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Sir David Tweedie
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30 Cannon Street
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on Exposure Draft ED/2010/8 *Insurance Contracts* (July 2010). Principal authors of this comment letter were Otto Altenburger, Rudolf Diewald, Roland Gröll, Christoph Krischanitz, Erich Kruschitz, Liane Hirner, Andreas Rauter, Thomas Smrekar, Guido Sopp, Georg Weinberger.

General remarks

AFRAC welcomes the opportunity to comment on the ED. We appreciate the work that has been undertaken by the IASB on the insurance project so far. Conceptually, we would like to point out the significant improvements made in this project compared to past publication by the IASB (i.e. Discussion Paper and existing IFRS 4). However, of course there are a number of areas in the ED where we would like to comment on and share our views with the IASB.

Following, we want to raise the most important comments very shortly and reference to our detailed explanations throughout the following pages:

- **Volatility:** We have strong concerns about the evolving volatility in income statement of insurance undertakings due to the ED. AFRAC makes a number of suggestions in order to limit the partly artificial volatile results. One of them is the re-calibration of the residual margin instead of the release over time approach chosen taken by the IASB. Another one is to apply a locked –in discount rate. Since IFRS 9 allows the use of amortised cost for certain financial assets, AFRAC propose an option to apply a locked-in discount rate determined at portfolio level at inception of the contract. This option should be available if it eliminates or reduces an accounting mismatch and is consistent with a business model of fulfilling the contracts.

- **Short term contracts/Non-Life insurance contracts:** AFRAC disagrees with the proposed premium allocation approach. Furthermore, we would support an unearned premium model for all contracts with a maturity of less than three years. This would reduce complexity but also provide for a comparable valuation technique to the building blocks model.
- **Presentation:** Highly connected to our remarks on volatility is the comment on performance presentation. However, a major doubt about the proposed summarised margin presentation model is the lack of experience in this area. Furthermore, we fear that the summarised margin approach will cause an inadequate effort on systems in order to generate the information necessary. In addition we see some inconsistency between the requirements of IAS 1.82 and the approach of the ED. It should be made clear how IFRS 4 and IAS 1 would interact for insurance companies.

Finally we are not convinced that this approach will enhance the transparency and understandability of insurance accounting due to its complexity.

- **Timetable and field testing:** We recommend that the board work closely with the insurance industry to comprehensively test the proposals with real data before finalising the standard to ensure the finalised model will produce information that is relevant to the decision-making needs of users. The field testing should enable the participants to fully test the proposals on a wide range of products. The European insurance industry has already had experience of such testing in the context of the Quantitative Impact Studies carried out to support the development of the Solvency II regulations. This testing demonstrated that field testing can enhance the understanding of the proposals and identify problems of interpretation and implementation of the measurement and disclosure requirements. It has also highlighted the amount of time that is required by the industry to implement extensive changes to systems and processes that are likely to be required and the Board should take this into consideration when setting the effective date for the new standard.

As part of the field testing it would be necessary to test not only whether insurance companies are able to perform reasonable and comparable valuations but as well whether the financial statements under the new standard help users of financial statements to make economic decisions.

Specific comments

Question 1 – Relevant information for users (paragraphs BC13–BC50)

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer’s financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

AFRAC agrees with the proposed measurement model for life insurance contracts. In this respect the building block approach represents a consistent valuation model and is a step towards better understanding for users of financial statements as it increases comparability and transparency throughout the industry.

Nevertheless, we think that for short term contracts (i.e. non-life insurance contracts) the proposed premium allocation approach does not adequately reflect the business model. For short term contracts we would prefer an unearned premium approach as stated in BC167 and BC168. In our view the unearned premium approach is significantly less complex, while it provides a compatible outcome to the proposed building blocks approach.

The unearned premium model ensures that no gains at inception would be realised. Furthermore, the part of the premium allocated to the unearned premium reserve would be consistent with a risk adjustment and implicitly a residual margin (if applicable). Due to the rather short time horizon and in order to provide for less complexity, discounting could be neglected for these types of contracts.

