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Dear Sir/Madam

IASB Exposure Draft ED/2010/8 *Insurance Contracts* and FASB Discussion Paper *Preliminary Views on Insurance Contracts*

We appreciate the opportunity to respond to the Exposure Draft *Insurance Contracts* (the ED), issued by the International Accounting Standards Board (IASB) and the Discussion Paper *Preliminary Views on Insurance Contracts*, issued by the U.S. Financial Accounting Standards Board (FASB) (collectively referred to as the proposals). We have consulted within the KPMG network in respect of this letter, which represents the views of the KPMG network, including KPMG LLP (U.S.). This letter is being submitted to both the IASB and the FASB (the Boards).

Measurement Model

We believe that the proposed measurement model represents an improvement from the exit value measurement approach proposed in the IASB's May 2007 discussion paper *Preliminary Views on Insurance Contracts*. We also believe that arriving at common requirements under both IFRSs and US GAAP would benefit financial reporting for insurers significantly considering the current diversity under IFRSs in accounting practices in different jurisdictions.

We agree with a measurement approach that bases the measurement of rights and obligations under an insurance contract on the amounts that an insurer expects to receive and pay through the life of the contract rather than a model based on an "exit value" as if transferring the contract to a hypothetical market participant. In our view, this focus on expected cash flows increases

the relevance of financial statements over the “exit value” model in the 2007 IASB discussion paper and FASB invitation to comment since the expected cash flows approach is aligned with the business model of insurers, which includes long-term servicing of insurance contracts as opposed to contract trading for a short term gain.

Volatility

A key area of concern is that the proposals on the measurement of insurance contracts may lead to short-term fluctuations in reported profitability that is more pronounced than other accounting models such as those for revenue recognition or financial instruments.

Sources of volatility include:

- Recording gains and losses from changes in assumptions that reflect the inherent uncertainty as to the future cash flows of insurance contracts directly in the statement of comprehensive income while leaving the residual or composite margin fixed at inception;
- Recording losses at inception on ultimately profitable contracts by discounting cash flows at rates below the rates inherent in pricing; and
- Discounting at fluctuating current discount rates.

Such volatility arguably is unrelated to the long-term business model of an insurer and would mean that results as reported would offer limited benefits in predicting long-term performance. It might result in distorted perceptions of the insurance sector as a whole relative to other industries, including some for which significant portions of both assets and liabilities may be reported using an amortised cost model.

The measurement of insurance contracts under the proposals result in volatility from re-measuring the contracts at each reporting date to reflect fluctuations in inputs such as interest rates. The analysis performed by various insurers as discussed at the Insurance Working Group meeting that was held 11-12 November and the financial information of insurers currently applying some form of a current measurement model both reinforce that there may be a significant amount of short-term volatility generated as a result of the proposed measurement model. We believe that the Boards should consider other approaches that may produce more relevant and decision-useful information by focussing on the drivers of this volatility and whether and how this volatility should be reflected in the measurement of insurance contracts and in presenting those changes in the statement of comprehensive income.

Approaches that are emerging that, for the reasons above, the Boards ought to consider include:

- Remeasuring the residual or composite margin to reflect the effect of changes in assumptions not observable in financial markets including some financial assumptions. Differences between estimates for the current period and amounts actually experienced would be recognised in profit or loss;
- Discounting cash flows based on the current rates inherent in how insurance contracts are priced, to reduce losses at inception on contracts that are expected ultimately to be profitable;
- Providing an option to unbundle components such as account balances which may allow for measurement of these account balances at amortised cost under IFRS 9 *Financial Instruments*, to the extent unbundling would eliminate or significantly reduce an accounting mismatch.
- Reflecting the effect of changes in some or all assumptions in other comprehensive income; and
- Permitting the use of discount rates established at the inception of the contract for the entire duration of the contract, to the extent the use of a locked-in interest rate would better reflect an insurer's business model. The IASB has refrained from pursuing a full fair value model for financial instruments, but has instead provided a mixed measurement model with amortised cost accounting for financial assets under IFRS 9 based on the contractual cash flows characteristics of the asset and an entity's business model. Under the business model of insurers, financial assets that include solely payments of principal and interest may be held for collection of contractual cash flows rather than for sale or settlement with a third party. The measurement model of the ED may cause these insurers to avoid measuring such financial assets at amortised cost in accordance with their business model because of the potential resulting accounting mismatches with insurance contract liabilities measured using current discount rates.

Other issues

Transition: We do not agree with the proposals regarding transition. Although it is recognised that determining the remaining amount of the residual margin on transition may represent a challenge, we are concerned that the transition proposals as currently presented do not permit any residual margin upon transition. Depending on the specific circumstances, these residual margins may be significant. We believe that the Boards should require insurers to apply a full retrospective approach, as discussed in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and FASB ASC Topic 250 *Accounting Changes and Error Corrections* if practicable, and apply an alternative approach to be developed by the Boards, such as fair value consistent with the business combinations guidance in the proposals, if it is impracticable to apply a full retrospective approach. For insurers with long-term insurance contracts, applying

the proposals as drafted will not faithfully represent the performance of insurance contracts that are in force at transition in reporting periods after the date of transition and will introduce inconsistency between identical products written before and after the date of transition. Because of the long-term nature of some insurance contracts, such inconsistencies could persist for long periods of time.

We believe that retrospective application should be required unless impracticable. Those insurers able to perform a full retrospective approach in order to eliminate such transition impacts should not be prevented from doing so by the Boards. The difficulties associated in implementing a full retrospective approach may be reduced if the residual or composite margin were subject to remeasurement after initial recognition.

Presentation: One of the key areas for which further consideration is desirable relates to the presentation of the statement of comprehensive income and whether the summarised margin approach will provide information that users consider relevant. Although the summarised margin approach may be aligned conceptually with the proposed measurement model, we encourage the Boards to undertake outreach and consultation with users of financial statements to determine whether they believe that it provides them with the most relevant and decision-useful information or whether they would prefer alternative approaches or supplementary information.

Remeasurement of residual or composite margins: We believe that consistency with the revenue recognition exposure draft with respect to the recognition of the residual or composite margin is important for the Boards to consider in re-examining their proposals. One of the key arguments for supporting the existence of a residual or composite margin to eliminate day one gains is that under the fulfilment approach the insurer has not fulfilled any performance obligations at the inception of a contract.

Remeasuring the residual or composite margin for changes in estimates would also be conceptually consistent with the proposals for revenue recognition, where changes in future revenue and cost estimates would only be recognised immediately in profit or loss when a contract becomes onerous. Another key argument for not recognising any gain at the inception of an insurance contract is the inherent uncertainty in the estimates used to measure the present value of the fulfilment cash flows. Remeasurement of the residual or composite margin for specified changes in estimates reflects their status as an uncertain measure of future profit that cannot be recognised immediately in profit or loss. We believe that the residual or composite margin should be adjusted for changes in the risk adjustment (residual margin only) and in assumptions about future cash flows that are not observable in financial markets because it is the inherent uncertainty in these assumptions that would prevent any day one gain being recognised. We agree that differences between estimates for the current period and amounts actually experienced should be recognised in profit or loss.

Losses at inception: The proposals for initial recognition of insurance contracts may lead to losses at inception for contracts that ultimately are expected to be, and are profitable, due to discounting cash flows at rates below the rates inherent in pricing the contracts. We believe that further consideration should be given to how the discount rates used to measure insurance contracts should be determined and how the effects of changes in discount rates are presented in the financial statements. As discussed further in response to Question 3, we believe that a discount rate based on the rates inherent in how an insurance contract is priced may be more reflective of the characteristics of the liability than adjusting a risk-free rate for illiquidity.

Risk adjustment: The proposals limit the number of techniques available for determining the risk adjustment. We believe that limiting the determination of the risk adjustment to only specified techniques does not contribute to consistency, the Boards' objective in limiting the number of available techniques, since these methods are not calibrated to one measure. Not limiting the techniques would allow further measurement techniques to be developed and incorporated into the accounting model, with appropriate disclosure, in response to new insurance products or enhancements of techniques used for existing products.

Recognition: The recognition proposals, which state that an insurer should recognise the insurance contract at the earlier of when the insurer is bound by the terms of the contract and when first exposed to risk, which may be before the start of coverage, would introduce unnecessary complexity. We believe that a more practical and relevant approach of recognising insurance contracts is to require an insurer to recognise insurance contracts at their effective date (i.e. date that coverage or service begins). In applying this approach, the insurer would be required to record any cash receipts received and cash payments made before the start of the coverage period and also would recognise a provision for any contract that becomes onerous. This approach would treat the contract as executory until the start of coverage consistent with proposals in the revenue recognition exposure draft.

Timing should not compromise quality

The Boards' primary consideration should be the quality of the final standard, even if this comes at the expense of a delay in the finalisation and implementation of the proposals.

Given the extended period since the project commenced and the relatively short time given to constituents to digest and respond to the proposals, we believe that it is important that the Boards ensure that the final standard is based on sound principles and reflects adequate consultation. We do not think that the IASB should be held to a fixed timeframe if this risks compromising the quality of the final standard.

We also believe that it is important for the credibility of the project that the final requirements of the IASB and FASB are consistent. At present, there are several important differences between the proposals of the IASB and the FASB that we believe the Boards should resolve in order to settle on a unified measurement model, as this will avoid pressure on either Board to eliminate any differences through convergence in the period after the Boards issue their respective standards. Our commentary on resolving these differences is included within the Appendices.

The proposals will require significant effort for most financial statement preparers, including some entities that are not insurers but that issue insurance contracts as defined in the proposals. It will take preparers and users time to become familiar with applying the new reporting requirements and how to interpret them. It is important that the standard is high quality, stable, clear and based on sound principles that can be applied consistently from when it is first issued and without over-reliance on prescriptive rules.

Despite the consultation and field testing undertaken by the Boards, it is possible that there will be unforeseen consequences from applying the proposals. Insurance contracts exhibit highly diverse characteristics across business segments and jurisdictions and some of the proposals have had much less opportunity for consultation and testing than others. In order to have a final standard that does not require modification or interpretation soon after issuance, we believe that the proposals ultimately adopted should be subjected to field testing to determine how the adopted proposals would work in a variety of circumstances.

Some of the proposals would pose specific operational challenges to organisations. We believe that the final standard would benefit from the Boards conducting further field testing with emphasis on the following:

- Adjusting the residual or composite margin for changes in estimates and obtaining a fuller understanding of the financial impacts for insurers under both locked and unlocked approaches to reflecting changes in estimates;
- Determination of the discount rate, including adjustments to reflect the characteristics of the liability;
- Estimation of the risk adjustment;
- Presentation of the statement of comprehensive income under not only the summarised margin approach proposed but the alternative methods discussed by the Boards (including the expanded margin presentation) and how these alternative methods compare to existing presentation models; and
- Feasibility of the proposed disclosure requirements.



Attached to this letter, we have provided answers to the questions posed in the ED and Discussion Paper (Appendices).

If you have any questions about our comments or wish to discuss any of these matters further, please contact Mary Tokar or Joachim Kölschbach with KPMG's International Standards Group in London at +44 (0)20 7694 8871, or Darryl Briley with KPMG LLP in New York at +1 (212) 909 5680.

