To: Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
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Mr Robert H. Herz  
Chairman  
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United States of America  

Ref: ECO-ACC-10-084  
Subject: Cost of Capital  

Brussels, 8 June 2010  

Dear Sir David,  
Dear Mr Herz,  

The CEA is the European Federation of insurers and reinsurers, who represents all types of insurance and reinsurance undertakings, accounting for approximately 95% of total European premium income.  

The CEA has actively followed the IASB and FASB considerations regarding the selection of the techniques for measuring the risk adjustment to be included in the insurance liabilities. We understand that this topic is on the agenda of the joint Boards meeting on 10 June for decision. In this context, we would like to express our views and some critical concerns we have regarding the discussions of the Boards to date.  

We fully support the inclusion of an explicit adjustment for risk in the measurement of insurance liabilities. An explicit risk adjustment delivers useful and relevant information to users of financial statements, which a composite margin does not convey. Furthermore, we believe that it is of utmost importance that the cost of capital methodology is maintained as one of the possible techniques used to estimate the risk adjustment.  

In our view, an insurance contract should be measured based on the expected cash inflows and outflows together with a margin for risk and uncertainty. This basis of valuation represents an economic reflection of the value of the insurance contract. We support the measurement objective of the risk margin based on “the amount the insurer would rationally pay to be relieved of the risk taking into consideration that the amount of benefits and claim costs actually paid may exceed the amount expected to be paid”. Therefore, in line with this objective, there should be an explicit adjustment for risk, reflecting the uncertainty associated with the cash flows.
In our opinion, a margin for risk may be appropriately measured by the cost of the economic capital that is required to be held by the insurer to support the contract over its lifetime. Under the cost of capital approach, risk is assessed by valuing the uncertainty related to the underlying insurance cash flows.

Technically, the cost of capital and the quantiles techniques are not that dissimilar. Both methods use stochastic techniques to measure the uncertainty associated with insurance obligations to a certain confidence level. They both use the same risk distribution. In that context, the cost of capital is based on the amount of economic capital required by the business for the remaining life-time of that obligation.

The European insurance industry developed (and currently uses) a cost of capital method for quantifying risk associated with insurance contracts, generally both for internal risk control and also as a contribution to the European Commission for Solvency II. We believe that it is an adequate measurement of risk associated to insurance contracts, therefore, we support that the cost of capital approach be allowed for accounting purposes.

In conclusion, the CEA considers that cost of capital approach should be allowed to assess the risk in the valuation of insurance liabilities as it adequately reflects the amount required to manage insurance obligations over their lifetime. We strongly encourage the IASB to include the cost of capital as an available approach to calculate the risk adjustment, and we urge that its use should not be restricted to any particular types of insurance liabilities such as those with complex distributions of risk.

In addition, we draw your attention on the fact that limiting the range of available techniques to measure the risk adjustment would impose undue restrictions on the development of new and advanced methods, or require regular revision of the future insurance standard in light of actuarial developments.

We would be pleased to further discuss this topic with you in the coming weeks and would be willing to organise a meeting between you and technical experts should you find it useful.

Yours sincerely,

Isabella Pfaller
Chairman CEA Accounting Steering Group