



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

October 24, 2013

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

Dear Sir,

Re: IAA comments on the IASB 2013 Exposure Draft *Insurance Contracts* (ED/2013/7)

In response to the request for comments on the Exposure Draft *Insurance Contracts* (the ED), I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations.

These comments have been prepared by the Insurance Accounting Committee of the IAA. If, upon reading these comments, you identify any points that you wish to discuss or obtain further insight, please do not hesitate to contact Francis Ruygt, chairperson of that committee, care of the IAA secretariat. We have been pleased to have provided assistance to the IASB Board and staff on this project and we look forward to providing further assistance as the IASB moves to finalizing the revision to its final standard. The IAA will be pleased to develop the ideas presented in this comments further with you.

Yours sincerely,

Kurt Wolfsdorf
President

[Attachment](#): IAA comments

Comments by the International Actuarial Association on the IASB 2013 Exposure Draft *Insurance Contracts* (ED/2013/7)

International Actuarial Association and its Due Process

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our sixty-four Full Member actuarial associations, listed in [Appendix B](#) to this statement, represent more than 95% of all actuaries practicing around the world. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact on the areas of expertise of actuaries.

The IAA is pleased to be given the opportunity to provide input to the IASB on this important Exposure Draft. These comments have been prepared by its Insurance Accounting Committee, the members of which are listed in [Appendix C](#) to this statement. It has also been subject to the due process required for it to constitute a formal view of the IAA, and will be posted to the IAA’s official web site

General Comments

Overall, the IAA supports the model proposed in the IASB Exposure Draft for all insurance contracts within the scope of the ED. We agree that the fundamental objective of the measurement of insurance contracts should be to use a current value approach that incorporates all of the available information in a way that is consistent with observable market information. To the extent practical, the overall measurement principles that underlie the final insurance contracts standard should be grounded in sound economic principles and reflect the business model of the reporting entity. While the revised proposal goes a long way to eliminating inconsistencies between financial reporting and economic reality, there are still several areas where the proposed standard conflicts with these principles and with the desired level of transparency.

Our primary recommendations and comments regarding the Exposure Draft on insurance contracts are as follows.

1. *Contractual Service Margin*: While we support the general approach to updating the CSM, we believe that the detailed approach proposed runs counter to the underlying principles and adds unnecessary practical complications to what is essentially a simple concept. Conceptually, the CSM is the present value of amounts to be released into revenue over the life of the contract in proportion to the expected delivery of services. These amounts should be discounted on the same basis as the fulfilment cash flows. They should be updated to absorb future changes in estimates of those fulfilment cash flows. Where there is objective evidence that projected service delivery in the current period has been brought forward from or deferred to future periods, the CSM releases should be similarly brought forward or deferred, as is the case in, for example, a construction contract, where revenue is released in accordance with the stage of completion. We believe that the currently described distinction between items that impact the CSM and those that do not is not clear, and that a significant expansion of the text in B68 is needed. In particular, under the FVOCI approach, this text should explicitly describe the impact on the CSM of:
 - cash flows that use the mirroring approach (effects from the change in the carrying amount under 34(a) are entirely reported in P&L or OCI);
 - cash flows that are not measured under the mirroring approach but vary with returns on underlying items (effects from changes in the underlying items to the cash flows and the applied interest according to 26(a) are entirely reported in P&L);
 - cash flows or discount rates determined entirely using market variables (effects from changes in market variables are entirely reported in P&L); and
 - all other cash flows.

2. *Contracts with participation features:*

- We support the concept of considering underlying items in the measurement of dependent liabilities in order to eliminate accounting mismatches where there is no economic mismatch. However, we believe that the standard should be principles based and the guidance, specifically in paragraphs B85 and B86, should not prescribe or indicate preference for a specific valuation technique to achieve that objective. In particular, although decomposition of cash flows is one approach, we do not favour it because it is not only too complex to apply and understand, but also difficult if not impractical to implement, while not providing additional information.
- The approach of adjusting the CSM should allow for changes in the insurer's share of returns on underlying items (including mortality, administration cost, reinvestment, and asset gains and losses) to be reflected in the CSM. Such amounts should then be recognised over the coverage period in a manner consistent with the provision of services under the contract.
- The criteria to determine whether to apply the concept of mirroring are too strict and do not embrace the wide variety of business models and products with participation features that can be found around the globe.
- The intent underlying paragraphs 33 and 34 would be better achieved if the discount rate applied in the P&L is consistent with the P&L presentation of the investment income from actual assets.
- We do not support the requirement in paragraph 66(b) to present changes in the measurement of embedded derivatives in the P&L. We believe those embedded derivatives in insurance contracts that are not separated, should be measured and presented in a manner consistent with the other cash flows.