To allow for a clear and practically sound differentiation between the valuation models, we would propose to permit the use the unearned premium approach for all insurance contracts where an insurer can demonstrate for a coverage period greater than 12 months that applying the unearned premium approach would result in a similar measurement result to the building blocks approach. We refer to our answer in Question 8 (a). All other contracts would be accounted for as proposed in the ED.

Furthermore, we are concerned about the higher volatility in valuation of insurance contracts due to the new model. As the proposed valuation principles drafted in IFRS 9 for financial instruments will not always fully compensate the volatility in the valuation of insurance contracts we see a certain potential for a remaining accounting mismatch. Therefore AFRAC made some suggestion to handle the upcoming volatility at least within the income statement. We prefer to recalibrate the residual margin in cases of changes in overall parameters for the fulfillment value, i.e.:

- a. changes in the level of interest rates,
- b. recalibration of risk adjustment,
- c. changes in estimates of expected cash flows.

For each of those parameters the entity should disclose the amount of change, during the period and cumulatively.

However, any experience adjustment that already occurred should not be considered in the valuation of the residual margin but in P/L.

AFRAC also has some concerns relating to the definition of a portfolio of an insurance contract as we believe the term "...broadly similar risks..." may be too narrow to ensure an aggregation of the portfolios as managed together within the insurance undertaking. We believe in order to ensure an economic approach providing useful information to users of financial statements the management approach, i.e. the aggregation due to the way an insurance undertaking manages the contracts should be superior to the similarity of risks.

In this respect we would also like to raise the point that in some areas of the ED it was not clear to us if the unit of account is the insurance contract or a portfolio of insurance contracts. To us the only economic sound interpretation is the portfolio of insurance contracts as the unit of account.

Moreover, we have some concerns relating to different areas of the ED. These are discussed throughout the answers to Questions 2 to 19.

Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)

(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?

(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

(a) AFRAC supports the measurement principle of an insurance contract through the proposed fulfilment model. Insurers do not typically transfer insurance contracts in the normal course of business and therefore a fulfilment objective better reflects the substance of the contract compared to the exit notion based on hypothetical market participants.

However, we are concerned that some cash flows can not be easily distributed to specific contracts; e.g. premium redemptions on the basis of a policyholders account (i.e. relating to a bundle of different types of insurance contracts).

Furthermore, we would propose to permit the unearned premium model for all contracts where an insurer can demonstrate for a coverage period greater than 12 months that applying the unearned premium approach would result in a similar measurement result to the building blocks approach (see answer to question 1 and 8 (a) for further details). However, we think that the estimation of the fulfilment cash flows is the same for the unearned premium approach as the fulfilment cash flows are reflected in the received premiums of an insurance contract.

(b) We believe that the guidance regarding the definition of future cash flows is at the right level of detail except for the points raised in Question 7 (acquisition costs).

Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)

(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?

(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

(a) AFRAC agrees that the cash flows arising from the insurance contract should be discounted with a risk-free rate. However, AFRAC would support an option to apply a locked-in discount rate determined at the inception of the contract. This option should only be available at the level of a portfolio if it eliminates or reduces an accounting mismatch and when it is consistent with the business model of the insurer. This option will allow insurers that hold bond and other debt securities as part of an asset liability matching strategy, to measure these assets at amortised cost. Under IFRS 9, 'Financial Instruments', these assets would typically be held to collect contractual cash flows and would be measured at amortised cost. It is unclear why insurers should be required to measure these assets at fair value through profit and loss using the fair value option when their business model is to hold these assets to collect the contractual cash flows. Allowing a locked in discount rate for insurance contracts would therefore eliminate an accounting mismatch that would arise due to interest rate changes arising in the measurement of the insurance liabilities and the assets backing these liabilities.