Yours faithfully

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Appendix 1

KPMG's Responses to Specific Questions posed by the Boards

IASB Exposure Draft (ED)

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?

We believe that the proposed measurement model represents an improvement from the exit value measurement approach proposed in the IASB's 2007 Discussion Paper *Preliminary Views on Insurance Contracts* (the IASB DP) and the FASB's related invitation to comment which incorporated the IASB DP. We also believe arriving at common requirements under IFRSs and US GAAP would benefit financial reporting significantly for insurers considering the current diversity under IFRSs in accounting practices across different types of insurance product and different jurisdictions.

We agree with a measurement approach that bases the measurement of rights and obligations under an insurance contract on the amounts that an insurer expects to receive and pay through the life of the contract rather than a model based on an "exit value" as if transferring the contract to a hypothetical market participant. This approach increases the relevance of financial statements over the "exit value" model in the IASB DP since it is aligned more closely with the business model of insurers, which includes long-term servicing of insurance contracts as opposed to contract trading for a short term gain.

With respect to the measurement model, although we agree with the principle of basing measurement on the expected cash flows, there are areas of concern that are addressed in further sections of this appendix and within the cover letter. Key areas of focus within our response related to the aspects of the measurement model that drive volatility include:

- Recording gains and losses from changes in assumptions that reflect the inherent uncertainty as to the future cash flows of insurance contracts;
- Discounting at fluctuating current discount rates directly in the statement of financial position and comprehensive income while leaving the residual or composite margin fixed at inception;
- Recording losses at inception on ultimately profitable contracts by discounting cash flows at rates below the rates inherent in pricing; and
- Discounting account balances that represent deposits at fluctuating current discount rates.

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) We agree that the measurement of an insurance contract should reflect the expected present value of the future cash outflows less the future cash inflows that are expected to arise as the insurer fulfils its obligations under the contract.

(b) We agree broadly with the principles set forth in the proposals for estimates of future cash flows. We believe that the application guidance relating to cash flows should be principles based and should not attempt to provide a formulaic approach or a “recipe” to actuarial modelling for estimates of future cash flows. However, we believe that further clarification is needed relating to specific areas in the cash flow guidance. These areas are the application guidance regarding estimates of future cash flows and cash flows included in measurement. Each area is discussed below:

Application guidance regarding estimates of future cash flows

Overall, we believe that the application guidance is at the right level of detail for a principles-based standard. However, further clarification is needed particularly with reference to the guidance contained in B38 and B39 of the ED with respect to the terminology “estimated probability” and the consideration of “all possible scenarios” in determining an estimate of cash flows. This concern is heightened with property and casualty insurers who utilise established actuarial techniques for the measurement of their insurance contracts. Estimated ultimate payments of property and casualty contracts used for reserving in many jurisdictions today are based on approaches to estimate the expected cash flows using aggregated claims data. While the goal of these methods is to determine an unbiased mean (i.e. actuarial central estimate), these methods do not calculate a mean using estimates of probabilities.

We understand that the purpose of paragraph B38 is to describe that the measurement objective is to determine a mean value of possible outcomes and that paragraph B39 indicates that the approaches used to determine the mean value can vary depending on the circumstances as long as all relevant information is considered. This concept may be articulated more clearly if the term “mean” is incorporated into paragraphs 22 (a), B38 and/or B39.

We think that it also is important to allow flexibility in applying various actuarial techniques that have evolved over time and are used commonly in the insurance industry. We suggest that the guidance in B38 and B39 be reworded in a way that does not contain a rebuttable

presumption that all modelling is stochastic and allows for other techniques which may not be based on the estimates of probabilities of all possible outcomes.

Cash flows included in measurement

We believe that further clarification also is needed regarding paragraphs B61 and B62 of the ED, in order to describe the cash flows that should be included in and excluded from measurement.

- Paragraph B61 (g) refers to policy administration and maintenance costs, such as costs of premium billing and costs of handling policy changes. The paragraph states “Such costs also include recurring commissions expected to be paid to intermediaries if a particular policyholder continues to pay the premiums specified in the insurance contract.” We believe that this reference only is appropriate when the commissions are paid to the intermediary for providing administrative and maintenance services. If these commissions are paid to the intermediary for selling the insurance contract, then those commissions instead should be considered incremental acquisition costs covered under paragraph B61 (f).
- Further description of certain costs such as maintenance costs referenced in paragraph B61 (g), which are included in the measurement of insurance contracts, and overhead costs described in paragraph B62 (f), which are not included in the measurement of insurance contracts, would aid in consistent application of the measurement model.
- Many of the costs associated with insurance contracts may be recognised as expenses and liabilities under other specific IFRSs or in accordance with the definitions in the *Conceptual Framework for Financial Reporting* prior to their payment in cash. For example, employee benefits and operating lease rentals associated with contract activities generally are recognised as expenses in accordance with IAS 19 *Employee Benefits* and IAS 17 *Leases*. The proposals do not discuss the interaction between its guidance and the recognition of expenses and liabilities for costs associated with contract activities under other IFRSs. We believe that a final standard should clarify that it does not override the guidance on liability recognition included in other standards but, to the extent that a liability and expense for costs related to contract activities have been recognised appropriately in accordance with other IFRSs, the related cash flows are no longer included in the measurement of the relevant insurance contracts. Without such a clarification, there is a risk that preparers might inadvertently “double count” the effects of these costs or fail to apply the requirements of other IFRSs.
- *Cash flows arising from participation features.* Paragraph B61 (j) requires that payments to current or future policyholders as a result of a contractual participation feature that provides policyholders with participation in the performance of a portfolio of insurance contracts or a pool of assets are included in the estimated cash flows when measuring a portfolio of any such contracts. We believe that the reference to “payments to current or future

policyholders” causes an element of confusion in determining the appropriate boundary for measurement. See additional reference in Questions 10 (a) and 10 (d).

- We agree with the proposal in paragraph 61 that an insurance contract that results in cash flows in a foreign currency be treated as a monetary item for the purposes of applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*. This is consistent with the focus of the proposed measurement model on cash flows and it is simpler to treat all components of the measurement of a contract denominated in a single currency as monetary.

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)/(b) One area of the proposed measurement model that poses a significant amount of volatility is determining discount rates that do not reflect the pricing inherent in setting the premium. We believe that this should be a key area of consideration by the Boards given its significance to the proposed insurance contract accounting model.

We agree that to the extent cash flows or a portion of the cash flows of an insurance contract depend on the performance of specific assets, the discount rate for that portion of the cash flows should reflect that dependence.

We also agree with the principle that the discount rate used for non-participating contracts should reflect the characteristics of the liability and not those of the insurer’s assets. The effect of liquidity or lack thereof also referred to “illiquidity” is a key characteristic of an insurer’s liability. This illiquidity adjustment reflects the fact the insurer has a lower burden as compared to that of other entities that have more liquid liabilities which can be withdrawn by a creditor at any point in time. We believe that this is an important characteristic of the liability and should be reflected in its measurement. However, given the practical difficulties associated with calculating illiquidity adjustments, we are concerned that the guidance on liquidity will not promote consistent application in practice and may lead to diversity in practice. This concern is furthered by the recent amendments to IFRS 9, whereby the IASB recognises that there are

operational challenges in determining liquidity risks and distinguishing them from credit risks in a fair value measurement, including those of traded instruments (IFRS 9 B5.7.12 and BC 5.62).

We are unclear as to how the adjustment for illiquidity for an insurance liability which has no market is expected to be determined in practice. We believe that further guidance is needed on how to calculate an adjustment for illiquidity and how to distinguish liquidity risk incorporated in the discount rate and any liquidity impact taken into consideration in the probability-weighted estimates of future cash flows, as well as in the calculation of the risk adjustment, to avoid “double counting” the effects of illiquidity.

One possible way to derive a rate that reflects a risk free rate plus an adjustment for the characteristics of the liability may be to look at the way an insurance product is priced when sold and subsequent pricing for identical or similar products. This does not imply a principle of using a “locked in” discount rate based on pricing assumptions at inception, but rather considering the mechanics and assumptions used in the pricing process in determining the discount rate (current risk-free interest rate plus an adjustment to reflect the characteristics of the liability) for subsequent measurement of the contract.

In order to apply this approach and retain consistency with the objective of the measurement model to determine a discount rate which is a current reflection of the characteristics of the liability, we suggest that an insurer use the most relevant pricing that an insurer has available. For example, to the extent an insurance product with similar characteristics is currently being marketed and priced by the insurer we believe that this benchmark may be the most relevant for updating the discount rate. To the extent that there is not a current pricing benchmark based on similar products, we suggest using the last pricing point that would be relevant to the product based on its characteristics and updated to reflect current market data such as changes in risk-free rates. To the extent that this model is utilised for the calculation of a discount rate that incorporates an adjustment for characteristics of the liability, we also recommend that the insurer disclose the methodology and assumptions (including those used in pricing if relevant) used in determining the discount rate.

(c) We agree with the proposals that non-performance risk should be excluded from the discount rate as we do not believe that incorporation of an insurer’s own credit risk would be consistent with the “fulfilment” measurement objective. Additionally the proposal is consistent with the results of the IASB’s outreach activities in respect of ED/2010/4 *Fair Value Option for Financial Liabilities* and the July 2009 *Report of the Financial Crisis Advisory Group* which indicate that many users believe that unrealised gains and losses attributable to changes in the credit risk of non-trading liabilities should not be included in profit or loss.

Measuring insurance contracts using a discount rate that is significantly lower than the rate implicit in setting premiums could result in recognition of losses at the inception of contracts on contracts expected to be profitable. We understand that in a number of jurisdictions, long duration insurance contracts commonly are sold at “market level” insurance premiums which reflect assumed discount rates that are typically higher than risk-free interest rates, and may be

higher than risk-free plus a liquidity adjustment, depending on how the liquidity adjustment is determined, and that these products generally are regarded as consistently profitable under existing accounting frameworks.

However, it is not clear how the proposed adjustment for illiquidity would be determined, and we believe that additional guidance would be very useful to support consistent application of the final standard. We suggest that an alternate approach to consider, consistent with basing the discount rate on the characteristics of the liability, would be to reflect the discount rate assumptions that an insurer uses to price the insurance premium for the initial measurement of the liability, with subsequent measurement reflecting updates of these assumptions in every reporting period as discussed above.

Other approaches that are emerging that the Boards ought to consider:

- Reflecting the effect of changes in some or all assumptions in other comprehensive income; and
- Permitting the use of discount rates established at the inception of the contract for the entire duration of the contract, to the extent the use of a locked-in interest rate would better reflect an insurer's business model. As detailed in the executive summary, this approach also may limit accounting mismatches that may arise from applying the mixed measurement model in IFRS 9 and resulting accounting mismatches with insurance contract liabilities measured using current discount rates. Consistent with the proposals in IFRS 9, an approach for the measurement of an insurance contract liability that uses a locked-in interest rate might consider an option for application and perhaps require a "business model test" similar to that included in IFRS 9 which restricts reclassification. Coupled with such an approach, the Boards also may want to consider whether an onerous contract test is warranted (i.e. when expected earned rates become insufficient to cover the expected unwinding of discounts) to ensure that the insurance contract liabilities are sufficient at the reporting date.

