

14 December 2010

International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH  
United Kingdom

Dear Sir / Madam

**Re: IASB Exposure Draft *Insurance Contracts***

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Insurance Contracts* ('the ED'). This letter is intended to contribute to IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

EFRAG is pleased that in developing the proposals the IASB addressed a number of concerns expressed in respect of the Discussion Paper *Insurance contracts* that was issued in 2007 and we agree with many of the proposals in the ED. In particular, we agree with the IASB's decision to require measurement based on fulfilment cash flows and a building block approach that includes, separately, the recognition of a risk adjustment and a residual margin. With respect to acquisition costs, we concur with the IASB's decision to include incremental acquisition costs in the fulfilment cash flows.

We have, however, a number of concerns that we highlight below:

- *Accounting mismatches*: EFRAG considers that the measurement model proposed in the ED will be a step forward in accounting for insurance contracts. However, we believe that the Board has not sufficiently considered the interaction between the proposals in the ED and other standards (e.g. IFRS 9 *Financial Instruments* and IAS 16 *Property, Plant and Equipment*), which require application of different measurement models to the assets and liabilities of an insurer. This gives rise to accounting mismatches, particularly when an insurer measures some of its assets at amortised cost in accordance with IFRS 9.
- *Performance of an insurer*: We do not believe that the IASB has sufficiently explored issues around what constitutes the performance of an insurer and how this should be presented in the financial statements. We believe that the proposals as currently drafted do not offer a complete approach to performance reporting by an insurer. We would recommend that the IASB explore these issues in more detail to improve the decision-usefulness of the information for users of an insurer's financial statements.
- *Residual margin*: The ED proposes to lock-in the residual margin and release it over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage. We believe the residual margin should be adjusted to offset the

changes from remeasurement of the present value of fulfilment cash flows that affect future periods. We believe that this would be more appropriate as it is consistent with measurement at contract inception. It is conceptually right that no day one gain is recognised because the insurer earns the profit over the coverage period. Therefore, the changes from remeasurement should be recognised in profit or loss only as far these changes relate to the current period or past periods.

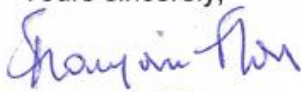
- *Financial statement presentation:* The ED proposes a summarised margin presentation, which does not allow volume information for long duration contracts to be presented on the face of the statement of comprehensive income. We believe volume information, such as premiums, claims, benefit expenses and claims handling expenses should be presented on the face of the statement of comprehensive income for all insurance contracts because they are key information for the users of financial statements. A presentation combining actual volume information and margins is therefore desirable.
- *Transitional requirements:* The ED proposes to record the difference between the insurance liabilities measured under IFRS 4 *Insurance Contracts* and the insurance liabilities measured under the new proposals into retained earnings. This is in fact an elimination of all future gains from the insurance business in force. We disagree with this treatment as it will prevent an insurer from recognising gains from its current contracts in profit or loss. We believe that IAS 8 *Accounting Policies, Changes in Estimates and Errors*, which requires retrospective application unless it is impracticable, should be applied upon initial application of the standard.
- *Field-testing:* The proposals in the ED represent a major change from current accounting for insurance contracts. We urge the Board to consider carefully the results of the field-testing performed and to share the results with constituents.

Our detailed responses to the questions in the ED are included in Appendix 1 to this letter.

We acknowledge that addressing our concerns may not be feasible before the June 2011 deadline that the Board has set for itself in this project. However, we believe that finding an appropriate solution to the performance reporting issues raised by these proposals is essential to its goal of providing decision-useful information.

If you would like to discuss our comments further, please do not hesitate to contact Ralitzza Ilieva, Annemiek Vromans or me.

Yours sincerely,



Françoise Flores  
**EFRAG, Chairman**

## APPENDIX 1 – EFRAG’s response to the questions in the Exposure Draft

### MEASUREMENT MODEL

#### Question 1 – Relevant information for users

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?

#### EFRAG’s response

- **EFRAG considers that the measurement model proposed in the ED will be a step forward in accounting for insurance contracts.**
- **EFRAG considers that the proposed measurement model does increase the relevance of information for users since there will be more consistency and comparability in the financial statements and eliminate the existing diversity of accounting principles used for the measurement of the liability.**
- **However, EFRAG believes that the IASB should explore in more detail the issues around what constitutes the performance of an insurer and how this should be presented in the financial statements.**
- **We also have concerns about some of the other proposals where we do not believe that they will improve the usefulness of information provided. These concerns relate specifically to subsequent measurement of the residual margin, presentation in the statement of comprehensive income and the transitional rules.**

- 1 EFRAG considers that the measurement model proposed in the ED addresses many concerns expressed in our comment letter to the discussion paper. We consider that the proposals will result in an increase in the usefulness of information for users of an insurer’s financial statements. A primary reason for this is that there will be a single regime for insurance contracts under IFRS, resulting in greater consistency in the financial statements of insurers compared to the range of accounting models currently applied.
- 2 We particularly agree that the proposed measurement model provides more relevant information about the ‘amount, timing and uncertainty of future cash flows that will arise as the insurer fulfils its existing insurance contracts.’
- 3 However, we do not believe that the IASB has sufficiently explored the issues around what constitutes the performance of an insurer and how this should be presented in the financial statements. In this respect, the IASB should specifically consider:
  - (a) The impact of differences in accounting for financial instruments under IFRS 9 and insurance contracts as proposed in the ED;
  - (b) The need for users to understand the effects of any mismatches;
  - (c) The need to distinguish between short-term volatility and long-term trends in understanding the performance of an insurer; and

- (d) The requirements to report some aspects of performance in profit or loss and other aspects in other comprehensive income.
- 4 We believe that the proposals as currently drafted do not offer a complete approach to performance reporting by an insurer. Many of our constituents have suggested alternative models and approaches (e.g. frozen/locked-in discount rates, the use of OCI, adjustment of the residual margin and asset-based discount rates) that aim to address the performance reporting issues that have been raised by the proposals in the ED. We would recommend that the IASB explore these issues in more detail to improve the decision-usefulness of the information for users of an insurer's financial statements. EFRAG would be happy to provide assistance to the IASB in addressing these issues.
- 5 We have concerns regarding certain other aspects of the proposals in the ED, which we think reduce the relevance of the information for users. In particular we are concerned about the proposals concerning the subsequent measurement of the residual margin, financial statement presentation and the transitional rules. Our concerns are detailed in our responses to Questions 6, 13 and 17.

#### **Question 2 – Fulfilment cash flows**

- (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?

#### **EFRAG's response**

- **EFRAG supports a measurement approach for insurance liabilities that is based on the expected present value of the fulfilment cash flows (future cash outflows less future cash inflows).**
- **We agree that the portfolio is the appropriate level of measurement for the probability weighted cash flows of insurance contracts. We have concerns about the different levels of measurement required by the proposals as we believe that a consistent unit-of-account should apply throughout the standard for all building blocks.**
- **We believe that the definition of portfolio may be too wide when it refers to 'broadly similar risks' and 'single pool', which may lead to an imprecise level of aggregation. We note portfolios are also a level of measurement in other standards, notably IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9. The IASB should ensure consistent interpretation of portfolios. We recommend that the IASB conduct additional outreach activities to determine whether this definition is appropriate.**
- **We believe that the guidance regarding the definition of future cash flows is at the right level of detail. We recommend including guidance on the treatment of taxes in future cash flows.**

*Question 2(a) – Measurement of the insurance liability at the expected present value of future cash flows*

- 6 As we indicated in our response to Question 1 of the ED, the amount and timing of future cash flows are important elements of a measurement model and they provide important information to users and reflect the way an insurer measures and manages its insurance contracts.
- 7 EFRAG therefore agrees 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.
- 8 We note that our agreement in response to this question relates to several different aspects of the measurement model, namely:
- (a) The estimate considers cash flows that arise as the insurer fulfils its obligations under the insurance contract;
  - (b) The insurance contract reflects a single package of cash inflows and cash outflows;
  - (c) The measurement model is based on an estimate of probability-weighted future cash flows;
  - (d) The portfolio level provides reliable measurement and is in line with the way the insurer manages its business;
  - (e) The estimate of probability-weighted future cash flows needs to be discounted to a present value; and
  - (f) The definition of a portfolio should be strengthened.
- 9 In order to provide more detail about the reasons for our support, we consider that it is worthwhile addressing the above elements to the question separately below.