3. *Presentation (OCI):* The requirement in the proposed standard for presenting interest expense does not reflect the wide variety of business models within the global insurance industry. As a consequence, this may result in a presentation that does not reflect economic reality as well as being costly to implement and apply. While the proposed presentation, although appropriate under business models where insurance liabilities are matched by fixed interest assets held to maturity at amortised value, this is not the only business model adopted by insurers. Non-life insurance claim liabilities, in particular, because of their uncertainty and volatility, are unsuited to this static investment model. Further, many insurers operate under a variety of business models, where assets include equities, property, derivatives, etc. or are more actively traded. In addition, in many jurisdictions, the fixed interest market is too short to allow satisfactory duration matching, and some liabilities are so long that there are no matching assets. In such cases, the FVOCI model provides no benefits to justify its considerable implementation cost and FVPL presentation provides more understandable information for users. As a result, we recommend that entities should have the ability at the portfolio level to irrevocably recognise the effects of the changes in discount rates in P&L when doing so would result in more relevant information because it eliminates or significantly reduces an accounting mismatch that would otherwise arise from recognising the gains and losses on assets and liabilities on different bases.

4. *Transition.* The idea of requiring a CSM on in-force business at time of transition is excellent and represents a significant improvement over the 2010 ED. What is currently being proposed, however, is potentially very complicated and may be impractical to implement. It is essential that a reasonable treatment of the concept of impracticality be included, as we suggest in our response to question 5. In addition, the approach for OCI at transition needs to be enhanced to provide for a fair comparison between entities subject to different accounting regimes in prior periods.

The IAA intends to provide implementation assistance for the final insurance contracts standard for use by actuaries worldwide. This assistance will include a monograph on risk adjustments that is currently under development. We have already completed monographs on stochastic modelling and on discount rates for financial reporting. These monographs, while educational and not binding guidance, should provide actuaries with assistance in implementing the final standard. In addition, we plan to develop International Actuarial Standards of Practice and International Actuarial (educational) Notes to support the technical application of the accounting standard. The goal of the actuarial profession is to provide sound and objective professional advice to our clients through

application of such actuarial standards of practice, educational background material and a rigorous professional discipline process where needed.

In the remainder of this document we first address our views on the specific questions raised in the ED, followed by other comments addressing items that are not changed from the prior ED.

Comments in response to the Questions raised in the Exposure Draft

Question 1 Adjusting the contractual service margin Relevant information for users

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:

- (a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and
- (b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

IAA Comments

In these comments the following items are discussed:

1. Overall, we believe the CSM should reflect the impact of any change in estimates affecting future profitability of the contract. The current proposals are not in line with this view and hence result in complexities and potential incorrect implementations.
2. Further, we believe that for subsequent measurement a forward looking approach based on a simplification using appropriate drivers should be allowed.
3. The approach for subsequent measurement once the CSM has become negative requires clarification.

We understand the concept as follows: The pre-claim liability can be regarded as the present value of the amounts released period by period from premiums and interest thereon. Unless a contract or portfolio is onerous, the profit in a period should be the difference between the amount released and the cost of services provided during the period. For an orderly release of profit, the amounts released in each period should appropriately reflect the value of the services provided in that period and should neither anticipate future releases nor hold over current releases.

The pre-claim liability comprises the present value of the period by period:

- expected incurred cost of claims;
- expected releases of risk adjustments; and
- releases of the contractual service margin (CSM).

Both of the first two relate directly to the services provided under the insurance contract:

- reimbursement of insured losses; and
- bearing the risk of uncertainty.