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.

We agree with including an explicit risk adjustment in the measurement of an insurance contract and believe that this is conceptually consistent with the fulfilment objective set forth in the ED and with the insurer's business model. We concur with the arguments as presented in the Basis of Conclusions paragraph 109 (a) and (b) that the risk adjustment provides useful information around the insurer's assessment of the economic burden of risk and its resulting management of that risk. However, there appears to be implementation issues that present an added element of complexity around the risk adjustment (see Q5 (a) and (b) below) and to the extent these issues

are not resolved we encourage the Boards to consider a composite margin approach for measurement.

The composite margin approach may be more practical and may enhance comparability to the extent concerns with the risk adjustment are not addressed. If the Boards were to select a composite margin approach, further consideration would need to be given to how the recognition of the composite margin in profit or loss should work under the modified approach for short-duration contracts. Under the composite margin approach as in the FASB's DP paragraph 102, the post-claims liability of short-duration contracts would be measured as equal to solely the expected present value of future probability-weighted net cash flows. Therefore, the measurement would not distinguish between less risky and more risky portfolios and also may not reflect the economic burden of risk that is borne by the insurer until claims liabilities are finally determined. Our recommendations regarding measurement of the residual margin apply equally to the composite margin.

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 broadly agree with the objective provided for the risk adjustment, however we believe that it would be helpful if the application guidance describing the objectives and characteristics of the risk adjustment could clarify how the risk averseness of the insurer should be reflected. The wording in paragraph 35 of the ED, specifically the reference to the “ultimate cash flows that *exceed* those expected” appears to take into account only the downside risk and does not take into account the compensating effect of upside risk. Risk averseness usually is considered by reference to considering all deviations from the expected value. An insurer would factor in both upside and downside in establishing a risk adjustment in a transfer (such as a portfolio transfer of contracts using reinsurance), albeit in our experience greater weight is given to the adverse deviation in the measure. There is a risk that if the objective is not worded properly, then the measurement techniques may not be applied properly.

(b) Although we agree that that all the techniques prescribed in the ED may represent appropriate measures of the risk adjustment, the proposal limits the number of techniques available for determining the risk adjustment. We believe that limiting the risk adjustment to only specified techniques does not contribute to consistency, the Boards’ objective in limiting the number of available techniques, since these methods are not calibrated to one measure. Not limiting the techniques would allow further measurement techniques to be developed and incorporated into the accounting model, with appropriate disclosure, in response to new insurance products or enhancements of techniques used for existing products.

One way to achieve further comparability and allow for further enhancements to the measurement techniques, should the Boards still prefer to limit the techniques, would be to word the guidance in a way that there is a rebuttable presumption that an insurer would use the three techniques described in the ED and if an insurer chooses a different technique then they would be required to justify and disclose the reasons why the insurer is using a method that differs from the three described in the ED. We also suggest a requirement for disclosure of the key assumptions used in any measurement technique applied and a limit on changing measurement techniques so that measurement techniques may be changed from one reporting period to another only if there is an appropriate reason.

(c) We believe that disclosure adds only a limited amount of comparability as to the measurement of the risk adjustment, especially as it does not provide any information on risks beyond the confidence level. The costs of using multiple measurement techniques in cases where the confidence level technique is not applied for measuring the risk adjustment may outweigh any benefit of limited comparability. If this disclosure is required, then it should be clear at what level diversification effects are taken into effect in calculating the confidence level since the disclosure presumably would be based on an entity rather than a single portfolio.

In addition, it would be helpful to clarify further how this disclosure would be applied to portions of portfolios of insurance contracts that are measured using a replicating portfolio approach which is based on the fair value of replicating assets. In these circumstances, would an insurer have to develop a “hypothetical” risk adjustment to equate a confidence level for the purpose of disclosure?

(d) We believe that measurement of the risk adjustment at a portfolio level of aggregation is appropriate as a starting point however we believe that further consideration should be given to the points raised below.

- The ED proposes not to reflect the effects of diversification between portfolios of contracts. Under the ED the risk adjustment shall be the maximum amount the insurer rationally would pay to be relieved of the risks. The risk adjustment reflects the insurer's view of the economic burden imposed on it by the presence of risk. Since this economic burden is determined not only by pooling effects within a portfolio but also by diversifying risks between portfolios, we believe that it would be inconsistent with the principle as expressed in paragraph 35 of the ED not to reflect those effects fully.
- Furthermore we do not believe that pooling and diversification effects should be limited in consolidated financial statements on a legal entity basis. In consolidated financial statements, diversification effects should be considered at a group level considering the effect of pooling or offsetting of risks across different constituent legal entities consistent with the objective of consolidated financial statements, namely to present the group as a single economic entity, as stated in IAS 27 *Consolidated and Separate Financial Statements*. This also would be consistent with the specific principles in other standards for dealing with risk management and the nature of an entity's business model, e.g. the principles in IAS 39 *Financial Instruments: Recognition and Measurement* do not preclude hedging risks across legal entities.

(e) We agree that the application guidance in Appendix B on risk adjustments is at the right level of detail.

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

- 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?*
- 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 the interest should be accreted on the residual margin (see paragraph 51 and BC 131-BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?***

(a) Yes, we agree that the standard should not permit a gain at inception consistent with a fulfilment value notion under which revenue is recognised as the insurer fulfils its obligations under the contract.

(b) Yes, we agree that the residual or composite margin should not be less than zero, so that any loss at initial recognition of an insurance contract would be recognised immediately in profit or loss.

(c) We agree, however, we would expand the proposal. We agree that an insurer should be able to measure the residual/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 (also referred to as the “cohort” level). We agree the use of portfolios and cohorts is a practicable approach to measurement. However, we do not believe that that an insurer should be precluded from calculating or allocating the residual/composite margin on an individual contract level if it is able to do so. It might also be more straightforward to allow for the impact of lapses in the recognition of the residual or composite margin, as required by paragraph 35 of the ED, if the residual or composite margin is allocated to a contract level.

(d) We would prefer a more principle based approach which would permit an insurer to select the approach that it considers best reflects its exposure to risk and the other services it provides. One possible approach would be to make it a rebuttable presumption that the margin is released on the basis of passage of time unless there is evidence that some other method better represents the release from risk and the provision of services.

We recognise that full conceptual alignment with other related standards (e.g. revenue recognition, provisions, or financial instruments) may not be achievable fully as the proposed

model is one designed for insurance contracts. However, we believe that consistency with the proposals for revenue recognition should be retained through the treatment of the residual or composite margin as the residual and composite margin have a fundamental basis consistent with the principles proposed in the revenue recognition exposure draft.

In order to achieve this we recommend an approach that would adjust the residual or composite margin for some changes in estimates of future cash flows rather than the effect of those changes being recognised immediately in profit or loss.

Remeasuring the residual or composite margin for changes in estimates

One of the key arguments for recognising a residual or composite margin to eliminate day one gains under a fulfilment approach is that the insurer has not fulfilled any performance obligations at the inception of a contract. This approach is consistent with the proposals in the revenue recognition exposure draft.

Remeasuring the residual or composite margin for changes in the risk adjustment (residual margin only) and in assumptions about future cash flows that are not observable in financial markets would also be conceptually consistent with the proposals for revenue recognition under which changes in such estimates would affect revenue or costs immediately only to the extent that they relate to performance obligations that have already been fulfilled or contracts that are onerous.

Another key argument for not recognising any gain at the inception of an insurance contract is the inherent uncertainty in the estimates used to measure the present value of the fulfilment cash flows. Remeasurement of the residual or composite margin for specified changes in estimates reflects its status as an uncertain measure of future profit that cannot be recognised immediately in profit or loss. We believe that the residual or composite margin should only be adjusted for changes in the risk adjustment (residual margin only) and in assumptions about future cash flows that are not observable in financial markets because it is the inherent uncertainty in these assumptions that would prevent any day one gain being recognised.

We believe that the impact of any adjustment to estimates for actual experience in the current reporting period and any changes to observable financial variables should be recognised immediately in the statement of comprehensive income.

Other arguments for supporting this remeasurement approach include:

- Due to the inherent uncertainty in the estimates used to measure the present value of the fulfilment cash flows and the resulting residual or composite margin at inception, recognising changes in assumptions regarding the cash flows in the residual or composite margin provides a more reliable current measure of the contract.

- An approach that remeasures the residual or composite margin for changes in estimates used to measure the present value of fulfilment cash flows would be consistent with the measurement used to determine the residual or composite margin at the inception of the contract. If the assumptions have changed since the inception of the contract, then the amount of margin that the insurer recognises throughout the life of the contract also should be adjusted to reflect a current estimate of the remaining profit in the contract.
- It is counterintuitive to some users that an insurer could recognise a loss in subsequent periods for an adverse change in assumptions when the contract may be profitable as a whole and the embedded profits in the residual margin are released over the coverage period or the composite margin released over the coverage and benefit-paying period (which can extend for a number of years for some contracts) or could recognise a gain shortly after inception from favourable changes in assumptions that would be precluded from recognition at inception.

As indicated above, the nature of the measurement model and proposals would introduce a significant amount of volatility in the statement of comprehensive income. Some of this volatility would result from mixing of the effects of current conditions that ideally should be reflected in current profit or loss and the effects of future events and changes in conditions that generally should be reflected in future profits but which the proposals treat as an adjustment to current profits. Adjusting the residual or composite margin for changes in estimates about future events and conditions would reduce volatility that does not represent optimally the long-term nature of an insurer's business. We believe adjustments for actual experience in the current reporting period and observable financial variables should be recognised in the statement of comprehensive income.

In addition, if the residual or composite margin is remeasured then the Boards may consider a "retrospective" approach to adjusting the residual or composite margin similar to that in US GAAP under FASB ASC Topic 944 *Financial Services - Insurance* based on FAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long Duration Contracts* (i.e. the residual margin would be "trued up" each period for changes and the related amortisation of the residual margin would be recalibrated resulting in adjustments in the current period for changes in amortisation recognised in previous periods). This retrospective approach also is consistent with the amortisation of the composite margin in the FASB's discussion paper. However, if the Boards are concerned with the complexity of this recognition approach then, a prospective approach to amortisation would simplify the model by changing future amortisation for the effects of changes in estimates. This approach would also moderate volatility arising from changes in assumptions and would be consistent with the treatment of changes in estimates that affect both current and future periods in IAS 8.

Additional comments on a composite margin approach

(e) We believe that a principle, consistently applied, to amortise the composite margin over a reasonable period in a rational manner that considers the exposure to risk and services rendered in paying benefits, would be an improvement over the formulaic approach in the proposals.