Fulfilment cash flows

- 10 EFRAG agrees with the IASB's proposal that the measurement of an insurance contract should be based on a fulfilment value rather than an exit value for the following reasons:
- (a) An insurer generally has the intention to fulfil insurance contracts and is usually not able to sell or transfer them. Consequently the fulfilment concept better reflects the business model of an entity that issues an insurance contract;
  - (b) The use of fulfilment value entails the use of entity-specific information. In our view, the economic characteristics of an insurance liability are determined by the way the insurer manages these liabilities in combination with its other assets and liabilities. Therefore, the use of entity specific data is appropriate in the measurement of the insurance liability.

The insurance contract reflects a single package of cash inflows and cash outflows

- 11 EFRAG agrees that the measurement of an insurance contract should combine both cash inflows and cash outflows. These cash flows are generated by insurance, financial and service elements that together form the rights and obligations arising from the insurance contract. The measurement results in a net value, which we consider reflects the economic substance of an insurance contract.

#### Probability-weighted future cash flows

- 12 EFRAG agrees that a key building block of an insurance contract is based on the expected values of future cash flows. We agree that when estimating cash flows:
- (a) The inputs used, such as interest rates and equity prices, should be consistent with observed market prices.
  - (b) The estimate should incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all the cash flows arising from the obligation. That means each possible scenario should be identified; the present value of the expected cash flows from the scenario estimated; and a probability-weighted average calculated.
  - (c) The estimate should be based on currently available information; in other words, it should take fully into account conditions at the balance sheet date.

#### Measurement at the portfolio level

- 13 We note that paragraphs 16 to 22 of the ED (except for paragraph 20) refer to the individual contract in the context of measurement. In paragraph 23 (regarding probability weighted cash flows) and paragraph 35 (regarding the risk adjustment) the measurement is at the portfolio level.
- 14 EFRAG agrees with the IASB's proposal in paragraph 23 of the ED that cash flows arising from insurance contracts should be estimated at the portfolio level and agrees with the reasons given in paragraph B65 and B66. We recognise that probability-weighted estimates of future cash flows can be measured more accurately at the portfolio level and that most insurers manage and measure their insurance contracts at that level.
- 15 We note the residual margin and acquisition costs are measured using different levels of aggregation. We believe the standard should in principle require a consistent level of measurement for all building blocks.

#### Present values (discount rate)

- 16 EFRAG agrees that the time value of money should be taken into account to represent faithfully future cash flows at the reporting date. For further comments on the proposals regarding the discount rate in the ED, please refer to our response to Question 3.

#### Definition of portfolio

- 17 The ED defines a portfolio of insurance contracts as comprising 'insurance contracts that are subject to broadly similar risks and managed together as a single pool'. However, including 'broadly' and 'pool' in the definition may lead to inconsistencies between insurers accounts. 'Broadly' can be interpreted as including a wide range of risks and using the term pool suggests a higher level of aggregation than portfolio. Thus an entire group of portfolios may constitute a pool.

- 18 Other standards also use a portfolio as the unit-of-account, notably IFRS 9 and IAS 39. Neither standard defines a portfolio, but IAS 39 aggregates, for derecognition, assets with similar risks. Removing the term broadly and single pool would provide more consistency across standards.

*Question 2(b) – Application guidance on estimates of future cash flows*

- 19 We believe that the guidance regarding the definition of future cash flows is at the right level of detail.
- 20 We note that the guidance on cash flows of an insurance contract includes transaction-based taxes (paragraph B61(h) of the ED). The impact of special insurance taxes on future cash flows can be different in different jurisdictions, depending on local tax and insurance legislation. We recommend therefore that the IASB include general guidance on the treatment of tax in the guidance on cash flows to ensure consistency of application.

**Question 3 – Discount rate**

- (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?

**EFRAG's response**

- **EFRAG agrees that the discount rate should reflect the characteristics of the liability. In case the amount, timing or uncertainty of the cash flows arising from an insurance contract depends wholly or partly on the performance of specific assets, the discount rate should reflect that.**
- **EFRAG suggests that the IASB provide implementation guidance on the selection of the discount rate.**
- **EFRAG believes that liquidity can be a characteristic of an insurance liability that should be taken into account for measurement purposes. However, the guidance on illiquidity should be improved, particularly in order to avoid double counting.**
- **We agree that the effects of an entity's own credit risk should not be included in the measurement of an insurance liability.**

*Question 3(a) – Discount rate reflects the characteristics of the liability*

- 21 EFRAG agrees that the time value of money should be taken into account in order to faithfully represent the value of future cash flows at the reporting date that arise from all existing insurance contracts.
- 22 EFRAG agrees that the rate used to discount non-participating contracts should be a rate that is consistent with observable current market prices and that reflects the characteristics of the insurance liability because:
- (a) In EFRAG's view, the value of an insurance contract is independent of the value of the assets in which an insurer invests unless there is a contractually defined relationship that clearly links the cash flows of both (e.g. participating features);
  - (b) A risk-free rate that reflects the characteristics of the liability (e.g. currency, duration and country of the insurer) uses observable market information thus adding consistency across different liabilities; and
  - (c) Under the ED's building block approach, risk is considered when calculating the explicit risk adjustment.
- 23 We understand that the difference between the discount rate on insurance liabilities and the yield on invested assets will create a mismatch. In EFRAG's view this mismatch reflects the economic difference between assets and insurance liabilities. We consider this as useful information because it highlights the level of 'unmatched' risks in an entity's insurance activities.
- 24 However, EFRAG notes that the 'reference to observable current market price' is not sufficiently clear given the wide range of discount rates that are observable in the market. We recommend that the IASB include implementation guidance on the selection of the appropriate discount rate.
- 25 We note that some of our constituents believe that the way the discount rate is determined should be considered in the light of the discussion on accounting mismatches. Using an asset-based discount rate or a frozen/locked-in discount would provide a solution for the accounting mismatch. As we noted in our response to Question 1, we believe that the proposals as currently drafted do not offer a complete approach to performance reporting by insurers. We recommend that the IASB explore these issues in more detail.
- 26 Paragraph 32 of the ED provides that where the amount, timing and uncertainty of cash flows arising from insurance contract 'depend wholly or partly on the performance of specific assets, the measurement of the insurance contract shall reflect that dependence'.
- 27 We note that this requirement to reflect the cash flows arising from certain underlying assets impacts all aspects of the present value of fulfilment cash flows (i.e. estimated cash flows, discount rate and the risk adjustment). We therefore consider that its current placement in the ED under the sub-heading 'Time value of money' is confusing.
- 28 We think that the phrase 'depend wholly or partly on the performance of specific assets' should be clarified. From paragraph BC97 of the ED we understand (and agree) that unit-linked contracts and some participating contracts are within the scope of this paragraph. Paragraph B47 of the ED also indicates that the requirement may also apply to cash flows replicating the performance of a put option on a basket of traded assets. We are therefore uncertain whether the insurer (or a third party) must actually hold those specified assets. The reference to the 'basket' of traded assets



suggests that this is not the case, and we agree to this, but we consider that the IASB should be clearer on this point.

- 29 In the context of insurance liabilities that depend wholly or partly on the performance of specific assets, we believe the reference to replicating portfolios in paragraph 32 should be moved to the implementation guidance. The use of replicating portfolios is only one way to determine the insurance liability.

*Question 3(b) – Liquidity adjustment*

- 30 EFRAG interprets ‘risk-free rate’ as the observable market rate for highly-liquid assets (government bonds). We understand that long-term assets are less liquid than shorter term assets and command a premium over the (highly-liquid) risk-free rate.
- 31 Generally, insurance contracts are not liquid because they cannot be freely sold by the policyholder or put back to the insurer without significant additional cost. Insurance contracts also tend to be long-term in nature. Therefore, by analogy, the liquidity premium that attaches to less liquid long-term assets should be reflected in the measurement of (long-term) insurance liabilities. EFRAG also understands that the ‘illiquidity’ of an insurance liability measures the extent up to which its cash flows are certain in amount and in timing due to consideration being given to the resilience to forced sales.<sup>1</sup>
- 32 EFRAG is concerned about the requirement to adjust the discount rate used in measuring an insurance liability for the effects of illiquidity. Illiquidity is, at least in part, a measure of the ability of a policyholder to sell an insurance contract or let an insurance contract lapse and is therefore better suited to a measure based on exit value. However, we acknowledge that where illiquidity is a characteristic of an insurance liability that is accounted for under a fulfilment approach, it should be taken into account in the measurement. To the extent that the illiquidity represents the inability of a policyholder to terminate a contract, we believe that this should be reflected in the probability-weighted cash flows (i.e. the first building block). If the effect of illiquidity had to be reflected in the discount rate (i.e. the second building block) then the Board would need:
- (a) To ensure that illiquidity is only considered when this is a characteristic of the underlying insurance contract;
  - (b) To provide more explicit guidance on how the effect of illiquidity is to be reflected in the second building block; and
  - (c) To ensure that the guidance is sufficiently clear to avoid that illiquidity is considered more than once for measurement purposes.
- 33 We note that the conceptual basis of the illiquidity premium as a component for measuring insurance contracts is not fully developed. We believe therefore that if illiquidity is an element of the discount rate, specific disclosures on the nature of the adjustments, the specific assumptions, the methods and the sensitivity (with respect to the illiquidity premium) should be required.