If either of the first two items changes as a result of changes in the level of assumed future experience, there will be a strain or surplus, which should not flow immediately into profit or loss, but should be released over the balance of the coverage period. The mechanism for this is to offset these changes in the CSM. This is done simply, by equating the pre-claim liabilities under the old and new assumptions, using the CSM.

If this approach is followed, profit and loss in a period will not be open to manipulation by changing assumptions about future experience.

Our understanding is that the impact of any change in estimates affecting future profitability of the contract should be reflected in the measurement of the CSM.

Based on our understanding of the concept, we have the following comments:

1. As currently stated, the CSM is not affected by changes in the risk adjustment, since this is not part of future cash flows. This is not supported by the above conceptual analysis and opens up a window for manipulation of profit and loss by perhaps the most subjective element in the valuation assumptions – the entity’s assessment of the value of risk.

The rationale for such treatment can also be based on our agreement with the statement in BC36 that the CSM represents unearned profit that should logically be adjusted for changes in the estimate of the present value of risk associated with future coverages. From this perspective, it seems entirely inappropriate, to recognize a profit or loss in current period for changes in risk adjustment relating to future coverage or future services.

We do not agree with the arguments listed in BC37 for not including risk adjustments changes as offsets in the CSM. Taking the reasons listed in order:

- a. This is correct, however, changes to present value of risk adjustments related to coverages expiring in future periods may be material, especially in the early years of long duration contracts. The approach we propose would release that part of the risk adjustment that relates to the current period *in* the current period;
- b. This runs directly counter to the reasoning that led to the conclusion that changes in future cash flows should lead to re-measurement
- c. This is untrue, if anything, the calculations are simpler if re-measurement is based on changes in estimates of fulfilment cash flows. It is straight forward to dis-aggregate changes in risk between elements that expire in the current period and changes in future period estimates
- d. This is untrue. In present value terms, the total risk adjustment released over the life of a contract is a constant. If an amount of risk adjustment is released into profit and loss earlier, there is that much less for later release, and vice-versa.

Our proposed approach can be implemented simply, by substituting “fulfilment cash flows” for “future cash flows” in paragraph 30.

2. There are other separate issues with the wording of paragraph 30, as follows:
 - (a) The likely approach for run-off of the CSM in practice. As discussed above, the CSM can be conceptually approached as the present value of a series of releases of amounts whose initial present value is the initial CSM. If this conceptual approach is followed in the specification of how the CSM is subsequently measured, it can more easily accommodate both the use of a yield curve, rather than an average discount rate, and the current discount rate approach if interest expense is not partly put through OCI.
 - (b) A further issue arises from certain types of insurance contract, where the benefits payable depend on the occurrence of events that are not, themselves, insured events. One such example is home builders warranty insurance, as required in a number of Australian states and territories. These contracts cover one set of insured events (mainly loss of progress payments) during the construction of a house, however long that might take, and a different set of insured events (emergence of defects) for a fixed period (6 years) after completion. The single premium is paid at or before the start of construction. Experience has shown that rates of completion vary substantially, depending largely on economic circumstances. If, for example, there is difficulty in financing progress payments, work can slow or halt, sometimes for years.

Such variations are automatically allowed for in the fulfilment value. We believe that the CSM should also reflect these variations, so that it, too, is earned as services are provided, if there is adequate evidence that the actual pattern of provision differs from the pattern expected at initial or previous measurement.

Our preferred position is to eliminate the use of locked-in discount rates. We also believe that for subsequent measurement of the CSM while based on principles, a simplified approach should be allowed, using an appropriate driver. We suggest incorporating this allowance in the standard.

3. In addition, we believe that paragraph 30 should more explicitly cover how changes in policy persistency (e.g. lapses / surrenders different from expected levels in a period) impact the CSM amortization pattern. Our interpretation is that the CSM amortization within a period would be updated for changes in policy persistency (i.e. it is the expected “unit” value of CSM that would be maintained at period end rather than the expected quantum before considering changes to future estimates), but this is again subject to other interpretations. Certainly the former approach is more consistent with the CSM on a lapsing contract being set to zero at the end of the period.