We believe that the composite margin amortisation method may generate unusual results that are not reflective of the coverage or services being provided for some types of products, particularly those products that have a cash payment at the end of the contract term if no losses have been reported under the contract. Take for example a ten-year term life insurance contract under which there is a survival benefit paid to the policyholder equal to a significant percentage of the premiums if the policyholder keeps the contract in-force for the entire term. In this case the formula in the FASB's discussion paper, which is an update of the formula in the ED, would allocate premiums over the ten-year period and reflect benefits over the life of the portfolio with a significant amount of the benefits being paid in cash survival benefits at the end of the ten-year term. This portfolio would have a large portion of the composite margin recognised in profit or loss only at the end of the portfolio's term.

It may be difficult to provide a formula that gives rational results for all of the wide variety of insurance contracts that exist. We believe that the Board should develop a principle, consistently applied, to amortise the composite margin over a reasonable period in a rational manner that considers the exposure to risk and services rendered in paying benefits. Such a principle would allow for selection of amortisation approaches that best reflect the exposure to risk and services provided in the product whether based on: 1) passage of time; 2) pattern of expected claims; or 3) services provided. The amortisation period estimated at inception and re-evaluated each reporting period should consider changes in estimates such as lapses of contracts consistent with the amortisation of residual margins in the ED.

In some contracts, such as term life, the coverage period represents virtually the entire period for which services are provided. In other contracts, such as workers compensation insurance, there are services provided well beyond the coverage period. Rational allocations may include, but not be limited to:

- straight-line over the coverage period in which the benefit payment period extends only for a relatively short period after the coverage period (e.g. term life);
- in proportion to coverage provided and services rendered (e.g. universal life insurance contracts under which the account balance is not unbundled or deferred annuities); or
- a combined coverage period and benefit payment period model as described in the proposals.

To the extent that the formula approach discussed by the Boards is retained, the formula in the FASB Discussion Paper should be used as the formula in the ED would not amortise all of the

composite margin over the life of the contract, as changes in estimates would cause the sum of all percentages of composite margin recognized to not add up to 100%.

(f) No, we do not believe that interest should be accreted on either a residual or composite margin. Although we understand the conceptual basis for accreting interest, as outlined in the Basis of Conclusions, we believe that accreting interest adds unnecessary complexity for little added benefit.

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

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?

Yes, we agree with the proposals that initial measurement of the insurance contract includes incremental acquisition costs and that all other acquisition costs are expensed as incurred. We believe this treatment is consistent with how cash flows are treated in the measurement approach and with an insurance contract's pricing which is generally set to recover these costs through future premiums and surrender charges.

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) We believe that the Boards should permit but not require the use of a modified approach for short-duration contracts. As stated in the Basis for Conclusions paragraph 147 of the ED, requiring an insurer to use a measurement method which is intended to be a simplification is inconsistent with the rationale for the approach. Some insurers write contracts that may be subject to the modified approach and write contracts that do not meet the criteria prescribed, such as insurers that write life and non-life contracts or property and casualty insurers with many longer duration contracts. These insurers may incur a significant amount of costs to incorporate a separate measurement approach which has relevance only to contracts written with coverage periods of a year or less. Allowing rather than requiring this approach may improve comparability within the financial statements of insurers who write multiple lines of business.

Additionally, the proposals under the modified approach require clarification for the following reasons:

- This approach seems to imply that an insurer has to calculate the present value of fulfilment cash flows (including risk adjustments) at each reporting date to ensure that a contract is not onerous; we believe that such a requirement would make the modified measurement approach overly burdensome. We suggest that a calculation of the present value of fulfilment cash flows should be required only if there are indicators that a portfolio of contracts is onerous. The level of detail required by the onerous contract test should consider how close a portfolio is to being considered onerous. Portfolios with a large margin of profitability could use less detail in confirming that the portfolio is not onerous.
- Under the modified approach, there is a requirement to discount future premiums and to accrete interest on the pre-claims liability. We believe that there should not be a requirement for the accretion of interest in the pre-claims period consistent with our response in 6 (f). To remove some of the added complexities, we suggest removing the requirement for discounting the present value of premiums in the pre-claims period and similarly removing the requirement to accrete interest on the pre-claims liability. It is presumed for contracts with a short-duration of coverage of one year or less that the impact of discounting on any pre-claims liability will not have a significant enough impact to justify the added complexity. Indeed it is this presumption that in part supports having a simpler approach for short-duration contracts.

(b) We believe that there should be a broader definition of “short-duration” contracts similar to the current definition in US GAAP (ASC Topic 944) which does not draw such a bright line at the 12 months criterion introduced in the proposals, which appears to result in some unintended consequences. Under ASC 944-20-05-12 to 13, a short-duration contract is a contract that provides insurance protection for a fixed period of short-duration and enables the insurer to cancel the contract or to adjust the terms of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided. Including a definition that does not have a bright line in determining what is defined as “short-duration” may resolve some of the concerns that we, have observed about certain types of insurance and reinsurance contracts in applying the Boards proposed approach:

- For some contracts with premiums or coverage that are variable or indeterminable (e.g. reinsurance, transport or credit insurance for which a premium rate for each unit of coverage over a period is specified but the volume of coverage may vary), it may not be practicable to apply the current definition.

- The 12-month criterion as stated in the proposals may limit or preclude some types of reinsurance contracts that are written on an underwriting-year basis. For example, many proportional reinsurance contracts have coverage periods that are based on an underwriting year and include all contracts written during that 12-month period. As the underlying direct contracts written each have a 12-month coverage period, the reinsurance contract's coverage period would be up to 24 months. Under the bright-line guidance in the proposals these reinsurance contracts would not appear to be in scope of the modified approach resulting in an inconsistent measurement approach from the cedant's perspective between the direct insurance contracts that are reinsured and the reinsurance contract. On 25 October, the IASB presented a web cast on reinsurance aspects of the ED. The webcast indicates that this type of reinsurance contract would be in the scope of the modified measurement approach. We support such an outcome, but do not understand how it is consistent with the wording in the ED.

In addition, we believe that further clarification may be needed in the proposals on applying the modified measurement approach with regard to the following areas:

- Although we support the use of the modified measurement approach for reinsurance contracts consistent with the reasons outlined in the Basis of Conclusions paragraphs 231 and 233, paragraphs 43 and 44 of the ED are not clear with respect to the applicability of the modified measurement model to reinsurance ceded as the reference in paragraph 43 only refers to the general measurement approach starting at paragraph 17. We believe that clarification is needed in final standard that both the general measurement approach and the modified approach are allowable for reinsurance.
- To ensure consistency with the general measurement model, we believe that paragraph 57 (a) of the ED should be revised to be explicit that future incremental acquisition costs are included in the measurement of the expected present value of the future premiums in the pre-claims obligation/liability.
- The onerous contract test described in paragraph 60 of the ED states that the insurance contract is onerous if, at initial recognition or subsequently, the present value of the fulfilment cash flows relating to future insured claims that are within the boundary of an existing contract exceeds the carrying amount of the pre-claims obligation. The reference to the present value of fulfilment cash flows for future "insured claims" may imply that the onerous test does not include any other incremental costs that would be included under the general measurement model, such as maintenance and administration costs. We believe that such exclusions would be inappropriate and inconsistent. In any event, it would be helpful to clarify if this is the intent of the guidance in carrying out the onerous contract test.

- There appears to be a conflict in the standard between recognising the pre-claims obligation based on the discount rate at inception in paragraph 56 and 57 and accruing interest on the pre-claims liability at an “updated” discount rate in paragraph 59. This point is complicated further by the fact that the expected present value of future premiums also would seem to be updated each period using a current discount rate.

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?

Yes, we agree with the proposed boundary principle as it reasonably reflects the extent of the insurer’s obligation to extend coverage on specified or potentially unfavourable terms and believe it is an improvement from the approach proposed in the 2007 IASB DP which included separate onerous and guaranteed insurability tests. We believe the contract boundary principle can be consistently applied for both single and multiple premium contracts as it provides a clear principle that can be applied based on the terms of the existing contract and relevant laws. However, we believe the Boards should undertake field testing with insurers, especially those that may be most impacted by the proposals, such as health insurers, to identify any unintended consequences.

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) Yes, we agree that the measurement of insurance contracts should include participating benefits on an expected present value basis as this is consistent with the general measurement

model. However, we believe the measurement guidance should be amended as discussed in (d) below.

(b) We believe that financial instruments with discretionary participation features, as defined in the proposals, are most appropriately accounted for within the scope of a final standard on insurance contracts as the guidance on accounting for financial instruments does not address such discretionary features (see (c) below). The expected cash flow measurement model should provide a reasonable and robust framework for the measurement of such instruments. The additional benefits related to financial instruments with discretionary participation features are by definition connected to and interdependent with participating benefits of insurance contracts issued by the entity. Therefore using the same measurement model for these financial instruments and the participating insurance contracts promotes consistency and reduces the scope for mismatches to arise between the measurements of the similar participating features of each of the two types of contracts, as well as with the measurement of any insurance contracts within the underlying pool. The promotion of consistency is further buttressed by having the ED, unlike IAS 32 *Financial Instruments: Presentation* or other standards on financial instruments, contain specific guidance as to the classification and measurement of instruments with discretionary participation features which considers their unique features.

(c) We agree in principle that financial instruments that are not insurance contracts and which do not participate with insurance contracts in the results of specific assets or the entity should be scoped into the IFRSs on financial instruments. However, as noted above, IAS 32 does not provide specific guidance as to the classification and measurement of discretionary participation features and the application of the financial instrument standards may give rise to practical difficulties and diversity in practice, including:

- a. whether typical DPFs are classified separately as equity or liability from the obligation to provide guaranteed benefits;
- b. the treatment of benefits based on regulatory, statutory or constructive obligations; and
- c. the treatment of benefits that the entity may be obliged to pay to either current or future instrument holders and not necessarily only to current holders. This will be more complex if such payments may be deferred for an extended period and the future instruments do not yet exist. Also see response to (d) below.

Therefore, we think that the goal of high-quality financial reporting would not be advanced by removing these instruments from the insurance standard and into the financial instruments standards without providing answers to these questions.

(d) Except as discussed below, we agree that the measurement guidance included in paragraphs 64 and 65 of the ED is useful. However, we do not find the proposed guidance included with respect to the contract boundary in paragraph 64 and with respect to “which cash flows” in

paragraph B61 (j) to be sufficiently clear or consistent. Paragraph 64 defines the contract boundary for a financial instrument with a DPF as “the point at which *the* contract holder no longer has a contractual right to receive benefits arising from the discretionary participation feature in that contract.” However, as mentioned in (c) above, practical difficulties may arise with the measurement of DPFs since discretionary benefits may be paid to future contract holders, rather than to the current contract holders and perhaps after current contracts have been extinguished. Paragraph B61 (j) appears to seek to resolve these difficulties by indicating that the expected cash flows to be included in measuring the contract should include “payments to current and future policyholders as a result of a contractual participation feature.”