*Question 3(c) – Impact on long-duration insurance contracts*

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<sup>1</sup> See page 6/33 of Committee of European Insurance and Occupational Pensions (CEIOPS) Task Force on the Illiquidity Premium (2010): Report. Ref. CEIOPS-SEC-34/10, 1 March 2010.

- 34 EFRAG considers that own credit risk is not a relevant characteristic of a liability as the fulfilment value of the insurance liability does not change because of changes in the credit status of the insurer.

**Question 4 – Risk adjustment versus composite margin**

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.-

**EFRAG's response**

- **EFRAG supports the proposed separate recognition of a risk adjustment and a residual margin and not the recognition of a single composite margin.**
- **EFRAG also believes that the risk adjustment can be reliably measured because assessing risks is integral to an insurer's business and therefore can be explicitly included as a separate building block.**
- **As the risk adjustment is highly sensitive to the underlying inputs and methodology, we recommend that the IASB require specific disclosures in the final standard.**

- 35 We support the explicit recognition and measurement of a separate risk adjustment because:

- (a) It separates two distinct elements of an insurer's liability;
- (b) The different natures of the risk adjustment and residual margin require the release of both elements based on different patterns (i.e. over the claims period and coverage period, respectively);
- (c) A separate risk adjustment could result in more contracts being determined as onerous on initial recognition, since its inclusion reduces the difference between the premiums and the present value of fulfilment cash flows. Given that we consider that including a risk adjustment reflects more accurately an insurer's view of its obligations under the contract, we consider this earlier recognition of onerous contracts provides more relevant information;
- (d) It provides useful insight into an insurer's view about the uncertainty of its estimate of future cash flows arising from its insurance contracts and the uncertainty and risk affecting different products;
- (e) EFRAG considers that given the nature of insurance portfolios and the way insurance businesses are managed, the uncertainty around estimates of cash flows is an important and material component of that business;
- (f) In our view, it can be reliably measured. Unlike other liabilities that have uncertain amounts, in our view a risk adjustment can be reliably determined for an insurance contract because:
  - (i) Insurance contracts represent a bundle of contractual cash flows. In our view, a value representing the uncertainty in estimates of contractual cash flows can be more reliably measured than the uncertainty of non-contractual cash flows such as those arising from civil or criminal lawsuits.

- (ii) A measure for the uncertainty of estimated future cash flows arising from an insurance contract will generally be considered when pricing that contract. It follows that the techniques used to measure that uncertainty for pricing purposes can also be used for accounting purposes.
  - (iii) Insurance contracts are generally grouped into portfolios that form large well-understood populations and insurers have a wealth of statistical information available. As a result the accuracy of estimates of future cash flows arising from these populations can be more reliably estimated.
- 36 Given that EFRAG considers that the risk adjustment provides useful information and can be reliably measured, we would not support a composite margin approach.
- 37 We do note, however, that the risk adjustment is highly sensitive with respect to the underlying inputs and methodology. Paragraph 90 of the ED requires disclosure of methodology and (if practicable) quantitative input. We note the three methods proposed in the ED each have particular inputs. Therefore, we recommend that the IASB require qualitative and quantitative disclosures specific to the method applied by the insurer.

#### **Question 5 – Risk adjustment**

- (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 (i.e. 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?

#### **EFRAG's response**

- **EFRAG agrees 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.**
- **EFRAG believes that methods that can be used to measure the risk adjustment should not be limited. Instead, a principle should be developed that drives the selection of an appropriate measurement methodology.**

- **We disagree that the confidence level to which the risk adjustment corresponds should be disclosed. The insurer should generally be required to explain the level of prudence applicable in measuring the risk adjustment.**
- **EFRAG supports measuring the risk adjustment at the portfolio level. Additionally, EFRAG believes that diversification between portfolios should be taken into account under specific circumstances.**
- **The level of application guidance in Appendix B on risk adjustments is sufficiently detailed.**

*Question 5(a) – Definition of the risk adjustment*

- 38 We 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. We support this definition because we consider it is consistent with a fulfilment notion as it represents the entity's assessment of the risk. It can be differentiated from a 'transfer' or 'exit' notion that would represent the amount a market participant would charge in relation to the uncertainty in cash flows.

*Question 5(b) – Techniques for estimating the risk adjustment*

- 39 EFRAG is of the view, that the risk adjustment, along with the estimate of cash flows, should be remeasured each period.
- 40 Whilst we agree that the three techniques set-out in paragraphs B73-B90 would enable an entity to measure the risk adjustment reliably, we do not agree that it is necessary to limit the measurement to these techniques.
- 41 EFRAG would recommend limiting measurement techniques only on the basis of a stated principle. Stating a principle, rather than prescribing specific techniques would allow for the use of techniques that may be developed in the future.
- 42 In our view the ED should allow an entity to use the technique that results in the fair depiction of the maximum amount the insurer would rationally pay to be relieved of the risk arising from the uncertainty in an insurance contract's cash flows. This principle is similar to the criteria used by the IASB to decide on the three techniques prescribed in the ED.
- 43 However, we recognise that limiting the choice of methods that can be used for measuring the risk adjustment enhances comparability. Therefore, we suggest that there should be a rebuttable presumption that an entity will use one of the three methods prescribed in the ED unless an entity can prove that a different method would be more appropriate as it better reflects the risks of its portfolio in the notes.
- 44 We acknowledge that the principle should be accompanied by clear disclosure requirements about the methodology used in determining the risk adjustment including why it meets the measurement objective.

*Question 5(c) – Confidence level disclosure*

- 45 EFRAG is concerned that requiring disclosure of confidence level information may bias the choice of the technique used for measuring the risk adjustment. The requirement creates an incentive to apply the confidence level technique, which is not necessarily the most appropriate approach in every circumstance. Alternatively, it may mean that

many entities would, at least to some extent, apply two techniques to calculate the risk adjustment.

- 46 From a user perspective, EFRAG is also concerned that the disclosure of the confidence level, if this is not the most appropriate technique, would not be useful information.
- 47 We believe that users of financial statements need disclosures that give an indication of the prudence level of an insurer's operations (i.e. information on the riskiness of its insurance contracts). We agree with the proposals in the ED that this could be given by disclosure of confidence level information on a portfolio basis. However, in our view other disclosures could also provide this information. Therefore, we suggest requiring insurers to provide the following information about the methods used to estimate the risk adjustment (paragraph 90 of the ED):
- (a) General description of the method used, the underlying assumptions and the input parameters;
  - (b) Information that explains the level of uncertainty about the amount and timing of the cash flows inherent in an entity's insurance contracts (for example this could be given by providing confidence level information, or by explaining how often it is expected that the actual insurance benefits paid will exceed the present value of fulfilment cash flows);
  - (c) Overall confidence level for regulatory purposes, if applicable;
  - (d) Reasons for choosing this methodology.

*Question 5(d) – Risk adjustment: Level of aggregation and diversification*

- 48 As we indicated in our response to Question 2, we consider that insurance contracts should be aggregated at the portfolio level for the purposes of estimating future cash flows. It therefore follows that we support measurement of the risk adjustment at the portfolio level.
- 49 Measurement of the risk adjustment at the portfolio level will naturally take into account the impact of diversification within the portfolio. EFRAG considers that diversification between portfolios should also be considered when measuring the risk adjustment, but only when:
- (a) Insurers manage their portfolios in such a way that risks are offset (or increased) across portfolios because this means an alignment with the business model; and
  - (b) The insurer is able to legally and practically take advantage of the risk diversification. This means, there should be no legal or practical impediment to realising the diversification effects e.g. the legal restrictions that may exist between portfolios.
- 50 Where the above criteria are met, EFRAG considers that including the diversification effects between portfolios would more faithfully reflect how insurance contracts are managed. It would also reflect better the financial position of an insurer as it reflects the offsetting of risks between portfolios from which the insurer benefits.
- 51 EFRAG considers that if diversification across portfolios has been taken into account when measuring the risk adjustment, the amount and nature of that diversification should be disclosed.