Regarding participating contracts we would like to express our concern relating to the wording in para 32 of the ED. The proposal that measurement of contracts that wholly or partly depend on the performance of specific assets should reflect that dependence seems to be generic and provides little guidance. Replicating portfolios are a very interesting but also very theoretical approach and we fear that this approach will not help too much in practical application of the standard. We would welcome either additional guidance or a consistent use of discount rate for all sorts of insurance contracts including participating contracts.

(b) AFRAC's view on introducing an illiquidity premium is rather ambivalent. On the one hand, AFRAC is concerned that the application of an illiquidity premium is not based on a sound conceptual framework. The major argument in favour of an illiquidity premium is the lack of possibility to sell the insurance contract. AFRAC cannot agree upon this argument under the fulfilment value approach. However, an illiquidity premium might be useful to dampen effects of asset side illiquidity induced spread increase and thus might prevent accounting mismatches at least in some cases. Apart, AFRAC has some reservations concerning the reliable derivation of the illiquidity adjustment for insurance contracts.

- (c) We agree that the effects of a change in the entity's own credit standing should not be included in the subsequent measurement of an insurance liability as we consider this to give misleading information to users of financial statement.

Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

AFRAC supports the separate use of a risk adjustment and a residual margin (as the IASB proposes) provided that no economic mismatch resulting from different valuation principles for risk adjustment and residual margin evolve. In this respect we have some doubts regarding the lock-in approach for the residual margin. Please refer also to our answer to question six.

Nevertheless, we think that the initial margins can be reliably measured and serve as an important information for users of financial statements.

Moreover, in respect to the risk adjustment an explicit risk margin represents an economic valuation and explicitly quantifies the risk and uncertainty in the underlying liability. Thus, the model with separate risk and residual margins seems significantly more appropriate to us than the aggregation of these two elements together in a single composite margin.

However, if the recommended field testing leads to the conclusion that a segregated sound and proof valuation process of risk adjustment and residual margin is too complex and burdensome the concept of an alternative approach should be considered.

Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)

(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?

(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?

(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?

(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

- (a) We agree with the proposed definition of the risk adjustment. Please refer also to our answer to Question 3 concerning the risk adjustment.
- (b) We agree to use the proposed models by default. More detailed guidance on how to calculate the proposed approaches would be necessary, in order to allow for a consistent application. The use of other models to derive the risk adjustment should be allowed as long as they lead to (more) reliable results and are sufficiently described. Thus, we think the proposals should not be restricted to three techniques only, but leave also room for more advanced valuation methodologies. This will allow insurers to use more appropriate and reliable methods to calculate the risk adjustment that may be developed over time.
- (c) The disclosure of the confidence level should be part of information provided about the way the risk adjustment is calculated. However, the confidence level itself does not seem to be a significant information source in this context. We expect a well balanced qualitative and quantitative disclosure on this topic.
- (d) We agree that the risk adjustment should be calculated at a portfolio level of aggregation. Diversification effects may exist between different portfolios. However, as the unit of account is the portfolio level there should be no possibility to reduce the risk adjustment by recognition of further diversification beyond the portfolio level.
- (e) We think that the application guidance in Appendix B on risk adjustment is useful. Further guidance on how to calculate the proposed approaches would be appreciated in order to allow for a consistent application.

Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

(a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?

(b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?

(c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?

(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?

(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?

(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

(a) We agree that an insurer should not recognise any gain at initial recognition of an insurance contract. This is consistent with the proposals/principles in the revenue recognition exposure draft. Nevertheless it is important, that the residual margin is shown separately from the risk adjustment to present the potential additional profit to be realized over the lifetime of the contract.

We do not feel comfortable with the “release over time”-principle also applied for the residual margin as the liability might be overstated if an originally profitable contract becomes onerous.

(b) We agree that the residual margin should not be less than zero; as a consequence a loss at initial recognition of an insurance contract would be recognised immediately in income. This principle was already accepted and successfully implemented in IFRS 4 (liability adequacy test / recognising any shortfall resulting from the expected cash in- and outflows). This principle is also accepted when assessing present obligations under IAS 37 (onerous contracts).