We believe that there are two difficulties with this approach. Firstly, the guidance in paragraph B61 (j) does not appear to be consistent with that in paragraph 64. However, as paragraph B61 (j) deals with “which cash flows”, it is not entirely clear that paragraph 64 is intended to override or limit it with respect to financial instruments with a DPF. Given the significant impact of B61 (j), we think that the guidance in paragraph 64 (i.e. in the main body of the standard) should be modified to deal explicitly and appropriately with the conflict. Secondly, we think that the guidance is not worded appropriately. Paragraph B61 (j) appears to require all expected payments to future policyholders to be included in the measurement of current policyholder liabilities. If paragraph B61 (j) is considered limited by paragraph 64, then it would include payments to future policyholders up until the time that the DPF in respect of current policyholders was extinguished. There seems little merit to restricting the expected cash flows on this basis since cash flows arising after the expiry of existing policies may relate to the distribution of surpluses arising from investment performance at the reporting date and which the issuer is obliged to distribute eventually to either current or future policyholders. For example, an insurer may be under an obligation to distribute to participating policyholders 90% of the surpluses arising in a fund, although it may not be constrained as to when such surpluses are distributed. Excluding cash flows related to that obligation may result in an understatement of liabilities and a potential mismatch with the recognition of gains and losses on the pool of investments or policies in which the DPF participates.

Accordingly we believe that the guidance should be modified to state that the measurement of a DPF should include all expected cash flows related to an obligation to distribute surpluses to policyholders (current or future) that are reflected in the measurement of the underlying pool of investments or contracts in which the DPF participates.

Furthermore, we note that the problems noted above with respect to paragraph B61 (j) apply to insurance contracts with DPFs as well as to financial instruments with DPFs and that the measurement guidance with respect to both should be changed in accordance with the above suggestion.

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 provided in the proposals; however we have identified some unintended consequences in the additional criteria proposed in paragraph BC191 of the ED.

It appears that the test described in BC191 (c) would not, in practice, change the determination of whether a contract transfers significant insurance risk for an insurance contract other than a reinsurance contract, as compared to the existing IFRS 4. In normal circumstances, such contracts provide for the possibility of insured benefits that significantly exceed premiums paid, and this determination is made on a contract-by-contract basis. Even when a class of policies is fundamentally very profitable, individual policies may prove to be unprofitable.

However, the proposed test described in BC191 (c) could affect the treatment of some reinsurance contracts. Some reinsurance contracts reinsure defined groups of contracts in aggregate, for example “quota share” reinsurance, under which the reinsurer assumes a stated percentage of premiums and claims on a defined group of contracts from the insurer. The individual contracts could each qualify as insurance contracts, but when combined as a group of contracts and reinsured, it is often difficult or impossible to demonstrate a significant possibility of a loss on the group of contracts in aggregate, even though the underlying contracts reinsured are all properly considered to be insurance contracts. US GAAP (Codification paragraph 944-20-15-53 in *Financial Services Insurance*) provides that when the insurance risk transferred is not significant, but substantially all of the insurance risk that relates to the reinsured portions of the underlying insurance contracts is transferred to the reinsurer, the arrangement would be accounted for as an insurance contract. This is a significant aspect of practice under US GAAP, and since the proposals do not include a corresponding proposal, perhaps unintentionally, some reinsurance agreements would likely no longer fit within the definition of an insurance contract in the proposals. This appears to contradict the Board’s stated expectation that the addition of the test described in BC 191 (c) would not lead to a change from IFRS 4 in practice.

For the reasons expressed above and the resulting risk of inconsistent application, we believe it may be more practical to eliminate the proposed criteria and leave the guidance on the definition consistent with IFRS 4.

We believe the definition of an insurance contract and the related guidance in Appendix B of IFRS 4 provides reliable and consistent framework for defining an insurance contract. As a result of the significant transition process that entities went through on transition to IFRS 4 and the similarities of the definition between IFRS 4 and US GAAP, we believe that applying the

proposed guidance in BC191 to an existing definition may be costly and time consuming without providing improvement to the existing guidance.

If the Board believes that the additional criteria should remain, then it would be helpful to expand on the rationale for this decision in the Basis of Conclusions.

Scope overlap with IFRS 9

We believe that there are some common instruments where it is not clear from the proposals whether it is the Boards' intention that the instruments should be considered within the scope of the financial instruments standards or within that of the new insurance contracts standard or, given the lack of clarity regarding the proposed guidance on unbundling (see our response to Question 12), partly within the scope of one and partly within the scope of the other.

Based on the proposed definition and scope guidance, it would appear that a contract that transfers significant insurance risk is an insurance contract within the scope of the proposals. Additionally, unless the "closely related" criterion in paragraph 8 of the ED is satisfied, it appears that no component of the contract would be accounted for separately. It appears that this analysis might apply equally to many contracts that have conventionally been thought of as being financial instruments or as including financial instrument components, for example, a loan contract that waives repayment if the borrower dies.

Based on the above, in the case of some common instruments, it may be unclear whether the instrument should be accounted for as:

- a financial instrument in its entirety;
- as an insurance contract in its entirety; or
- as an insurance contract (being the financial guarantee contract) together with an unbundled financial instrument.

We describe below some specific instances in which there may be uncertainty and a risk of diversity in practice based on the proposals.

Non-recourse loans

We understand that some constituents believe that, under IFRS 4, some debt instruments for which recourse in the event of default is limited to specific non-financial assets of the debtor (e.g. a non-recourse mortgage loan secured against a particular residential or commercial property) are or contain insurance contracts. This belief is based on the notion that the debtor, as owner of the collateral, is exposed to adverse changes in the value of the collateral (a non-financial variable) but that the non-recourse feature in the loan serves to transfer some or all of

that risk from the debtor (supposedly as holder of an insurance contract) to the creditor (supposedly as issuer of an insurance contract).

We believe that a non-recourse feature that limits the remedies of a creditor in the event of the debtor's default or relates to a debtor's ability to settle a loan by choosing to surrender the collateral is not an insurance contract, even if the debtor has a pre-existing exposure in relation to the value of the collateral (e.g. the collateral was not purchased using the proceeds of the loan).

The proposals do not include guidance that addresses this question. We believe that most entities that hold non-recourse assets have presented these assets as financial instruments and accounted for them in accordance with the requirements of IAS 39. Historically, given the absence of prescriptive guidance in IFRS 4 as to the accounting for insurance contracts, we believe this question has not given rise to any significant diversity in practice as to measurement of non-recourse assets. However, given the more detailed prescriptive guidance on the measurement of insurance policies in the ED together with the specific references to non-recourse financial assets in IFRS 9 and other potential impacts of the IAS 39 replacement project, we believe that the Board should provide an explicit answer to this question so as to forestall any significant diversity arising in the future.

Collateralised debt obligations (CDOs) and similar asset-backed securities

As the Board is aware, entities usually do not separate an embedded credit derivative from an investment in a non-synthetic CDO accounted for under IAS 39 (see *Q&As on accounting for some collateralised debt obligations (CDOs) – prepared by the staff of the IASB* published in February 2009). In reaching this conclusion, many constituents believe that such an instrument may include an embedded financial guarantee contract rather than an embedded credit derivative (see *Clarification of accounting for investments in collateralised debt obligations (Agenda Paper 6E)* presented to the IASB in December 2008). Although IFRS 9 contains specific guidance on accounting for contractually-linked instruments recognised as financial assets within the scope of that standard, the ED would appear to leave untouched the notion that a CDO or similar security, whether held as an asset or issued as a liability, may contain a financial guarantee contract. Since the ED proposes to scope all financial guarantee contracts meeting the definition of an insurance contract out of IFRS 9 and into the new insurance contracts standard, and given the absence of clear guidance as to unbundling in the ED, it might in future be considered that a CDO or similar security should in its entirety be accounted for as an insurance contract.

Policy loans

Many life insurance entities issue policy loans. A policy loan is a loan made by an insurance entity (typically life insurers) to a policyholder and is collateralised by the cash surrender value of the underlying insurance policy. Policy loans in many cases are limited to a percentage of the cash surrender value of the life insurance policy and can be used in some cases as a funding

source for the current premiums due for the policy. Similar to other types of financial instruments, these loans can have a fixed or variable rate of interest stated within the policy. Many policy loans are outstanding until surrender or death typically without a stated maturity. If the borrower fails to repay the loan, then the repayment is deducted from the insurance policy's death/surrender benefit.

The proposals do not have any guidance that would help determine if the policy loan is meant to be included in the measurement of the insurance contracts. Based on the structure of these products, there is an argument that the cash value of the policy is "closely related" to the loan because of the collateralisation and funding options that may result in the insurance policy and the policy loan being inter-linked (i.e. funding of premiums, principal repayments etc). As a result these cash flows could be considered as cash flows stemming from the underlying insurance contract and included in the measurement as part of the cash flows of the insurance contract (i.e. not unbundled). An alternative view is that policy loans by their nature are financial instruments and would be out of the scope of the proposals. We believe that the Boards should provide some clarity in either B61 or B62 in the ED as to their intentions on the standard to use in accounting for policy loans.

(b) We agree with the majority of scope exclusions provided in paragraph 4, however we think that further clarification is needed around the scope exclusion in paragraph 4 (e) that discusses fixed-fee service contracts. Currently, the exclusion refers to fixed-fee service contracts that have as their primary purpose providing services, but expose the service provider to risk because the level of service depends on an uncertain event. Such contracts meet the definition of an insurance contract if the uncertain event would cause significant additional payments by the *insurer*. However, they would be outside the scope of the proposals if the primary purpose of the contract is to provide services. The proposals are not very clear to how a service provider (or insurer) would determine whether the primary purpose of a contract was insurance or the provision of services, particularly as some would consider the provision of insurance to be a service. For example, for certain types of contracts such as those that provide for automobile break down services that may have been treated as insurance contracts in some jurisdictions, it is not entirely clear if the primary purpose is insurance or the provision of other services.

We believe that the Boards should clarify that 4 (e) means there is an exemption based on whether an entity's business model leads it to perceive itself as a provider of non-insurance services or as a provider of insurance. We believe that entities that have an insurance "business model" and that have applied insurance accounting under IFRS 4 in the past should continue to be in the scope of the insurance standard. By contrast, entities that primarily are providers of the underlying services rather than providers of insurance, and who have accounted for such contracts as services, in accordance with relevant revenue recognition standards and policies, would be scoped out of the insurance standard. We believe that this rationale is consistent with the conclusion set forth in the Basis of Conclusions paragraph 209 of the ED.

(c) Although we agree that entities should have the ability to account for a financial guarantee contract (FGC) as an insurance contract under the new insurance contracts standard, we do not

believe that this should be mandatory. Rather we recommend that entities should have an accounting policy choice whether to account for different types of financial guarantee contracts as insurance contracts or as financial instruments depending on the nature of the contract and the entity's business model for managing such contracts.

We do not believe that the "one size fits all" approach proposed would provide the most useful information for users of financial statements. Our concerns are partly conceptual and partly practical.

Conceptually, FGCs have the attributes of both insurance contracts and pure financial instruments. The proposals make the case for insurance classification by emphasising that FGCs involve the transfer of risk from holder to issuer and that payment under a FGC is conditional on a specified debtor's failure to make payment when due under a debt instrument. This loss event may be characterised as a non-financial variable. Conversely, it may be argued that as the risk transferred from issuer to holder is credit risk, an FGC in essence relates to a financial variable. For many debt instruments, credit risk is the predominant risk. Credit risk is defined in IFRS 7 as "the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation." A failure to make payment when due is an example of failing to discharge an obligation.