*Question 5(e) – Level of detail of application guidance*

- 52 We consider that the level of application guidance in Appendix B on risk adjustments is sufficiently detailed.

**Question 6 – Residual/composite margin**

- (a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?
- (b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?
- (c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?
- (d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?
- (e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?
- (f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

**EFRAG's response**

- **EFRAG agrees with the proposed method for measuring the residual margin at inception and agrees that no gain should be recognised at the inception date. However, losses on initial recognition should be recognised immediately.**
- **EFRAG believes that the residual margin should be measured at portfolio level as all other building blocks.**
- **EFRAG agrees with the IASB's proposals regarding the pattern of release of the residual margin. However, in EFRAG's view the residual margin should be adjusted to offset the changes from remeasurement of the present value of the fulfilment cash flows.**
- **EFRAG disagrees with the accretion of interest on the residual margin.**

*Question 6(a) – No gain at initial recognition*

- 53 EFRAG agrees that an insurer should not recognise any gain at initial recognition of an insurance contract, because:
- (a) This is in line with the selected measurement attribute of fulfilment value and the fact that the insurer is not earning any profit at inception but over the coverage period;
  - (b) The residual margin represents the estimated margin that will be earned during the term of the contract.

*Question 6(b) – Losses recognised at initial recognition*

- 54 We agree with the proposals in the ED that a loss at initial recognition of an insurance contract should be recognised immediately in profit or loss when the present value of the expected future cash outflows plus the risk adjustment exceeds the present value of expected future cash inflows. It would not be appropriate to defer losses over the coverage period. A loss on initial recognition is different to a residual margin as an initial loss does not relate to the reward the insurer earns from bearing risk and fulfilling the contract.

*Question 6(c) – Level of aggregation*

- 55 As we indicated in our response to Question 2, EFRAG considers that the level of aggregation for the measurement of insurance contracts should generally be at the portfolio level. Also the risk adjustment should be measured at the portfolio level (Question 5).
- 56 Because the residual margin is a product of components that will be measured at the portfolio level we consider that the residual margin should also be measured at the portfolio level.

*Question 6(d) – Release of the residual margin*

- 57 EFRAG agrees that the residual margin generally should be released in a systematic way that best reflects the exposure from providing insurance coverage.
- 58 However, we do not agree with the IASB's proposals regarding the release of the residual margin. In EFRAG's view the residual margin should be adjusted to offset changes from the remeasurement of the present value of the fulfilment cash flows. Any expense arising from a remeasurement of the present value of fulfilment cash flows that exceeds the residual margin should be recognised immediately in profit or loss. Thus, the residual margin cannot become negative. However, if the change in estimates reverses in subsequent periods, the residual margin should be reinstated.
- 59 Our reasons for this view are detailed below:
- (a) In EFRAG's view, not allowing income and expenses resulting from the remeasurement of the fulfilment cash flows to be offset against the residual margin can lead to counterintuitive results. For example, under the proposals in the ED, an adverse change in the estimate of fulfilment cash flows arising from a portfolio of insurance contracts will result in a loss being recognised immediately in profit or loss. However, profit from the residual margin attributable to that same



portfolio of contracts will continue to be recognised in that period and over the remaining coverage period.

- (b) We consider that adjusting the residual margin for changes in estimates of future fulfilment cash flows is consistent with the methodology used at initial recognition of the insurance contract. At initial recognition the residual margin was calculated as the difference of these future estimates and the future premiums receivable. At a point in time estimates of future cash flows will change and therefore it seems consistent with the calculation at initial recognition, to adjust the residual margin in line with these re-estimates. We consider that the adjusted residual margin would better reflect the insurer's view of the profitability of the contract given current information. The adjustment should be both positive and negative up to the 'unearned' amount of the residual margin.

60 In order for subsequent measurement of the residual margin to be consistent with its measurement at initial recognition, EFRAG believes that changes in the assumptions/estimates relating to the current period or prior periods should be distinguished from changes impacting the insurance contracts future/expected profitability. As a result changes in assumption/estimates that have an impact on the current period or prior periods should be reflected in profit and loss. Changes in assumptions/estimates that have an impact on future periods should lead to an adjustment in the residual margin. This is consistent with the requirements on accounting for changes in estimates in IAS 8.

61 We also understand that from a user perspective, a residual margin that is released independently of the movements in the other building blocks does not provide useful information. EFRAG acknowledges that adjustments to the residual margin must be transparent and therefore must be accompanied by appropriate disclosure.

62 As we noted in our response to Question 1, we believe that the proposals as currently drafted do not offer a complete approach to performance reporting by insurers. We would recommend that the IASB consider the possible role of adjusting the residual margin in addressing this issue.

*Question 6(e) – Release of the composite margin*

63 As we indicated in our response to Question 4, EFRAG does not support the composite margin approach. On this basis and in line with our response to Question 6(d) above we do not support the method of accounting proposed for the release of the composite margin.

*Question 6(f) – Accretion of interest on the residual margin*

64 The residual margin represents the difference between the present value of fulfilment cash flows and the premium at inception and thus depends on the measurement of the other building blocks.

65 If a change in assumptions/estimates leads to an adjustment to the residual margin the accretion of interest would be inconsistent with our view that the residual margin should only be remeasured for changes in assumptions/estimates.

### Question 7 – Acquisition costs

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?

### EFRAG's response

- **EFRAG agrees that incremental acquisition costs should be included in the present value of the fulfilment cash flows. We believe the level of measurement is the portfolio as we support a uniform level of measurement.**
- **EFRAG considers that the term 'incremental' should be clarified as divergence in practice would otherwise arise.**
- **EFRAG believes that the IASB should address accounting for contract acquisition costs as a cross-cutting issue.**

#### Acquisition costs included in estimate of fulfilment cash flows

- 66 EFRAG agrees that acquisition costs should be included in the initial measurement of the insurance contract as contract cash outflows for the following reasons:
- (a) In EFRAG's view, acquisition costs are a necessary and unavoidable part of the fulfilment costs of the contract;
  - (b) On the basis that acquisition costs are compensated by the premiums paid under an insurance contract, then expensing acquisition costs on initial recognition would be inconsistent with recognising the attributable compensation when the residual margin is released. In EFRAG's view recognising a day one loss on an otherwise profitable contract does not provide useful information.

#### Incremental acquisition costs only

- 67 EFRAG agrees that only acquisition costs that relate to recognised insurance contracts should be included in the estimate of cash flows. We therefore agree that acquisition costs relating to unsuccessful underwriting should be expensed as they do not relate to a recognised insurance asset or liability. Likewise, we agree that if the contract pricing is insufficient to recover all of the relevant acquisition costs, a loss should be recognised at initial recognition.
- 68 EFRAG therefore agrees that acquisition costs should be limited to incremental costs. We consider that acquisition costs relating to successful insurance contracts should form part of the contractual cash flows if those costs can be clearly identified as relating specifically to the contracts.
- 69 However, we do not agree to limit the measurement of acquisition costs to the level of the individual contract. As we indicated in our response to Question 2, EFRAG believes that the level of measurement for insurance contracts is the portfolio and this should be consistently applied.
- 70 We also note that the term 'incremental' may be subject to different interpretations. Some believe that the reference to 'incremental costs' includes 'directly attributable costs'. However, EFRAG believes incremental costs should only include costs that are

payable on acquisition of a contract. We therefore recommend that the IASB include explicit guidance on identifying 'incremental costs' in the final standard.

- 71 Contract acquisition costs are not unique to insurance contracts, but also arise in other industries. Therefore, we believe that the IASB should address this cross-cutting issue also in the context of other accounting standards.