(c) We agree that the residual margin should be calculated at a portfolio level of aggregation. Diversification effects may exist between different portfolios. However, as the unit of account is the portfolio level there should be no possibility to reduce the residual margin by recognition of further diversification beyond the portfolio level.

- (d) We do not agree with the proposed methods of releasing the residual margin. We believe the residual margin should not be locked-in at inception in order to reflect the economic value of an insurance contract even at after initial recognition. Otherwise the liability might be overstated if an originally profitable contract becomes onerous over the lifetime of the contract. We prefer to recalibrate the residual margin in cases of changes in overall parameters for the fulfilment value, i.e.:
- a. changes in the level of interest rates,
 - b. recalibration of risk adjustment,
 - c. changes in estimates of expected cash flows.

As stated before (see answer to question one) the recalibration of the residual margin should be linked with certain disclosure requirements.

However, any experience adjustment that already occurred should not be considered in the valuation of the residual margin but directly in income.

- (e) As stated in Question 4 we do not agree with the approach of the composite margin at all.
- (f) AFRAC believes that the accretion of interest concept appears to be inconsistent with the overall building block approach.

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)

(a) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

AFRAC conceptually agrees with the proposed treatment for acquisition costs. However, we have concerns with the limitation of acquisition costs to those that are incremental at contract level. We think variable overhead costs should be included as long as the rationale for an allocation to the single contract is reliable.

The current proposal could lead to a mismatch in acquisition costs per sales channel as brokers cause mainly direct variable costs (commission) whereas costs for own sales force evolve direct variable costs as well as salaries which are not directly linked to individual contracts. Finally costs of direct sale through internet and mailings usually cannot be linked directly to individual contracts at all.

Question 8 – Premium allocation approach

(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?

(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

(a) AFRAC opposes the proposed premium allocation approach (PAA). Rather, we would propose a uniform and less complex valuation model for short term contracts. We believe the PAA does not adequately reflect the business model of those insurance contracts and non-life insurance in particular. For short term contracts we would prefer an unearned premium approach as stated in BC167 and BC168. In our view the unearned premium approach is significantly less complex, while it provides a compatible outcome to the proposed building blocks approach. Another crucial point is that insurance undertakings as well as user of financial statements already do have experience with this model.

The unearned premium model also ensures that no gains at inception would be realised. Furthermore, the part of the premium allocated to the unearned premium reserve would be consistent with a risk adjustment and implicitly a residual margin (if applicable). Due to the rather short time horizon and in order to provide for less complexity, discounting could be neglected for these types of contracts.

To allow for a clear and practically sound differentiation between the valuation models, we would support the principle that the use of the unearned premium model should also be permitted where an insurer can demonstrate for a coverage period greater than 12 months that applying the modified measurement approach would result in a similar measurement result to the building blocks approach

(b) See answer to (a).

Question 9 – Contract boundary principle

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

AFRAC supports the proposed boundary principle. We believe that the proposed principle clarifies when an existing contract ends and a new contract begins and that insurers should be able to apply this consistently.

Question 10 – Participating features

- (a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?*
- (b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?*
- (c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?*
- (d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?*

- (a) AFRAC supports the inclusion of participating benefits on an expected present value basis. This reflects the true economic value of the insurance contracts and is in line with the fulfilment value notion.
- (b) For the time being AFRAC does not have a strong view on this topic.
- (c) We believe that the proposed definition of a discretionary participation feature is sufficiently clear and could be applied in practice.
- (d) For the time being AFRAC does not have a strong view on this topic.

Question 11 – Definition and scope

- (a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?*
- (b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?*
- (c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?*

- (a) We agree with the definition of an insurance contract in the existing IFRS 4. AFRAC does not see the need for the introduction of the so called notion of a loss (as described in BC 191 (c) and B25).

In general, we think the definition within the existing IFRS 4 did not lead to any misleading classification of contracts and thus should remain untouched.