Practically, many FGCs are issued by banks or similar credit institutions and not by entities whose principal business is issuing insurance contracts. Banks usually manage their credit exposures in relation to guarantees using the same framework and methodologies as they apply to their credit exposures on other financial instruments. Guaranteeing a loan provided to another party provides a similar risk and reward profile to making the loan. These methodologies usually are different from the actuarial techniques employed for insurance contracts. Some FGCs are issued by other corporate entities, often to related parties. These entities are unlikely to have relevant actuarial expertise. Also, these entities are unlikely to issue FGCs in sufficient numbers to constitute the type of sizeable portfolios for which the "risk adjustment" measurements proposed are most meaningful.

FGCs may relate to different underlying payment obligations and different types of guarantees may have different roles in an entity's business model. Although the ED in the main proposes accounting guidance only for issuers of insurance contracts and not for holders of insurance contracts, proposed changes as to the definition of an insurance contract and to the scope of IAS 39 in effect impact both the holder and the issuer. These different types and uses and the interaction of the issuer / holder accounting requirements create a recipe for potential accounting mismatches that the ED would worsen. For example, a bank may issue FGCs over loans or receivables originated by its customers and purchase FGCs over some of the loans it has itself originated and holds. All these activities may be managed together through a single credit risk management system with all the bank's own loans being measured at amortised cost. If all these FGCs were scoped into the insurance standard, then the issued guarantees would be accounted for on a different basis than the loans. By contrast, a bank may have a derivatives trading operation which purchases a guarantee that reimburses the bank in the case of a failure

of a particular counterparty to pay when due the amount it owes the bank in respect of a derivative transaction. If such a guarantee were considered an insurance contract and not a financial instrument, then the bank would be precluded from measuring the guarantee at fair value through profit or loss under IFRS 9 – even though the effect of the credit risk that is the subject of the guarantee would be included in the fair value measurement of the underlying derivative that is recognised in profit or loss under IFRS 9.

Based on the above, we believe that the proposals should allow entities an accounting policy choice whether to account for different types of financial guarantee contracts as insurance contracts or as financial instruments depending on the nature of the contract and the entity's business model for managing such contracts. This would enable entities to elect the accounting approach most appropriate to their particular facts and circumstances, thus reflecting their risk management practices and minimising potential accounting mismatches.

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?

We believe that it is appropriate to unbundle certain components of an insurance contract for investment or service components within an insurance contract that are not “closely related” to the insurance coverage given the difference in the proposed measurement model for insurance and the actual and proposed measurement requirements under IFRS 9 *Financial Instruments* and the exposure draft on revenue recognition. However, we do believe that clarifying the “closely related” principle and enhancing the application guidance is needed for consistent application.

Additionally, providing an option for unbundling elements of the contract, such as account balances that reflects a deposit. Unbundling would result in more relevant financial reporting because it eliminates or significantly reduces a measurement or recognition inconsistency (often referred to as an accounting mismatch) that otherwise would result from measuring assets and liabilities on different bases. This option may be used for example to unbundle an account balance in an insurance contract when the underlying assets supporting that account balance are accounted for at amortised cost under the guidance for financial instruments.

The “closely related” principle is a reasonable principle. However we believe that the principle is missing the supporting explanation and guidance required to allow preparers to understand how to apply it and the lack of further guidance may result in inconsistent application. We believe that this concern is relevant to products with investment features or account balances as the current example provided is very rules based and somewhat inconsistent with “closely related” principle.

Paragraph 8 of the ED purports to provide the “most common” examples of components that are *not* closely related to the insurance coverage and therefore would result in unbundling. Based

on the broad principle that is proposed, we believe that these examples may be interpreted as guidance rather than examples. Specifically, example 8 (a) which references policyholder account balances may lead to some confusion in practice. The example in 8 (a) of a component that is not closely related to the insurance coverage reads “an investment component reflecting an account balance that is credited with an explicit return at a rate based on the investment performance of a pool of underlying investments. The rate should pass on all investment performance but may be subject to a minimum guarantee.”

In many cases universal life contracts and participating contracts have an explicit account balance and explicit credited interest. Following the example set forth in the ED regarding account balances, it does not appear the unbundling requirement would be fulfilled in many of these contracts since there is no obligation to forward the entire investment return to policyholders. It is not entirely clear if these arrangements, which do not meet the full form of the example, still would be required to be unbundled subject to the closely related principle; as discussed above we would allow an option to unbundle these account balances in certain circumstances.

In addition, a significant degree of judgment may be needed to determine which components of a contract are not ‘closely related’ to the insurance coverage specified in the contract. Non-life products in particular include service components that can be marketed separately that may or may not be closely related to the insurance component. There does not appear to be clarification within the guidance that would allow for consistent application of the unbundling principle.

We recognise that the intention is that the proposed standard should be principle-based and would suggest refining the principle on unbundling so it could be applied more broadly and consistently. However given the complexity of the issues that arise with unbundling, we believe that further application guidance consistent with current IFRSs would be extremely helpful for practical application (specific comments on the guidance on embedded derivatives is described at the end of this section).

Specifically, the following enhancements to the current guidance contained in paragraph 8 are suggested:

- Providing more examples both of situations for which unbundling is appropriate and for which it is not appropriate would help in consistent application. We suggest that these examples address situations in difficult but mainstream grey areas such as universal life contracts.

- It is not clear from the proposals if the intention of unbundling the account balance in a unit-linked insurance contract is to achieve comparable accounting for the unbundled component (and any unbundled investment service component) with the accounting for a unit-linked contract that does not transfer significant insurance risk. Paragraph 9 of the ED states that all charges and fees assessed against an unbundled account balance should be regarded as belonging to the insurance component or another component. Presumably the same principle would apply to any incremental acquisition costs incurred on the issue of the unbundled contract? If not, then how would acquisition costs be allocated among the different components of the contract?
- It also is not clear from the proposals if an insurer would unbundle the investment service element of a unit-linked insurance contract and account for it under IAS 18 *Revenue* (or the proposed new revenue recognition standard) or leave it bundled with the insurance component. If unbundling is required, then it would be helpful if guidance was provided on how any incremental acquisition and policy administration costs should be allocated between the insurance component and the unbundled investment services component.
- See our suggestions for clarification in *Scope overlap with IFRS 9* in our response to Question 11 above.

Based on the difference in insurance products by jurisdiction coupled with the different practices that exist under local GAAPs, which may influence application of the unbundling principle, we encourage further consultation with constituents on the proposed principle and level of guidance provided with an emphasis on the impact of the proposals to different types of insurance products. Further, providing an option to unbundle components to avoid an accounting mismatch, as described above, would provide the flexibility to allow for a rather narrow requirement to unbundle components (e.g. embedded derivatives that are required to be unbundled under existing guidance and services that have been combined in an insurance contract for reasons that lack commercial substance (paragraph 8 (b) and (c) of the ED).

Embedded derivatives

We do not support the proposed changes to the guidance on embedded derivatives included in the ED. Also, we believe that other changes to the guidance on embedded derivatives should be considered in order to ensure consistency with the measurement model proposed in the ED.

Firstly, we do not believe that the Implementation Guidance and Examples from IFRS 4 that deals with the application of the embedded derivative requirements from IFRS 9 (previously IAS 39) should be deleted. This guidance has been and continues to be helpful in the practical application of the principles and we believe that it should be updated and carried forward. Removing the implementation guidance is likely to detract from consistency in application, as well as potentially cause confusion. The application of the requirements from IFRS 9 is technically challenging. Removing the implementation guidance needlessly increases the costs

associated with application as insurers would have to perform analyses of typical features from scratch as opposed to consulting the implementation guidance.

Secondly, we do not support removing the exception in IFRS 4.8 that precludes separation as an embedded derivative of an option to surrender an insurance contract for a fixed amount. Again, this is likely to cause confusion. The ED states that the Board does not believe that this would be a substantive change because IFRS 9 B4.3.8 (h)/ IAS 39.AG33 (h) still would preclude separation as the value of a surrender option is interdependent with the value of the host insurance contract. However, this analysis does not consider the tension with the guidance in IFRS 9 B4.3.5 (e)/ IAS 39.AG30 (g) that a call or put option is not closely related unless the exercise price is approximately equal on each date to the carrying amount of the host insurance contract. A put option is a type of surrender option and IFRS 4.8 serves to resolve this contradiction by overriding B4.3.5 (e)/AG30 (g) when the surrender option's price is fixed. Removing IFRS 4.8 merely makes the matter less clear.

Thirdly, we do not believe that the Boards have considered adequately whether the existing guidance in IAS 39 remains meaningful in the context of the proposed measurement model. For example:

- The application of IFRS 9 B4.3.5 (e)/IAS 39.AG 30 (g) is dependent on the determination of the “carrying amount” of an individual insurance contract throughout the life of the option. It is unclear how this would be operationalised given that the ED does not assign a carrying amount to individual contracts, but only to portfolios or, on inception, cohorts within a portfolio.
- The guidance in IFRS 9 B4.3.8 (d) /IAS 39.AG 33 (d) states that equity-indexed interest or principal payments embedded in a host insurance contract by which the amount of interest or principal is indexed to the value of the equity instruments are not closely related to the host instrument because the risks inherent in the host and embedded derivatives are dissimilar. Given the Boards' views on interdependence and paragraph B4.3.8 (h) /AG 33 (h), it is unclear to what extent it intends the guidance in B4.3.8 (d) /AG33 (d) to remain applicable.
- IFRS 9 B4.3.8(d)/IAS 39.AG33(d) implies that an insurance contract with premiums denominated in a foreign currency may require separation of an embedded foreign currency derivative. However, the ED proposes that insurance contracts be treated as monetary items for which foreign currency translation risk would be recognised through profit or loss in accordance with IAS 21. Given this approach, the logic in IFRS 9 B4.3.8 (c)/ IAS 39.AG33(c) rightly suggests that separation therefore should no longer be necessary.

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 you 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) We believe that further consultation is needed on the presentation of the statement of comprehensive income and whether the summarised margin approach will provide relevant information for users. Although the summarised margin approach may be conceptually aligned with the proposed measurement model, we encourage the Boards to undertake outreach and consultation activities with users of financial statements to determine whether they believe that it provides them with the most relevant and decision-useful information or whether they would prefer alternative approaches or supplementary information.

We are not convinced that eliminating income and expenses related to the core business from the statement of comprehensive income for some contracts provides more relevant information for the users of financial statements. Inconsistencies in the statement of income will arise if a reporting entity is composed of entities with different activities. An analysis of sources of earnings may be included in the notes to the financial statements if considered necessary to explain an insurer's performance.

Another alternative that the Boards should consider is an expanded margin approach differing from the version discussed previously in which premiums/revenue was the balancing figure. We believe that the Boards should consider an approach under which the premiums/revenue amount is calculated and the balancing figure to the underwriting margin is "other changes in insurance contract liabilities and assets." This would necessitate determination of allocated premiums, which also would be required under the FASB's method for amortising the composite margin, and splitting out deposit elements of the premiums.