## SHORT-DURATION CONTRACTS

### **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?

### **EFRAG's response**

- **EFRAG believes that a modified measurement approach should only be allowed for short-duration contracts with a coverage period extending to around one year.**
- **EFRAG considers the modified measurement approach for the measurement of a pre-claims liability on certain short-duration contracts is an acceptable measurement methodology as it is a reasonable proxy for the full measurement model proposed in the ED. We do however have concerns as to whether the modified approach represents a simplification over the full measurement model.**
- **EFRAG considers that the modified measurement approach should not be a requirement for short-duration insurance contracts. Instead an insurer should be able to apply the full measurement model proposed in the ED to all insurance contracts.**
- **We do not believe that the pre-claims liability should accrete interest.**

- 72 The ED proposes a modified measurement approach for the pre-claims liabilities of some short-duration contracts. We understand that under this measurement approach the pre-claims liability of an insurance contract is measured separately (and differently) from (post) claims liabilities. The pre-claims liability is measured as the unearned premium and allocated to profit or loss, following the same principle as for the release of the residual margin. The claims liability is measured on the same basis as other insurance contracts, except that no residual margin is included. Together they constitute the balance sheet liability.

- 73 We agree that the use of the premium allocation approach should be limited as the method is an exemption. We therefore agree that the proposed modification should be for short-duration contracts only. We note that in some jurisdictions legal requirements extend the coverage period of one-year contracts by several weeks. We therefore agree with the IASB that the exemption should cover contracts with a coverage period of up to approximately one year.

- 74 We understand that the IASB has proposed this approach because it is a simplification to the full measurement approach, but still provides a reasonable proxy of the present value of the fulfilment cash flows and the residual margin for some insurance contracts. We therefore agree with the IASB's objective to provide a pragmatic, simplified approach for certain short-duration contracts. However, given the need to estimate the post claims liability on the same basis as longer duration insurance contracts, we question whether the proposals result in any significant level of simplification.

- 75 In addition, EFRAG does not agree that the premium allocation approach should be mandatory for relevant contracts. In our view, the premium allocation approach represents a proxy for the full measurement methodology and therefore should not preclude a reporting entity from applying the full methodology which, in our view, would provide similar but more accurate measurement results. We do not consider that allowing some entities to provide more accurate measurements under the full methodology would impede comparability. In fact it would enhance comparability between insurance contracts held by that entity.
- 76 The ED does not address whether the modified measurement approach could also be applicable when measuring a reinsurance asset. EFRAG believes that the modified measurement approach should also apply to reinsurance assets in order to maintain consistency with the accounting for the primary contract. However, this approach should only apply to reinsurance contracts when the primary contract is a short-duration contract in accordance with the proposals.
- 77 We generally think that the accretion of interest on the pre-claims liability should be consistent with the treatment of the residual margin within the full current measurement approach. For this reason and because the premium allocation approach is a simplified measurement approach, we believe that the pre-claim liability should not accrete interest.

#### **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?

#### **EFRAG's response**

- **EFRAG supports the contract boundary as defined in the ED.**
- **In order to achieve a consistent application, the IASB should provide more extensive application guidance.**

- 78 As we discussed in response to Question 2(a), EFRAG supports the IASB's decision to recognise and measure insurance contracts on the basis of the net cash flows arising from each contract. An insurance contract reflects a bundle of rights and obligations that include options held by a policyholder to cancel or renew a contract.
- 79 EFRAG also supports the proposed definition of a contract boundary. We support the incorporation of criteria based on the insurer's contractual ability to re-price an insurance contract based on a reassessment of the risk of the particular policyholder. We believe that the ability to re-price as a result of such policyholder risk is a key element in determining the contract boundary.
- 80 We suggest the Board considers including as application guidance some examples regarding specific insurance contracts in order to ensure consistent application in practice.

- 81 Paragraph BC57 of the ED explains that an ability to re-price that does not mean a reassessment of the individual policyholder's risk profile will lie within the boundary of an existing contract.
- 82 However, different contracts may contain different features, for example in group insurance policies the policyholder may not be clear. In these contracts individual policies are part of the overall contract and it is not clear if the risks of those individual policies should be taken into account to define the contract boundary. We think in this case the contract boundary is assessed at the group level. There may be other examples. Therefore the definition should be more clear, or the IASB should provide more extensive implementation guidance.

## PARTICIPATING FEATURES

### 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?

### EFRAG's response

- **EFRAG agrees that the liability for discretionary participation features should be measured on an expected cash flow basis.**
- **We agree that financial instruments with discretionary participation features should be within the scope of the insurance standard since the inclusion results in consistent treatment of these features with similar features in insurance contracts.**
- **We consider that all financial instruments with discretionary participation features should be measured consistently. We therefore disagree that only financial instruments with discretionary participation features that share the performance of a pool of assets with insurance contracts with discretionary participation features should be within the scope of the insurance standard.**

- **We agree to the definition of discretionary participating features, except for the provision that there should also exist insurance contracts that provide similar contractual rights. We believe the same accounting treatment should be extended to all similar benefits.**
- **The modifications regarding the investment contracts with discretionary participating features are appropriate.**

*Question 10(a) – Measurement of insurance contracts includes participating features*

- 83 EFRAG agrees that the expected cash outflows from discretionary participation features should be included for measurement purposes in the estimation of the future cash flows of an insurance contract, because they are integral to the contract.

*Question 10(b) – Financial instruments with discretionary participation features are in the scope*

- 84 Although financial instruments with discretionary participating features do not transfer significant insurance risk we agree that these contracts should be in the scope of the insurance accounting standard because:
- (a) The inclusion results in the consistent treatment with similar participating features in insurance contracts;
  - (b) In EFRAG's view the current provisions of IAS 39 and the proposed provisions relating to liabilities in IFRS 9 would not provide the most representative measure for contracts with discretionary participation features. For example splitting the complex package of independent options and guarantees into its components may not provide a faithful representation of the contract as a whole.

*Question 10(c) – Investment contracts participate along with insurance contracts*

- 85 As indicated above, we agree with the IASB's proposal to include financial instruments with discretionary participation features within the scope of the insurance standard. We therefore do not understand why the IASB proposes to limit the scope-in to such contracts only if they share the performance of the same pool of assets as do participating insurance contract.
- 86 In our view, if discretionary participation features are to be treated consistently whether they are embedded in insurance contracts or financial instruments, it should not be restricted to situations where both participate in the performance of the same pool of assets. For that reason we would not support making the scope-in subject to this restriction.

*Question 10(d) – Modification of the measurement provisions for financial instruments with discretionary participation features*

- 87 EFRAG considers that the proposals in the ED to modify the measurement requirements regarding contract boundaries and the release of the residual margin are appropriate.
- 88 As financial instruments with discretionary participating features do not include significant insurance risk it follows that the contract boundary of such contracts cannot be defined by reference to insurance risk. We consider that setting the contract

boundary at the point where the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature is appropriate.

- 89 We also agree that linking the release of the residual margin to the asset management service is appropriate.
- 90 We note that paragraph B61(j) of the ED refers to future policyholders. It is not clear from the ED why future policyholders, with whom an insurer does not yet have a contractual relationship, would be relevant. We understand that this guidance is relevant to DPF contracts with unallocated surpluses which exist in, for example, the UK and Sweden. We believe that the IASB should clarify the purpose of the guidance in the ED and also whether unallocated surpluses are part of the liability or equity.

## DEFINITION AND SCOPE

### 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?

### EFRAG's response

- **EFRAG believes that the IASB should retain the definition of an insurance contract as currently included in IFRS 4 as it has worked well in practice, and the changes in the definition may cause certain contracts to be excluded.**
- **EFRAG agrees with the exclusion of some fixed fee contracts but we believe that the criteria for exclusion of fixed fee contracts from the scope of the standard are not clear enough.**
- **Given the practicability concerns regarding the application of the insurance contracts proposals to all 'financial guarantee contracts', we believe it is better to retain the current option in IAS 39 which has worked well in practice.**

- 91 The definition of insurance contract is largely the same as the definition in the current IFRS 4. The additional requirement to take into account the time value of money affects the assessment of the significance of insurance risk and improves the ability to differentiate between a financial contract and an insurance contract. We understand that making this requirement explicit is not intended to change current practice under IFRS. However, several constituents have raised concerns that it will. Therefore, we recommend that the IASB not change the wording of the definition, which has worked well in practice.
- 92 Although financial instruments with discretionary participating features do not include significant insurance risk we agree that these contracts should be in the scope as the



inclusion results in the consistent treatment with similar participating features in insurance contracts. Please see also our comments regarding Question 10.