- (b) AFRAC agrees with the proposed exclusions.
- (c) AFRAC does not agree in bringing all financial guarantee contracts within the scope of IFRS 4. We deem necessary to differentiate at least between typical financial guarantee contracts and credit insurance contracts for the following reasons:
1. Financial guarantee contracts serve as credit substitutions and thus are based on an individualized credit assessment of the debtor. In contrast, typical credit insurance contracts cover the credit risk of a portfolio of receivables. Hence, they are based on the principle of risk balance within the portfolio. Credit assessment is stochastic based rather than individualized.
 2. Financial guarantees are managed on the basis of the credit rating of the debtor. Hence, in determining the probability of default, the guarantor needs to focus on the individual debtor and movements in his specific credit rating. This is different from typical credit insurance contracts which are managed on an open portfolio basis according to actuarial principles.

Due to this, financial guarantees seem to be more comparable to original credit contracts than to insurance contracts. AFRAC therefore considers that financial guarantees should be in the scope of IFRS 9, while credit insurance contracts being in the scope of IFRS 4. We assess management at portfolio level and risk balance within the portfolio as suitable criteria to distinguish financial guarantee contracts from credit insurance contracts.

Question 12 – Unbundling

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

AFRAC agrees with the proposed criteria for unbundling. However in our opinion the examples provided in 8.a.i and ii do not represent necessarily examples where the insurance component and the investment component are not closely related. In our opinion there is a strong link between the insurance component and the investment component in unit linked business since the amount of potential loss of the insurance company in case of the insured event is directly linked to the performance of the underlying asset. We therefore suggest deleting the examples 8.a.i and ii.

Question 13 – Presentation

(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?

(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

(a) AFRAC has doubts about the interpretation of the effects of the new summarised margin presentation. In our view it is extremely unlikely that all effects of this rather crucial change to financial statement presentation for insurance contracts can be reliably analysed. Given the different types of insurance contracts accounted for within the insurance undertakings we think a final judgement about the pros and cons of this approach can only be made through a detailed quantitative field test (over a period of at least two years). Especially effects resulting from presentation of very different insurance products should be carefully tested. Moreover, we assume that there could be significant dislocations within the income statement of a start-up insurance undertaking and an insurer in run-off. However, an objective analysis seems impossible without reliable quantitative information from insurance companies.

Furthermore, AFRAC has some doubts about the interrelations with non-insurance activities within the performance reporting of the companies concerned; e.g. revenue from non-insurance activities. Under the summarised margin model, insurers will not be presenting those elements that are included in the fulfilment cash flows (premiums, incremental acquisition costs or expenses) which will hinder comparability with other unrelated operations.

Furthermore, we fear that the summarised margin approach will cause an inadequate effort on systems in order to generate the information necessary. In addition we see some inconsistency between the requirements of IAS 1.82 and the approach of the ED – i.e. “As a minimum, the statement of comprehensive income shall include... (a) Revenue...”.

Thus, in our view the presentation of a single line item for the “technical profit” of insurance contracts is not in line with the minimum requirements for the statement of comprehensive income under IAS 1.82. It should be made clear how IFRS 4 and IAS 1 would interact for insurance companies.

Generally the presentation of a single line item for profit (offsetting income and expenses) reduces information which usually would be given on the face of an income statement. Users of financial statements might expect to see profit as the bottom and not as the top line of the income statement.

Finally we are not convinced that this approach will enhance the transparency and understandability of insurance accounting due to its complexity.

(b) As stated in (a) we have doubts about the effects from the summarised margin presentation approach. In connection with our comments made in question 2 concerning the higher volatility

in income of insurance undertakings we would prefer alternative approaches for the performance presentation of insurance contracts.