Although we do not have a preferred approach regarding the presentation of the statement of comprehensive income, we would like to point out the following considerations and inconsistencies with the summarised margin approach as proposed in the ED:

- It is unclear how the guidance on presentation would apply to insurance contracts which in whole or in part apply the replicating portfolio approach. For example, it is not clear for insurance contracts that are measured using a replicating portfolio approach (i.e. fair value of underlying replicating assets), how the presentation requirements related to the underwriting margin and changes in risk adjustments and related disclosures would be quantified and applied. In drafting the final standard, the Board should incorporate further guidance in this area.

- Some users and analysts have expressed concerns are that there is a loss of volume (premiums and claims) information under the summarised margin approach. Although the nature of certain products, particularly life business presents some difficulty in splitting premiums between “risk” business and “investment” business, some form of expanded presentation for premiums which excludes deposit elements may be valued by users.
- The presentation proposals are inconsistent for insurers that write short-duration contracts subject to the modified approach and insurers that write longer term business subject to the general measurement model. The presentation of underwriting margins for short-duration contract (paragraph 75 (a) of the ED) requires disaggregation of premium revenue, claims incurred, expenses incurred and the amortisation of incremental acquisition costs either in the statement of comprehensive income or in the footnotes. Disclosing such aspects of the underwriting margin may allow users to derive some information traditionally used to analyse the profitability of property and casualty insurers, including loss and expense ratios. However, this presentation of the underwriting margin varies significantly from that of long-duration contracts and a dual presentation may create some additional challenges for insurers combining separate presentation approaches for long and short-duration business.
- It is not clear whether and how the presentation requirements for unit-linked contracts would be applied to cases, where the insurer shares proportionally in the development of units.

(b) In principle, we prefer that all elements of income and expense arising from insurance contracts should be presented in profit or loss. However, several other existing IFRS standards result in elements of income and expense being presented in other comprehensive income, and also may affect the determination of liabilities for insurance contracts. For example, revaluation of own-use real estate, and certain foreign exchange adjustments and adjustments to post-employment benefits, are required to be reflected in other comprehensive income. These adjustments may affect insurance contract liabilities including participating policy balances. In some jurisdictions, participating benefits may be required by law or by the terms of the contracts to include all elements of income and expense, whether included in profit or loss or other comprehensive income. If the effect on the valuation of insurance contract liabilities is not also reflected in other comprehensive income, an accounting mismatch would arise. Accordingly, we suggest that when income and expense items are related to changes in measurement that are required to be included in other comprehensive income by other IFRS standards, providing an option to present any corresponding direct effect on insurance contract liabilities in other comprehensive income should be provided in order avoid an accounting mismatch.

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)/(b) We agree that the proposed disclosure requirements meet the proposed objective; however, we also believe that the statement in paragraph 81 of the ED ‘An insurer shall aggregate or disaggregate information so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics’ is an important principle that should be given more prominence. We also believe that it would be helpful if the aggregation principle was amended to refer to ‘the aggregation of significant items or groups of items that have different characteristics’. Further outreach may be warranted to determine (i) the extent to which the proposed disclosures present a challenge for preparers to assemble the footnotes in a timely manner and (ii) whether they result in excessively long footnotes.

(c) We suggest additional disclosure requirements consistent with our responses in the following areas:

- Discount rate (Question 3)
- Risk adjustment (Question 5)
- Transition (Question 17)

We believe that these disclosures will enhance further the comparability of the financial statements for reasons detailed in our detailed responses on these questions.

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?

Proposed amendments to IAS 32 and IAS 16

We believe that the proposed amendments to IAS 32 and IAS 16 lack clarity and consistency and are not sufficiently explained in the ED. The ED does not appear to contain the full text of the proposed amendments and therefore it is difficult for us to understand the nature of what the

Board might be proposing. In order to ensure that the final standard undergoes full due process and to avoid any technical errors or unintended consequences with respect to the drafting of any final amendments to IAS 32 and IAS 16, we recommend that the Boards expose a detailed draft of the proposed changes for comment by stakeholders prior to finalisation.

We note that the proposed amendments are stated to apply to “unit-linked contracts” of “insurers.” However, the amendments to IAS 32 and IAS 16 do not include a definition of either term. Applying the definitions contained in the ED for the proposed insurance standard would not achieve a meaningful result. In particular, an insurer is defined as the obligor under an insurance contract whereas many unit-linked contracts are not insurance contracts or would be unbundled from an insurance contract. Also, although they may not meet the definition of unit-linked, other participating contracts also may present the same exposure to an accounting mismatch; it is unclear whether or how the proposed amendments would apply to such contracts.

Paragraph BC 154 of the ED indicates that own shares would be treated as assets measured at fair value through profit or loss to the extent that they relate to the interests of unit-linked contract holders and that, if the insurer has its own interest in the fund, then the shares would be treated as assets measured at fair value. The proposed amendments to IAS 32 and IFRS 9 in Appendix C make no such distinction. It is thus unclear where changes in the fair value of own shares related to the insurer’s own interest would be presented. We see no argument for including those changes in profit or loss since no accounting mismatch arises in relation to the insurer’s own interest in the fund.

We note that the proposed amendments conflict with the current principles in IAS 32 (i.e. treasury shares are deducted from equity while shares held as an agent are not treated as assets). We also note that an accounting mismatch between own shares held and contracts linked to them may arise in many other situations (e.g. an investment bank purchases its own shares and writes a cash-settled derivative over them). We believe that the proposed amendments are supportable only if the Board explains and defines the specific features of “unit-linked contracts” that justify a different approach so as to determine a principle that is applicable generally. The ED currently does not do that.

Unbundling

As discussed in further detail in our response to Question 12 on unbundling under suggested enhancements to the current guidance contained in paragraph 8 of the ED, it is not clear from the proposals if the intention of unbundling the account balance in a unit-linked insurance contract is to achieve comparable accounting for the unbundled component (and any unbundled investment service component) with the accounting for a unit-linked contract that does not transfer significant insurance risk.

Presentation

We agree with the proposed presentation requirements for the single item presentation for unit-linked contracts as the assets are not available for general use and acquisition and disposition of the assets is at the direction of the policyholder, as well as, the portion of liabilities of unit-linked contracts linked to the assets. However, it appears that this guidance would only apply to unit-linked contracts in the scope of the insurance standard. This may create inconsistency with presentation of unit-linked contracts and related assets that are not within the scope of the standard or where a unit-linked component is unbundled.

Question 16: Reinsurance

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

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

(a) We agree with an expected loss model for reinsurance contracts and believe that it is consistent with an expected loss model for measuring the impairment of financial assets. We believe that consistency with that model is important and hence the insurance proposals should reflect relevant changes.

(b) There are a number of areas that we believe would be helpful to clarify in the final standard regarding reinsurance which are summarised below:

- We believe that further clarification is needed in paragraph 44 of the ED which addresses the recognition of the residual margin. This paragraph indicates that an insurer needs to recognise reinsurance balances related to direct contracts which have not yet been written (e.g. when reinsurance premium varies on treaty business written). In reinsurance contracts in which there are a direct flow-through of direct business into the reinsurance contract, we believe that the residual margin should be recalibrated through the term during which the underlying contracts are being written (i.e. quota share contracts with proportional share of premium and claim activity).

Further clarification on the timing of recognition and what is defined as a portfolio for reinsurance contracts would be helpful. We believe that there should be consistency between the recognition date of the reinsurance contract and the ceded direct contract (e.g. an insurer should not recognise a reinsurance contract balance prior to ceded contracts being written).

- Although some of the Board members and staff have implied that the reinsurance measurement principles also apply to short-duration contracts using the modified approach, we believe that paragraph 43 of the ED should be clarified to state this fact explicitly to eliminate confusion.
- We believe that the guidance should elaborate that there should be consistency of assumptions used in the determination of reinsurance assets and the ceded direct insurance contract liability with explicit recognition that the risk adjustment could vary for different reasons. One reason may be based on portfolio effects and on differences between the risk being ceded and that in the underlying ceded direct contracts and another reason may be that the residual margin varies from that determined for the direct business as the ceded residual margin will be determined based on the reinsurance pricing rather than the ceded liability.

However, recognising the residual margin based on pricing of the reinsurance contract has some unintended consequences and accounting anomalies when applying this guidance to proportional reinsurance agreements. For example, if the reinsurance premium paid less any ceding commissions, is higher than the reinsurer's share in gross cash flows and risk adjustment, then the cedant may recognise as a reinsurance asset an amount, benchmarked to the reinsurance premium paid which is *higher than* the corresponding share of the reinsurer in the liabilities including the corresponding residual margin. The guidance in the ED would suggest that this amount is recorded as a residual margin. Is this intended to be a deferred loss or represent something else? On the other hand, if the reinsurance premium paid less ceding commissions is *lower than* the corresponding reinsurer's share in gross cash flows and risk adjustment, then the cedant may continue to recognise/amortise a gross residual margin that relates to the cash flows and any related profits which have been ceded. We suggest the principle in these cases be clarified.

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) We do not support the transition proposals as presented. Although determining the remaining amount of the residual margin on transition may represent a challenge, we are concerned that the transition proposals as currently presented do not permit any residual margin upon transition. Depending on the specific circumstances and the interpretation of what is to be included in the building blocks, these residual margins may be significant. For example, the residual margin factors in all overhead and non-allocated administrative expenses as well as non-incremental acquisition costs not taken into account in the estimate of cash flows which are considered in pricing. The effect of not recognising a residual margin for contracts in existence at transition would be to depress the net income reported for those contracts in periods post-transition compared to a full retrospective application with recognition of a transitional residual margin balance. If a composite margin approach were applied to measurement, then based on discussion by the Boards the composite margin would be set equal to the risk adjustment and would not be remeasured subsequently but released into income in the same way as any other composite margin having a similar impact on post-implementation profitability.

Entering into otherwise identical contracts before and after the transition dates will have very different outcomes since the transition rules would result in some embedded profits being recognised directly in retained earnings rather than in future earnings. As a result, two identical contracts may have drastically different results analysed over the remainder of the coverage period. This may cause challenges for users or analysts that are analysing the results of an insurer over time.

We propose that the Boards consider the following options that will both allow for the determination of a residual margin upon transition and further comparability among insurers on and after the transition to the new insurance standard:

- Allow an insurer to apply a full retrospective approach in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and FASB ASC Topic 250 *Accounting Changes and Error Corrections*, if practicable. A fully retrospective approach could be approached by two methods. The first would be applying IAS 8 without hindsight, which is the method generally required by IFRSs requiring retrospective application, and the second would be application of IAS 8, allowing assumptions to be set with hindsight. It may be difficult in practice to apply a full retrospective approach without the use of hindsight because the data originally used to price older products may not have been maintained by many insurers and because of the dependence of risk adjustment calculations on the perspective of management. It is arguable that a residual or composite margin calculated with the benefit of hindsight would be less subjective and would be less subject to bias at transition. However, with the locked-in residual or composite margin as proposed, a full retrospective approach would generally necessitate maintenance of (or reconstruction to a reasonable degree of accuracy) of all the relevant contract history data in order to undertake the necessary calculations. We believe this approach should be considered for transition in the event that the Boards do not agree to re-measure the residual or composite margin for changes in assumptions. However we believe that if the residual or composite margin were subject to remeasurement after initial recognition, the difficulties associated with a full retrospective application may be reduced.
- As noted by the Board in the Basis of Conclusions paragraph BC248 in the ED, a full retrospective determination of a locked-in residual or composite margin (whether it is determined with or without hindsight) may be impractical and, if not impractical, then often would cause costs disproportionate to the resulting benefit for users. We believe that to remain consistent with current transition approaches for other IFRSs and allow for a residual or composite margin at transition, the Board should provide for insurers to use a full retrospective approach under IAS 8 using the benefit of hindsight in addition to another transition methodology to be developed by the Boards to the extent that a full retrospective application is not practicable. Such a methodology could be based on fair value similar to the approach used in business combinations under the proposals.