- 93 Regarding the exclusion of fixed-fee service contracts we note that the distinction between contracts is not clear-cut. Fixed fee service contracts will often meet the definition of an insurance contract and we understand from the Board's reasoning in paragraph BC209 of the ED that contracts issued by companies that provide services should be excluded, if providing such services is the main purpose of the contract. However, paragraph 4(e) requires an insurer that has insurance contracts in which goods and services are provided for insured events to apply the insurance standard. We think the Board should clarify the wording, as it is ambiguous and likely to result in many implementation issues.
- 94 We understand that some financial guarantee contracts are currently out of the scope of IFRS 4 for practical reasons.
- 95 We note that 'financial guarantee contracts' as issued by banks and 'credit insurance contracts' as issued by insurers could both meet the definition of an insurance contract. We acknowledge that it is generally desirable to have similar accounting for similar contracts. However, the existing guidance that only requires insurers to apply insurance accounting has worked well in practice. Therefore, given the practicability concerns regarding the application of the insurance contracts proposals by non-insurers, we believe it is better to retain the current option in paragraph 2(e) of IAS 39.

## UNBUNDLING

### 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?

### EFRAG's response

- **EFRAG agrees that unbundling can enhance the usefulness of information by increasing transparency and comparability if components are not related to the insurance contract.**
- **EFRAG is concerned that the term 'closely related' is not clearly defined and we would like to understand why the IASB has changed the wording from cash flows which are 'significantly interdependent' to cash flows which are 'closely related'.**
- **The underlying principle should be further clarified as unbundling can appear contradictory to the decision in the proposals not to split insurance contracts into different components.**
- **We suggest the IASB considers that if an insurer manages separately different components of a product, then unbundling may be appropriate. If they are managed together then they may be considered as one contract.**

- 96 As we indicated in our response to Question 2, EFRAG agrees that the measurement of an insurance contract should combine both cash inflows and cash outflows generated by its insurance, financial and service elements. However, EFRAG

recognises that in some circumstances unbundling the non-insurance components can increase transparency allowing users of financial statements to get an insight into the non-insurance components of insurance contracts.

- 97 EFRAG believes that unbundling is appropriate when separate recognition and measurement of the components better reflects the substance of the instrument and thus provides more useful information. We agree with the IASB that proposing unbundling when components are not closely related to the insurance coverage is heading in the right direction. Where components are not closely related to the insurance coverage, measuring cash flows arising from the non-insurance component as if it was an insurance contract would not produce relevant information. In addition comingling those cash flows with insurance related cash flows can obscure the true nature of the risks arising from both the insurance and financial component.
- 98 However, we consider that the proposals in the ED do not go far enough to provide guidance on how to interpret the term 'closely related'. In particular we are concerned that the guidance in paragraph 9(a) that introduces the term is made-up primarily of specific examples. However, specific examples may not sufficiently cover the nature of contracts to be considered. We also note the difficulties encountered by constituents in interpreting a similar requirement for embedded derivatives in paragraph 11(a) of IAS 39. So although we agree with the examples in paragraph 8(a) of the ED, we consider that further guidance may be needed.
- 99 We note that in paragraph 9, the ED proposes to require that an entity separate charges and fees from the investment component, while in paragraph 8 the investment results should be considered net of fees and charges. We recommend that the IASB clarify which charges are meant in each paragraph.

## PRESENTATION

### **Question 13 – Presentation**

- (a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?
- (b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

### **EFRAG's response**

- **EFRAG supports the proposals for the presentation in the balance sheet.**
- **EFRAG also supports a margin based approach for the statement of comprehensive income because it is driven by the measurement model and because margins provide decision-useful information.**
- **EFRAG considers that volume information, such as premiums written, claims expenses, and claims handling expenses, should be presented on the face of the statement of comprehensive income for all insurance contracts together with the underwriting margins. Thus, we are in favour of a margin approach combined with volume information**
- **We do not think the expanded margin approach as developed by the IASB is appropriate as the numbers are contrived.**

- **EFRAG does not support the proposal to require all income and expenses arising from insurance contracts to be reported in profit or loss. In our view, income and expenses arising from certain changes in estimates should be offset against the residual margin for measurement purposes, although not necessarily for presentation purposes.**
- **Where participating features relate to equity securities measured at fair value through OCI, it may be appropriate to report some income or expenses in OCI.**

100 EFRAG agrees with the IASB's proposal for presentation of insurance contracts in the balance sheet as a net presentation of the rights and obligations arising from insurance contracts.

101 We broadly support a margins-based model for the presentation in the statement of comprehensive income because we consider that such an approach provides the best link with the measurement model proposed in the ED.

102 However, EFRAG does have concerns about how this has been developed into the summarised margin approach. These concerns are detailed below.

Volume information should be presented on the face of the income statement

103 We understand that volume information about insurance contracts has historically been reported on the face of the statement of comprehensive income by many entities. Such reporting presents insurance contracts' inflows (e.g. premiums) as revenue and the outflows (e.g. claims, claims handling costs, etc) as expenses. Paragraph 74 of the ED proposes that volume information will no longer be allowed to be presented on the face of the income statement.

104 EFRAG considers that both margin and volume information is key to understanding the performance of an insurer and should be included in the financial statements for the following reasons:

- (a) We consider it provides, in many cases, valuable information about the level of activity of the insurer. As indicated in paragraph AV13 of the ED we believe that 'Insurance can be described as being paid to assume risk, reimburse insurance claims, have some internal expenses and possibly earn a financial return between the payments of premiums and claims'. We agree with those Board members that consider that financial statement presentation should reflect this information.
- (b) In our view gross flows are easier to predict than the net flows. Similarly, an increase in the net profit could result from an increase in margins or an increase in volume, but this would be difficult to determine if information about the gross cash flows was not transparent.

105 However, we also recognise that margin information is better suited to some insurance products (e.g. life products) and revenue (volume) information better suited to others (e.g. non-life products). For example, revenue is less informative for products with a deposit component, since these deposits may increase revenue, which is based on the level premiums, but does not provide any information about profitability<sup>2</sup>. Profitability is

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<sup>2</sup> Although the deposit element may become a component of profit if it reverts to the insurer on (untimely) death.

better presented by the margins approach and links directly into movements in the balance sheet, but it does not provide information about the level of activity of the insurer.

- 106 EFRAG is currently considering alternative presentation approaches that combine volume and margins information for both life and non-life contracts. At this stage the alternative proposals still require further work and consultation in accordance with our due process. EFRAG will discuss these proposals in its January 2011 meeting and will communicate its findings to the IASB at a later stage.
- 107 We note that the views expressed in this comment letter with respect to presentation of insurance contracts do not relate to views that we may have with respect to the project for financial statement presentation.

#### Optional presentation approach for short-duration contracts

- 108 The ED proposes to require a pure margin approach for the presentation of insurance contracts, other than short-duration contracts that meet the conditions in paragraph 54 of the ED. It is proposed that these short-duration contracts should be accounted for under the premium allocation approach (as specified in paragraphs 55-60 of the ED). In terms of presentation of short-duration contracts, the ED requires that a reporting entity presents the underwriting margin on the face of the statement of comprehensive income, but also gives the entity the option to disaggregate that margin into volume information on the face of the statement of comprehensive income (see paragraph 75(a) of the ED).
- 109 EFRAG does not support a mandatory application of the modified measurement approach, but no alternative presentational methods should be allowed for insurers that apply this approach as that would reduce comparability. For example, if a company uses the approach in paragraph 75 for its short-duration contracts, the amounts shown in the statement of comprehensive income of that company (e.g. premium income) may be disproportionately high in comparison to similar companies that did not use the approach. In addition, it will make presentation between the long-duration and short-duration businesses inconsistent. That is, the long-duration business will only be presented in the statement of comprehensive income by the release of margin which is not comparable with the 'gross flows' presentation provided for short-duration contracts. We therefore consider that the approach in paragraph 75(a) of the ED should be a required presentation on the face of the statement of comprehensive income as we also prefer it for long-duration contracts.

#### Information to be provided in the statement of comprehensive income or in the notes

- 110 Sub-paragraphs 72(a), (b) and (d) of the ED provide reporting entities with the option to present relevant measurement results on the face of the statement of comprehensive income or in the notes. Unlike volume information, we do not consider that disaggregated information set out in paragraph 72 is necessary on the face of the statement of comprehensive income. We are in favour of a concise income statement as possible. In addition, we consider that the provision of options decreases comparability. We therefore consider that the disaggregation options in paragraph 72 should be required disclosures only.

#### All income and expenses recognised in profit or loss

- 111 Paragraph 76 of the ED provides that all income and expenses from insurance contracts should be recognised in profit or loss. EFRAG has two concerns arising from this proposal, which we discuss below.