In order to avoid potential misunderstandings by preparers and users, we recommend including explanatory text in the future standard that the present value of future cash flows can, for certain contracts, be affected by the difference between actual experience and expected outcome of premium cessation rates during the reporting period. These changes will be unlocked through the CSM in accordance with paragraphs 30(c) and 30(d). Overall, in this regard, we believe that some more guidance may be helpful, either by expansion of the wording in the Basis for Conclusions or by illustrative examples.

4. Regarding paragraph B68(c), if this were only to refer to contracts for which the measurement approach as defined in paragraph 30, we do not agree. We note that on a portfolio basis any change in timing would automatically trigger a change in future fulfilment cash flows related to future services. It is not clear to us why in this case a delay or acceleration of the repayments of investment components should be treated differently from any other delay or acceleration for example by higher/lower lapses or higher/lower mortality experience.

Generally, we believe the definition between items that impact the CSM and those that do not is not clear, and that a significant expansion of the text in B68 is needed. In particular, under an FVOCI approach, this text should explicitly describe the impact on the CSM of:

- cash flows that use the mirroring approach (effects from the change in the carrying amount under paragraph 34(a) are entirely reported in P&L or OCI);
- cash flows that are not measured under the mirroring approach but vary with returns on underlying items (effects from changes in the underlying item to the cash flows and the applied interest according to paragraph 26(a) are entirely reported in P&L);
- cash flows or discount rates that are determined entirely using market variables (effects from changes in market variables are entirely reported in P&L); and
- all other cash flows.

5. We support the concept that the contractual service margin cannot be negative. However, paragraph 30(c) might be interpreted to require that in case of onerous contracts (CSM being zero) any improvement of the present value of future cash flows immediately causes the establishment of a CSM to the amount of the improvement. We do not agree with that. We believe that no CSM should be recognized before the improvement recovers the past losses. Our concerns are explained by the following example: At initial recognition the premium is 100, the fulfilment cash flows are valued at 90 and hence the CSM is 10. The next year (assuming no discounting and interest accretion) the fulfilment cash flows increase by 15 to 105. This results in 10 release of the CSM (bringing the CSM to zero) and hence a P&L impact of 5. The following year the cash flows decrease by 8 to 97.

Regarding CSM there are 3 possible approaches:

- a. The CSM remains zero, applying a concept that the CSM can never increase once it has become zero. Hence, the total liability becomes 97. In this case, there is 8 profit. The cumulative profit over the years is 3, which seems not in line with the concept that unearned profit should be distributed over time.
- b. The CSM becomes 8, hence the total liability becomes 105. The cumulative profit would be minus 5. This is basically a fresh start approach, which seems not to be in line with economic reality, as the loss recognised in the second year would be forwarded in the liability for the remaining years.

- c. The CSM becomes 3. This would reflect the favourable change in the fulfilment cash flows less the amount of loss recognition previously recognized. This would result in a CSM which reflects the cumulative changes in the liability.

We believe c) is the appropriate approach and suggest this to be clarified. The two other approaches are not in line with economic reality and are not consistent with the general approach for calculating and re-measuring the CSM. It can also be shown that when the opposite experience takes place that c) produces the only correct result.

On practicality, approach (c) can be implemented by just allowing CSM to go negative and continue the subsequent measurement process as provided in paragraph 30, but not including it in the liability itself. A corresponding change is required in the body of paragraph 28, as follows:

“At initial recognition, for the purposes of paragraph 18(b), an entity shall determine and, unless the portfolio of contracts that includes the contract is onerous recognise, the contractual service margin at an amount that is equal and opposite to the sum of:”

6. CSM for ceded reinsurance - The effect of changes in estimates for future assumption are offset through CSM, if any, for both the direct insurance contract and any associated ceded reinsurance contract. A problem arises regarding the asymmetry between the treatment between the direct and reinsured portion of the contract. To illustrate, if there is no CSM balance for the direct contract or if the effect of the change would be greater than the otherwise calculated CSM balance, the amount of this effect would go directly to P&L. In contrast, the same change would affect the corresponding ceded reinsurance contract differently -- the same change on the ceded reinsurance portion would be spread over the remaining service period of the reinsurance, as a negative CSM is allowed for that piece. Thus, if a contract was 100 percent reinsured and a pattern of expected loss is recognized, the gross loss in excess of the existing direct CSM would be recognized in the current reporting period, with limited offset from the reinsurance portion even though, absent a credit risk, none of that loss would belong to the insurer.