If either of these approaches are applied, then we believe that disclosure would be warranted in years subsequent to transition to provide comparability between insurers adopting a full retrospective or modified retrospective approach including disclosing the amount of residual margin recognised at transition and identification of the methodology applied in the insurer's transition calculation.

(b) We believe that further clarity is needed for the composite margin approach in order to apply the composite margin approach to the transition proposals discussed above. The retrospective application proposed discussed above also would apply to the composite margin approach.

(c) We recognise the time commitment involved in making such wide-ranging changes and this should be considered in allowing for additional time for implementation. Based on the complexities of the proposals, we think that the effective date will need to extend past 1 January 2013. In order for insurers to be able to develop the systems, test them and capture data by the beginning of the comparative year presented upon transition, we believe the effective date should be no earlier than 36 months after issuance of the final standard. A longer transition period also will allow more insurers to apply a retrospective approach to transition as described above. Also, we encourage a transition date consistent with IFRS 9 which would result in deferring the effective date of IFRS 9 beyond 1 January 2013. In the event that IFRS 9 is adopted before the future insurance standard, there should be an ability for insurers to comprehensively redesignate financial instruments at adoption, not just to fair value through profit or loss.

(d) See comment under (c)

Question 18: Other comments

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

Recognition

The recognition proposals, which state that an insurer should recognise the insurance contract at the earlier of when the insurer is bound by the terms of the contract and when first exposed to risk, which may be before the start of coverage, would introduce unnecessary complexity. For example, a direct writer which historically has very low acceptance rates may send out offers before year end. Insurers also may make offers through brokers that indicate the willingness to accept risks. Under the current proposals, the insurer would be required to recognise the offers as well as track subsequent changes in the financial statements although most of these offers may not be accepted.

As premised in paragraph 21 of the ED, we agree in many cases there may not be a material change if an insurer recognises a contract prior to the start of the coverage period. However, we expect that the investment in systems and procedures to record and track the changes between inception and the start of the coverage period will be significant. Additionally, discount rates may change significantly for reasons unrelated to any aspect of the insurance contract.

Many insurers may require significant systems changes or enhancements to capture the necessary commitment information to implement the proposals, which are likely to be both time-consuming and costly. If the impact for many insurers proves to be immaterial, as suggested in the rationale in paragraph 21, then the justification for the Boards' proposals may be undermined.

In addition to the system costs and changes that likely will be needed to accommodate the proposals, there are some additional practical implications and inconsistencies in the recognition proposals that we would like to bring to the Board's attention including:

- Recognition of certain types of reinsurance contracts has not been fully considered. In some cases, an insurer may be subject to recognition requirements prior to the underlying direct contracts being written (see reinsurance discussion above).
- The nature of some types of insurance contracts has not been considered fully in the proposals. For example:
- if an insurer becomes party to the contract long before coverage starts, e.g. in cases of some deferred annuities with guaranteed terms, the residual margin would be recognised in profit or loss only when coverage begins, which might be decades after initial recognition.
- group medical contracts present special challenges since the binding of the group contract may precede the determination of individual certificates of insurance under the group contract by a significant amount of time. The level of confidence in the estimates would be increased greatly if the period of recognition did not commence until coverage under the contracts commenced.

Once the residual margin is locked in, any changes to forward projections, such as changes in interest rates or changes in estimates of employees who will participate in a group medical contract, would immediately be recognised in the profit or loss account. Further consideration may be needed for contracts with such features.

We believe that a more practical and relevant approach of recognising insurance contracts which addresses many of the practical challenges is to require an insurer (or allow an insurer to continue) to recognise insurance contracts at their effective date. In applying this approach, the insurer would be required to record any cash receipts received and cash payments made before the start of the coverage period and also would need to recognise a provision for any contract that becomes onerous so as to treat the contract as executory until the start of coverage consistent with proposals in the revenue recognition exposure draft.

Business combinations and portfolio transfers

We support the proposals as they relate to business combinations and portfolio transfers. We believe that insurance contracts acquired in a business combination should be measured at the higher of the present value of the fulfilment cash flows or fair value in order to prevent losses being recognised immediately after the acquisition which would add confusion for users. Although this is a departure from the general requirement in IFRS 3 and ASC Topic 805 *Business Combinations*, we believe that it is consistent with other measurement exceptions made under IFRS 3 including those for employee benefits.

We believe that further clarification is needed with respect to the following areas:

- In the proposals, the guidance addressing measurement of insurance contracts in a business combination and a portfolio transfer indicates that the insurer would measure the contracts at the higher of fair value or the present value of the fulfilment cash flows. This guidance appears to be written in the context of an assumption that the portfolio is a liability as opposed to an asset. If the insurance contract is an asset it should be recognised at the lower of the positive fair value or the positive present value of the fulfilment cash flows.
- The proposals do not specify a treatment for acquisition of reinsurance contracts. In the case of a reinsurance contract, the likely assumption would be that each portfolio is an asset and, in mirror image terms, that it would be initially measured at the higher of the positive fair value and the positive present value of net inflows. However, this is not addressed explicitly in the guidance.
- In cases in which the fair value exceeds the present value of the fulfilment cash flows and a residual margin is recognised at the date of the business combination or portfolio transfer, the proposals do not provide any specific guidance on how this residual margin subsequently would be recognised in profit or loss. This would be of particular concern for portfolio transfers as the contracts assumed may be in run off and may not have an unexpired coverage period. Similarly, if only post claims liabilities of short-duration contracts are transferred, it would be inconsistent if the difference between the present value of fulfilment values and higher consideration received was attributed as a residual margin to the post claims liabilities.

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.

We believe that when finalising the proposals, the Boards should ensure that outreach is done to insurers and users on the benefits and costs of the proposals.

Appendix 2

FASB Discussion Paper

The following section addresses questions raised in the FASB Discussion Paper which are not already addressed above.

Improvements to U.S. GAAP

32. After considering your views on the specific issues contained in this Discussion Paper and the IASB's Exposure Draft, what do you think would represent the most appropriate improvement to U.S. GAAP?

- a. Pursue an approach based on the IASB's Exposure Draft?**
- b. Pursue an approach based on the IASB's Exposure Draft with some changes? Please explain those changes.**
- c. Pursue an approach based on the Board's preliminary views in this Discussion Paper?**
- d. Pursue an approach based on the Board's preliminary views in this Discussion Paper with some changes? Please explain those changes.**
- e. Make targeted changes to address specific concerns about current U.S. GAAP (for example, items included in paragraph 7)? Please describe those changes.**

We believe that b/d would be the most appropriate improvement to U.S. GAAP.

Current U.S. GAAP, particularly as it relates to long-duration contracts, is based on different models which serve as a reference base for establishing an accounting model when new products are developed:

- traditional long-duration contracts, originating in FASB Statement No. 60 extracted from other guidance in 1982, which use a locked-in set of assumptions;
- short-duration contracts, originating in FASB Statement No. 60 extracted from other guidance in 1982, which use a best estimate of incurred losses with discounting for time-value of money being an accounting policy election;

- non-traditional contracts such as limited-pay contracts and universal life insurance, originating in FASB Statement No. 97 issued in 1987, which for limited-pay contracts use locked-in assumptions with deferral of revenue over the life of the contract and universal life insurance use account balances, discount rates based on the rate credited to policyholders and current other assumptions;
- reinsurance, as revised in FASB Statement No. 113 in 1992;
- certain long-duration participating contracts, as revised by FASB Statement No. 120 in 1995, clarifying application of other literature to mutual life insurance entities; and
- financial guarantee contracts, originating in FASB Statement No. 163 in 2008, which use and unearned premium model and a best estimate of incurred losses with discounting at a current risk-free rate.

Other literature has been issued over time to further clarify U.S. GAAP based on issues being faced at the time, however, there has not been a comprehensive re-evaluation of insurance accounting since FASB Statement No. 60 was issued.

We believe that it is important for the credibility of the project that the IASB and FASB proposals are ultimately consistent. At present, there are several important differences between the proposals of the IASB and the FASB that we believe the Boards should resolve in order to settle on a unified measurement model as this will avoid pressure on either Board to eliminate any differences through convergence in the period after the Boards issue their respective standards. Likewise, making targeted improvements to U.S. GAAP would result in significant differences from the ultimate IASB standards that ultimately would require some level of convergence or, depending upon the ultimate determination by the Securities and Exchange Commission, adoption in conversion to IFRS.

We think this is important as the proposals will require significant effort for most financial statement preparers, including some entities that are not insurers but that do issue insurance contracts as defined in the proposals. It will take preparers and users time to become familiar with applying the new reporting requirements and how to interpret them. It is important that the standard is high quality, stable, clear and based on sound principles that are applied consistently from when it is first issued and without over reliance on prescriptive rules.

Other FASB Questions

4. Should benefits that an employer provides to its employees that otherwise meet the definition of an insurance contract be within the scope of the proposed guidance? Why or why not?

Benefits an employer provides to its employees, such as health care coverage, pensions, etc., are currently accounted for under ASC Topics 712 *Compensation – Nonretirement Postemployment Benefits*, and 715 *Compensation – Retirement Benefits*. We believe the scope exclusions for employee benefits proposed in the Exposure Draft are appropriate. The broad spectrum of entities that provide these benefits supports the need for any changes to accounting for these benefits to be made in a separate proposal outside the scope of accounting for insurance contracts.

23. What are the implications of the recent U.S. healthcare reform to the application of the proposed contract boundary principle, including whether health insurance contracts written under the new reforms would meet the conditions in the proposed guidance to be accounted for under the modified approach?

U.S. healthcare reform will change the nature of relationships between insurers and policyholders, particularly as it related to underwriting, establishment of premiums and continuation of coverage. We believe the Board should undertake field testing with health insurers to identify any unintended consequences of applying the proposals under the new regulatory environment.

26. The scope of the proposed guidance includes reinsurance contracts that an insurer issues or acquires. However, insurance contracts held directly by other policyholders would be excluded from the scope of the proposed guidance. Do you agree with this exclusion? Why or why not?

Accounting by policyholders, while analogous to reinsurance accounting by the ceding entity, should be addressed outside the proposals for insurance contracts. A model without all of the complexities of the insurance contracts model, including possible consideration of a risk adjustment, may be more appropriate for application by policyholders.