Changes in estimates offset against the residual margin

- 112 In accordance with our response to Question 6 of the ED, EFRAG considers that certain income and expenses that arise from changes in the present value of the fulfilment cash flows should not be reported in profit or loss, but rather should offset the residual margin.

Other comprehensive income (OCI)

- 113 The IASB proposes not to allow any changes in value of an insurance contract to be reported in OCI. However, because the changes in the fair value of equity securities can be reported in OCI in accordance with IFRS 9, there is a concern that an accounting mismatch could be created. This would occur, where under the terms of an insurance contract (or certain financial instruments) with participating features, the insurer will recognise the change in the equity instruments in OCI, while the change in the linked participating feature will be recognised in profit or loss.
- 114 EFRAG acknowledges that this mismatch could be significantly mitigated by the insurer not electing to classify the equity security at fair value through OCI, but instead reporting it at fair value through profit or loss. However, if it is appropriate to allow the use of OCI in IFRS 9, insurers should not be deprived from that election because it would create an accounting mismatch.
- 115 We refer to our response to Question 1 with regard to the presentation of the performance of an insurer, the adjustment of the residual margin and the use of OCI to achieve an adequate presentation.

Other comments

- 116 With respect to paragraph 72 of the ED, we are uncertain where a change in the estimate of the risk adjustment would be presented. We assume it would be presented in accordance with paragraph 72(d) but consider that this interpretation is not clear. We therefore recommend that the scope of paragraph 72(d) is clarified with respect to changes in estimates of the risk adjustment.
- 117 We are unsure what the IASB is trying to achieve in paragraph 73 of the ED. We think it is based on the understanding that assets and liabilities in a balance sheet are somehow linked. We would recommend the requirements of paragraph 73 are either removed or the IASB clarifies what it is proposing either through examples or further guidance.

DISCLOSURES

**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.

## EFRAG's response

- We agree with the proposed disclosure principle and broadly agree with the proposed disclosure requirements. However, we believe that the IASB should consider the balance between the principles-based approach and detailed disclosure requirements.
- EFRAG considers that volume/revenue information regarding all insurance contracts should be shown on the face of the statement of comprehensive income for all types of insurance contracts.
- EFRAG considers that the disaggregated amounts proposed as presentation requirements in sub-paragraphs 72(a), (b) and (d) should be required as disclosures in the notes.

### *Question 14(a) – Disclosure objective*

- 118 EFRAG agrees with the proposed disclosure objective, set out in paragraphs 79-80 of the ED, to provide information that enables users to understand the amount, timing and uncertainty of future cash flows arising from insurance contracts.
- 119 The IASB needs to strike a better balance between the principles-based disclosure approach and the need for detailed disclosure guidance.
- 120 Our remarks with regard to disclosures should be seen in the context of our comments on presentation in the statement of comprehensive income.
- 121 We note the proposal in paragraph 83 of the ED that information shall not be aggregated if it relates to different reportable segments, as defined in IFRS 8 *Operating Segments*. As IFRS 8 reporting is based on a reporting entity's internal reporting structure and information requirements, it seems unlikely that the summarised margin approach would form the basis for this internal reporting. Therefore, whilst we understand that the IASB wants to prohibit aggregation of information at the segment level for the purposes of the disclosure requirements proposed in the ED, we consider that such aggregation is unlikely to occur in practice and therefore the prohibition seems superfluous.

### *Question 14(b) – Explanation of recognised amounts*

#### Reconciliation of contract balances

- 122 EFRAG broadly agrees with the disclosure requirements set out in paragraphs 86 to 87 of the ED and considers they meet the disclosure objective. In our view the proposed measurement model is the fundamental basis underlying the new regime for accounting and reporting of insurance contracts. We therefore think it is critical to provide transparent disclosures about the movement, during a reporting period, in the reported values of insurance contracts.
- 123 As mentioned in our response to Question 13, we consider that volume/revenue information regarding insurance contracts is very important to the users of an insurer's financial statements. Although we recognise that the proposed disclosure requirements in paragraphs 86-87 will provide this information, we reiterate our view that this information should be shown on the face of the statement of comprehensive income for all types of insurance contracts.

124 In addition, we have the following minor concerns regarding these disclosure proposals:

- (a) There is no requirement to show ceding commissions separately, while there is a requirement to show incremental acquisition costs. We find this requirement inconsistent as these commissions are relevant information.
- (b) We see no separate line item for discounting (and unwinding). It may be covered by sub-paragraph 87(f) that requires disaggregation of income and expenses but this is not clear. We consider it should be a separate line item, since this would be much more transparent and fully in line with the building block approach;

125 We recommend to clarify the disclosure requirements by including some examples in the application guidance.

#### Methods and inputs

126 EFRAG agrees that an insurer should disclose information about the methods and inputs used to develop the measurements of insurance contracts. This information is crucial for a user to understand how and on what basis the measurement amount attributable to the contract was determined. It therefore provides information on the amounts recognised and meets the disclosure objective.

127 However, we do have the following minor comments regarding these disclosure proposals:

- (a) Paragraph 90(a) of the ED requires that quantitative information about inputs is required unless it is impracticable. Given the whole measurement model is based on quantitative inputs, we do not agree that the requirement to provide quantitative information about inputs should be limited.
- (b) Paragraph 90(d) of the ED requires a measurement uncertainty analysis of inputs that takes into account the effect of correlation where relevant. Such an analysis provides a realistic economic alternative value to the amount presented in the financial statements. EFRAG believes this is meaningful information. EFRAG also agrees that correlation is an important factor in providing a meaningful analysis of measurement uncertainty where that correlation is relevant and significant. In our view, a measurement uncertainty (sensitivity) analysis that considers correlation between inputs provides more relevant information than a similar analysis that has not taken into account the effects of correlation.

#### *Question 14(b) continued – Nature and extent of risks*

128 EFRAG broadly agrees with the proposed disclosure requirements in paragraphs 91-97 of the ED regarding the nature and extent of risks arising from insurance contracts. Given that the transfer, pricing and management of risks are fundamental to an insurer's business, we agree that disclosure about the nature and extent of risks is essential and meets the disclosure objective set out in the ED.

129 We do however have the following comments on the specific proposed risk disclosure requirements:

- (a) We refer to sub-paragraph 92(e)(iii) of the ED that requires disclosure of actual claims compared with previous estimates of the undiscounted amount of the claims (i.e. claims development). We note that the claims period may differ considerably between classes of business (e.g. fire insurance versus liability

insurance). Therefore, we suggest this requirement should be focused at the portfolio level, where homogenous risks have already been grouped.

- (b) Paragraph 94 of the ED includes a reference to 'other insurance contracts'. It is not clear to us what would be included in this category.



- (c) Paragraph 95(a) of the ED proposes that an insurer shall disclose a maturity analysis that shows the remaining contractual maturities or information about the estimated timing of cash out flows resulting from insurance liabilities. Since the measurement model for insurance contracts proposed by the IASB is based on expected values, in our view expected maturities would provide a more logical and consistent basis for this disclosure. This information would also be more readily available since it is used for measurement purposes.

*Question 14(c) – Additional disclosures*

- 130 As we indicated in our response to Question 13, EFRAG considers that the disaggregation options in paragraph 72 of the ED regarding presentation on the statement of comprehensive income should be eliminated since they compromise comparability. We therefore consider that the disaggregation of amounts proposed in sub-paragraphs 72(a), (b) and (d) should be required disclosures.

## UNIT-LINKED CONTRACTS

### **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?

### **EFRAG's response**

- **EFRAG agrees with the proposed approach for unit-linked contracts, but recommends that the IASB consider expanding the scope of the amendments to include other types of insurance contracts.**

- 131 In EFRAG's view there are two aspects to the IASB's proposals on unit-linked contracts, namely presentation and accounting mismatch.

#### Presentation

- 132 EFRAG agrees with the proposals in the ED regarding presentation. We consider that presenting assets and liabilities relating to unit-linked contracts as single line items on the balance sheet highlights to users that the assets relating to such contracts are effectively ring-fenced and are not for the benefit of other policyholders. The approach is consistent with the proposed unbundling principle, namely to require unbundling if components are not closely related. As the insurer actually holds the assets that are assigned to the policyholder in unit-linked contracts, the asset balance is not closely related to the other activities or obligations of the insurer.
- 133 Likewise, separate presentation of income and expenses of unit-linked contracts and the assets that back those contracts isolates and highlights the performance directly related to such contracts. Separate presentation of income and expenses ensures that such income is not attributed to the performance of the insurer.