- a. We would generally prefer to recalibrate the residual margin as described in question 6. This would have significant effects on the performance reporting as changes in estimates could be smoothed through adjustments in the residual margin. This is the preferred approach by AFRAC as it best reflects the economic value of the insurance contracts over time and also provides for less (artificial) volatility.
- b. Alternatively we could imagine presenting any changes in the risk adjustment, discount rates and expected future cash flows within other comprehensive income. The advantage is that the lock-in of the residual margin and the proposed release over time principle in the performance reporting could be persisted. This solution would also provide the full range of information for users of financial statements while reducing the (artificial) volatility of income to a lower level.
- c. Finally, the third possibility is to introduce an alternative valuation option for insurance contracts. Similar to the valuation of financial instruments an amortised cost option with locked-in discount rate and consideration of expected changes in future cash flows could be introduced in order to fairly limit the asset-liability mismatch. We refer to our answer in question 3 (a).

Question 14 – Disclosures

(a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?

(b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?

(c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

- (a) AFRAC agrees with the proposed disclosure principles. We think the proposal will provide users of financial statements with decision useful information.
- (b) We believe the disclosure requirements are at the right level of detail and meet the objective.
- (c) We believe the disclosure requirements are at the right level of detail.

Question 15 – Unit-linked contracts

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

We basically agree with the proposed approach. We also support to fair value treasury shares and owner-occupied property to address mismatches for unit-linked contracts. However, we are concerned that not all mismatches have been addressed, such as discounting deferred tax and treatment of own debt.

Question 16 – Reinsurance

(a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?

(b) Do you have any other comments on the reinsurance proposals?

(a) AFRAC agrees with the expected loss model for reinsurance assets in the ED.

(b) No other comments on the reinsurance proposals.

Question 17 – Transition and effective date

(a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?

(b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?

(c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?

(d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

(a) AFRAC disagrees with setting to zero the residual margin for contracts in force at transition. We see no need to insist on this explicit transition rule. In order to assure consistency with other IFRSs we consider the application in accordance with IAS 8 as more appropriate.

The current ED does not allow for the accounting of a residual margin on the pre-existing book of contracts and thus would result in a significant drop in post-transition earnings for most insurers AFRAC recommends to offer the proposed treatment as optional. IAS 8 should be applicable.

- (b) We disagree with the FASB approach of a composite margin. As a consequence we also disagree with transitional rules to start with re-measured risk margins being reversed according to the composite margin approach.
- (c) In order to minimise the operational burden it is crucial that insurance companies will have the opportunity to apply IFRS 9 and the final insurance contracts standard at the same time. The ability to re-designate financial assets at the time of adoption of the new standard on insurance contracts is less preferable; however, it should be open in both directions.
- (d) In order to give a reliable estimation, AFRAC would propose a quantitative field test as mentioned in our answer to question 13.

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

No further comments at this stage.

Question 19 – Benefits and costs

Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

In an overall view we are of the opinion that this standard is an important improvement to insurance accounting. Compared to the existing IFRS 4 the approach is much more harmonised and in most details also consistent with other IFRSs.

However, we are of the opinion that a quantitative field test with real data would assist to improve the ED in several areas and lastly also provides important experience to insurance undertakings as well as readers of financial statements in order to lower implementation costs and increase benefits stakeholders involved.

The field testing should enable the participants to fully test the proposals on a wide range of products. The European insurance industry has already had experience of such testing in the context of the Quantitative Impact Studies carried out to support the development of the Solvency II regulations. This testing demonstrated that field testing can enhance the understanding of the proposals and identify problems of interpretation and implementation of the measurement and disclosure requirements. It has also highlighted the amount of time that is required by the industry to implement extensive changes to systems and processes that are likely to be required.

As part of the field testing it would be necessary to test not only whether insurance companies are able to perform reasonable and comparable valuations but as well whether the financial statements under the new standard help users of financial statements to make economic decisions.

We believe that to the extent possible coherence with the Solvency II project is in terms of benefits

and costs preferable. However, we also want to point out that in principle the goals of IFRS 4 and Solvency II do differentiate and therefore reasonable differences can sometimes occur for a good reason.

Other than that, we agree with the assessment of the benefits and costs undertaken by the IASB.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl

Chairman