8.86	32.11
Year3	1,179.99	1,157.63	-9.75	22.36
Year4	1,227.19	1,215.51	-10.68	11.68
Year5	1,276.28	1,276.28	-11.68	0.00

The impact on the net assets is nil only in year 5, but not the intermediate results. The gain observed at the end of year 1 resulting in the drop in rates should not be published as a result. To keep it as advocated by the IAS conceals the fact that the 4% yield (from then on the new yield) will not suffice to cover the liabilities which is valued on (the basis of) 5%.

To correct this anomaly and attribute some meaning to the P&L, it is important to ask the IASB that the bonds be valued at amortised cost, even if the entity doesn't expect to keep the bond until maturity. In case of sale before time, the gain or loss resulting of the sale will be spread actuarially on the remaining life span length of the security.

3. Treatment of Co-operatives Shares under IFRS

[1] Redemption value, i.e. 1276,28 updated to 4%.

ACME is extremely concerned with the accounting treatment of Co-operatives Shares as currently proposed by the IASB. When redeemable at the option of the co-operator this standard considers those shares as puttable instruments and, hence, requalifies them as components of liabilities instead of equity. ACME disagrees with this proposed treatment, and favours the decision taken by the IASB at its September, 17th 2003 meeting "to include in the Standard illustrative examples of income statement and balance sheet formats that may be used (...) by entities that have equity but whose share capital is not equity as defined in IAS 32."

And ACME favours a still more balanced approach to this problem, inspired by the U.S. FAS 150 Standard which limits the scope of requalification to "mandatorily redeemable financial instruments", i.e., instruments which contain an unconditional obligation to redeem them for a specific date or if a certain event arise. This last feature is certainly not the most common among co-operators, due to the non-financial approach of their commitment - not investment- in a co-operative organisation.

We would like to outline the heavy implications implied by the IASB position as regards access to sources of financing and, especially, prudential regulations.
For instance, that position could lead some analysts to the false appreciation of an absence of "affectio societatis" and, even worse, to the conclusion that the co-operative is completely dependent upon creditors. Also, basic balance sheet ratios, such as the capital-debt ratio will worsen. We also would like to stress the changes that will be implied by the future European insurance "Solvency II" system. Today we cannot be sure that co-operatives shares requalified as liabilities will tomorrow, under this new solvency requirements, be accepted as components of the solvency margin. Those considerations are particularly acute when considering young insurance co-operatives whose shares constitute their unique resource of funds and which, in the meantime, do not have enough time to accumulate profits. In the climate of uncertainty caused by the concrete consequences of the application of the IAS on the solvency regulation and the constituent elements of the solvency margin**,** one cannot exclude the possibility that, due to a mere change in accounting, a company set up as a cooperative would no longer comply to solvency requirements.

While ACME has sympathy for the IASB position
a) when the co-operator has the right to redeem his/her shares above their nominal value, i.e. with a individual right on the accumulated profits;
b) when the co-operator has expressed his/her desire to leave the co-operative,
we raise serious doubts about this position when the right given to the holder is limited to the nominal value of the share, which is very common inside the co-operative movement.

Why do we have doubts about the relevance of the proposed IASB treatment ?

On one hand, consider a co-operator who commits 100 to take a share in an insurance co-operative . He gets the right to leave it when he wants and to get 100 back at that time. As a holder he receives each year an interest payment which is limited by the law or by the statutes (a very common feature among co-operatives) ; today an interest limit of 6% is common.
On the other hand, consider a financial investor who invests 100 in a quoted insurance company which is issuing shares. His rational expectation about his investment is a return calculated on the basis of the Capital Asset Pricing Model. The parameters of this very common model follow :
- 10 years Treasury bonds : ~ 4%
- market risk premium in Europe : ~4%
- Insurance sector Beta : ~1.25
- dividend growth : ~3% p.a.

which gives an expected return of ~ 9%.

In a strict rationalistic approach to his investment, this investor should be remunerated more than 9% in order to considerate an alternative investment in the insurance co-operative because of the relative illiquidity of the latter, which gives an equivalent-return of 10%.
If compared to the co-operator, the investor "gains" 4% each year.

On a perpetual ("going concern") basis, the "financial" value of the co-operative share is the annuity payment divided by a risk-equivalent yield, i.e. 6 / 10% = 60,
where the financial value of the quoted share is, on the basis of the Gordon-Shapiro formula (with a nominal dividend, for the first year, equal to the co-op interest , i.e. 6) : 6 / (9% - 3%) = 100 (which is the price he paid for the share on a liquid and without-arbitrage market).

Thus, on a perpetual basis, the financial investor has realized a gain of 40 when compared to the co-operator. In other words , the co-operator has a "dis-incentive" to leave and we think that the choice of leaving the co-operative must not be very common. In a more financial wording, to commit money in a co-op share is like buying a put option which is always "out-of-the-money".

Now take a look from both companies' points of view.
Where the quoted company has issued 100 of shares , it can logically write 100 under the equity on its balance sheet.

But the situation seen from an economical perspective is totally different for the co-operative, because it gets 100 from the co-operator, but the current value of this financing is only 60. So the co-operative has economically made an immediate profit of 40.

In those circumstances, we consider that, if the co-operative should follow the IASB rules and , therefore, accept treating those shares as liabilities, it should – at least – limit the accounting to 60 as liabilities and accounting the residual value, i.e. 40, as equity.

We hope we have convinced the IASB - at least partially – of the non relevance of its proposed accounting treatment of co-operatives redeemable shares, where the co-operator does not have an individual right on the accumulated profits.