### Changes to other standards to address accounting mismatches

- 134 EFRAG agrees with the proposed amendments to IAS 16 and IFRS 9 (regarding property and own shares, respectively), as it is a pragmatic way to avoid creating an accounting mismatch. However, EFRAG considers that the accounting mismatch may not be limited to unit-linked contracts only, as this issue also arises in connection with participating contracts that have substantially the same characteristics. Therefore, we recommend that the IASB consider expanding the scope of the amendments to include other types of insurance contracts.

### REINSURANCE

#### **Question 16 – Reinsurance**

- (a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?
- (b) Do you have any other comments on the reinsurance proposals?

#### **EFRAG's response**

- **EFRAG does not agree with the recognition of a gain at inception nor with the deferral of a loss that, in certain cases, would result from applying the proposals in the ED. EFRAG believes the accounting for the reinsurance contract should be aligned with the accounting for the primary contract.**

- 135 We do not agree with the IASB's proposals in the ED regarding reinsurance assets of a cedant.
- 136 In paragraph BC12(c) of the ED the Board states that the ED proposes that an insurer accounts for its reinsurance contracts in the same way it accounts for to its primary insurance contracts. However, this is not what is proposed in paragraph 43-45 of the ED.
- 137 For primary insurance contracts, the proposals in the ED prohibit recognition of a gain at inception and require that a loss on onerous contracts is immediately recognised. However, for reinsurance contracts the ED proposes that an insurer would recognise a gain if the premium ceded is lower than the fulfilment cash flows for the reinsurance contract. Also, no loss would be recorded if the premium ceded exceeded the fulfilment cash flows for the reinsurance contract plus the corresponding residual margin. We believe the IASB should align the accounting for reinsurance contracts with the accounting for primary insurance contracts.
- 138 We note however, the definition of a reinsurance contract in Appendix A. We consider that a reinsurance contract is an insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more insurance contracts issued by the cedant. If the contract compensates for losses on a non-insurance contract, e.g. for losses on a financial instrument, this would be a normal insurance contract and therefore from a policyholder perspective outside of the scope of the proposed standard.

## TRANSITION AND EFFECTIVE DATE

### Question 17 – Transition

- (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.

### EFRAG's response

- **We disagree with setting to zero the residual margin for contracts in force at transition.**
- **The standard should require retrospective application in accordance with IAS 8.**
- **In order to minimise the operational burden it is crucial that insurance companies will have the opportunity to apply IFRS 9 and the final insurance contracts standard at the same time. The ability to redesignate financial assets at the time of adoption of the new standard on insurance contracts is less preferable but it should be allowed.**

### *Question 17(a) – IASB's proposed transition approach*

- 139 EFRAG disagrees with the proposal in sub-paragraph 100(a) of the ED to set the residual margin to zero for insurance contracts reported at the transition date. In our view, such treatment prevents insurers from reporting a potentially significant part of the profits on existing contracts through profit or loss and reduces comparability between the results on existing and new business. After transition, profit arising from the release of the residual margin would only relate to insurance contracts entered into after the transition date. To the extent that the level of pre-transition insurance contracts remains significant after transition, we do not consider such reporting would fairly reflect the performance of the insurer. In addition, we are concerned that these transitional rules may reduce the usefulness of financial statements for many years in the case of long-term insurance contracts.
- 140 We recognise that the IASB proposed this transition approach (e.g. eliminating the residual margin for existing contracts) for practical reasons. We understand that the IASB was concerned that a residual margin on existing contracts could not be recreated at the date of transition without undue cost and the use of hindsight (see paragraph BC247 of the ED). In EFRAG's view it is inappropriate to seek to minimise the use of hindsight at the expense of providing relevant information. This is because we consider that in many circumstances the use of hindsight can be less harmful than the dramatic reduction in the comparability of the financial information.

- 141 We consider that the transition provisions in a final insurance standard should require IAS 8 to be applied. This means full retrospective application or application from the earliest date possible if full retrospective application is impracticable. In accordance with IAS 8, individual entities will assess whether they are able to apply the provisions of the new standard retrospectively or not, considering the potential use of hindsight and considering whether the costs outweigh the ongoing benefits to users.
- 142 We share the concerns of the IASB with regard to retaining the difference between carrying amounts under previous accounting standards and the first three building blocks as residual margin, as the profits that would be carried forward would not be comparable between insurers and would not reflect profits under the new proposals. We agree that the IASB rejected this approach for the reasons given in paragraph BC 249.

*Question 17(b) – FASB’s proposed transition approach*

- 143 The FASB proposes that upon transition the composite margin would be set equal to the risk adjustment determined under the IASB’s approach. This risk adjustment would not be subsequently remeasured.
- 144 EFRAG does not consider that this will put an insurer in a significantly different position to the IASB’s transition proposals, except that on an ongoing basis the composite margin/risk adjustment at the transition date would not be remeasured. Given our view that a risk adjustment should be subsequently remeasured (see our response to Question 5) and our response to the IASB’s transition proposals regarding the residual margin (Question 17(a) above) we do not agree with the FASB approach.

*Question 17(c) – Interaction with IFRS 9*

- 145 In EFRAG’s view, it is crucial for users (in terms of comparability) and preparers (in terms of operational burden) that insurers have the opportunity to apply IFRS 9 and the final insurance standard at the same time.
- 146 Accounting volatility that results from a differences in measurement bases, rather than economic mismatches, is misleading to users of financial statements. It is therefore important that the measurement of insurance liabilities and directly related financial assets reflects the nature of that relationship. Where that relationship is not reflected i.e. where offsetting financial assets and insurance liabilities are measured on a significantly different basis, accounting volatility in profit and loss would be created.
- 147 In order to avoid an accounting mismatch, insurers should be able to designate the measurement classification of financial assets in a way that best reflects their relationship with insurance liabilities e.g. minimises the measurement mismatch. It follows, that the classification decision on the asset side cannot be made before the accounting treatment of insurance liabilities is certain.
- 148 If effective dates for the insurance standard and IFRS 9 do not align, insurers should be given the ability to redesignate financial assets at the time that the new insurance standard is adopted. However this approach would not be EFRAG’s preference since:
- (a) It would be confusing for users if an entity adopts IFRS 9 in one period and a later period reclassifies some of its financial assets;

(b) It would impose an additional operational burden on the insurer who needs to create two transition dates, one under IFRS 9 for its financial assets and financial liabilities and another for its insurance contracts.

149 EFRAG therefore believes it is more efficient and effective to require insurance companies to adopt IFRS 9 and the final insurance standard at the same time.

150 If the IASB proceeds with proposals that allows or requires different transition dates for IFRS 9 and the insurance standard, but that allows redesignation of financial assets and financial liabilities upon adoption of the insurance standard, we consider that an insurer should not be bound by any previous designations under IFRS 9. That is designations at fair value through profit or loss using the fair value option, at amortised cost or at fair value through OCI, should be allowed to be reversed and redesignated at the date of transition for the new insurance standard

*Question 17(d) – Expected period required for adoption*

151 Insurers, in particular insurance companies, will need a reasonable period of time in order to adopt the new standard. It will be in the interest of all stakeholders for the IASB to allow a reasonable transition period in order to ensure a high quality application of this complex standard.

OTHER COMMENTS

**Question 18 – Other comments**

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

**EFRAG's response**

152 EFRAG has no further comments.

## BENEFITS AND COSTS

### **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.

### **EFRAG's response**

- **EFRAG is of the opinion that this standard is very important and we are convinced that – provided the issues regarding performance reporting are addressed – the benefits will exceed the costs of the implementation of this standard.**

- 153 EFRAG considers that a consistent and comprehensive IFRS for insurance contracts is urgently needed. Currently IFRS 4 allows insurers to keep using pre-existing accounting policies for their insurance contracts. The financial impact of these policies is included in IFRS financial statements. This means that some entities use local accounting standards, others use foreign standards (e.g. US GAAP) and some international groups may even use combinations of different local accounting standards. This significantly impedes the comparability of companies within the insurance sector.
- 154 Given this current situation, we understand there is a strong commitment to developing a new comprehensive standard on insurance contracts from both insurers and users of insurers' financial statements. Such support makes the cost/benefit trade off more favourable than would normally be the case for an improvement to an existing regime. Consequently, we strongly encourage the IASB to move forward with this project.
- 155 We note that our final assessment of the benefits of these proposals will depend on how the issues regarding performance reporting by insurers have been addressed in the final standard.