Question 2 Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

- (a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?
- (b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (i.e. using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?
- (c) recognises changes in the fulfilment cash flows as follows:
 - (i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;
 - (ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and
 - (iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example,

with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

IAA Comments

We support the concept underlying mirroring whereby cash flows dependent on underlying items (in our response to this question referred to as 'participating contracts') are measured in a manner consistent with the carrying amount of those underlying items. This is an appropriate way to eliminate accounting mismatches that does not at the same time conceal economic mismatches. The measurement should reflect the nature of the applicable contractual feature and the actual risk position of the insurer under the feature. This is consistent with the recommendations in our comment letter to the prior ED. However, while we believe that the IASB has identified appropriate principles, parts of the draft guidance for implementing mirroring lacks clarity, is complex and confusing, impractical to implement and may lead to results which do not provide useful information for the wide variety of such features offered in many jurisdictions.

In the following section we provide comments on our four primary concerns regarding issues associated with this question. In [Appendix A](#) we include our recommendations regarding other topics we believe worthy of additional consideration.

- (1) **The standard should not require the decomposition of cash flows:** The standard as currently drafted prescribes a specific technical approach for complying with the measurement principles. This requires cash flows to be decomposed between those that vary directly with the returns of underlying items, those that vary indirectly and fixed cash flows. Such decomposition is complex to determine and understand, and is likely to lead to results that are not meaningful or potentially misleading, and may be inconsistent with their source.
- (2) **Changes to the insurer's share should be taken through the CSM:** Instead of recognizing the insurer's share in expected returns on underlying items (which might include mortality, administration cost, reinvestment, asset gains and losses) in comprehensive income in the current period, the CSM should be adjusted to off-set changes of the insurer's share in returns on these items. As a result, those amounts would be recognized as revenue as they are released from the CSM over the coverage period in line with the transfer of services.
- (3) **All participating contracts should be treated consistently:** We believe that a similar measurement principle should be applied to all participating contracts in order to eliminate potential accounting mismatches. It should be possible to reflect diverse participation features in different countries in an appropriate manner. The main results of this are:
 - a. The interest expense presented in P&L would be consistent with the investment income presented in the P&L; and
 - b. There would be no immediate gross P&L impact from changes in discount rates or the carrying amount of assets.
- (4) **Presentation of embedded derivatives that are not separated:** We do not support the requirements of paragraph 66(b) of the ED in which changes in the value of embedded derivatives that are not separated are included in the P&L. We recommend that all embedded derivatives be measured and presented in a manner consistent with other cash flows of the contract.

(1) There should be no requirement to decompose cash flows

We agree with the principle that, where there is a link between cash flows and underlying items, the measurement of those cash flows should reflect the measurement of the underlying items. Nevertheless, the detailed guidance in the ED would require a decomposition of cash flows that is both complex and impractical to implement. Specifically the guidance in paragraph B85 and B86 is oversimplified and over specified with respect to the product features and services provided for many participating contracts.

As a result, we suggest including a clarification regarding the use of alternative approaches (similar to those used for replicating portfolios in paragraph B47) and to state that the standard does not

prescribe a particular technique for achieving the objective of paragraph 34. Therefore paragraphs B85 and B86 and their discussion in the Basis for Conclusion should be eliminated. In particular, approaches that are not based on decomposed cash flows but measure the contract in the aggregate by applying the building block approach, should be permitted without restriction.

(2) Changes to the insurer's share should be taken through the CSM

A key issue that the standard should address regarding participating contracts is how the insurer's share in the underlying items is accounted for. We believe that the insurer's share is an integral part of the insurer's remuneration under the insurance contract and that changes in the insurer's share of the underlying items should be taken to the CSM and consequently be recognised over the coverage period in line with the transfer of services. This would be consistent with the broad requirements of the ED that describes the CSM as representing the unearned profit that the entity recognises as it provides services under the insurance contract.

This would ensure that participating contracts are treated consistently with unit-linked contracts. We believe that the principle described above is correctly applied for unit linked contracts where the CSM is remeasured reflecting the effect of changes in the insurer's expected share in the fund, i.e., the CSM is adjusted for changes in the value of projected future fees resulting from changes in asset values. However, we believe that this principle has not been consistently applied to other contracts that depend on underlying items. Under the ED, the insurer's share in asset returns for many participating contracts would not be earned over the contract in line with the provision of services. This creates inconsistent measurement of the CSM among participating contracts. The ED differentiates between contracts where the insurer's share in the increase of the underlying item is explicit (e.g. charges under unit linked contracts) or determined collectively based on a share of the changes in the underlying items (e.g. for participating contracts). We do not believe this difference justifies a different approach to the recognition of profit between otherwise similar contracts.

In summary, there should be no difference in the manner in which profit is recognised, regardless of whether an insurer's profit is derived from explicit fees charged on a fund or whether an insurer receives a share of returns on underlying items.

(3) All participating contracts should be treated consistently

We also note that the idea behind the mirroring approach as a concept to eliminate accounting mismatches by linking the measurement of liabilities to the measurement of underlying items is appropriate and should apply to all dependent liabilities, including those not covered by paragraph 34(a). That is, it should be permissible to reflect the measurement of the underlying items in the measurement of a contract's liability. Further, paragraph 26(a) in combination with paragraph B73 states that in determining the discount rate the measurement of the underlying item (e.g., the underlying assets) is considered. This eliminates a possible accounting mismatch between discounting and changes in asset values to the extent that the dependence eliminates an economic mismatch. We propose that all guidance for measurement in relation to the mirroring principle be consolidated to ensure that liabilities and underlying items are measured consistently.

The definition of a participating contract should be a contract that at outset is expected to transfer the predominant part of the economic risks in fulfilling the contract from the insurer to the policyholder, usually a group of policyholders. Such contracts should be measured applying the mirroring principle. We believe that this definition would cover nearly all of the contracts with participation features world-wide.

If the Board decides that special conditions for reflecting the carrying amount of underlying items in the measurement of liabilities are required, the guidance of paragraphs 33 and 34(a) could be retained subject to the proposed amendments included in the Appendix to this comment letter. In this way, the conditions in paragraphs 33 and 34(a) should be considered examples of perfect dependence or conditions for a safe harbour rather than explicit rules that restrict the application of general principles.

Paragraph 26(a) should be modified to refer to participating contracts and to require assumptions for these contracts that are consistent with the measurement of the underlying items. This includes a

requirement for consistent discount rates and would lead to a consistent presentation of interest expense and interest income in the P&L.

We believe that “dependence” does not apply to indirectly varying cash flows since they do not transfer any risk in fulfilling the contracts to the policyholders. Rather, they create risk for the insurer.

There are further presentation issues in the second sentence of paragraph 60(h). We believe a more relevant and faithful presentation would be achieved by always updating the discount rate used for the P&L when the entity updates the fulfilment cash flows that depend on returns on the underlying item. We propose that paragraph 60(h) should use the wording of 26(a) - “depend on the underlying items” to describe the looser connection between underlying items and the liabilities rather than “vary directly with the underlying items” that is used in connection with the mirroring approach. Paragraph 60(h) makes sense only in the case of a step-relationship, i.e. not more than “dependent” as in paragraph 26(a). An example is a Universal Life contract, where cash flows are generally expected to change in greater steps than those observed in the development of the assets. We understand the concept of the last sentence of paragraph 60(h) assumes a fully matched position for the current crediting rate; a significant change in crediting rate requires a review of the matching assets and therefore justifies updating the discount rate through the P&L. The reference to paragraph 66 in the first sentence of paragraph 60(h) should be restricted to paragraph 34(a).

To address this matter, we propose the following revision to the wording for paragraph 60(h):

“60 An entity shall recognise in profit or loss

...

(h) unless paragraph 34(a) applies,

- i. interest expense on insurance contract liabilities determined using the discount rates specified in paragraph 25 that applied at the date that the contract was initially recognised.*
- ii. For cash flows that are expected to ~~vary directly with~~ depend on returns on underlying items, the entity shall update those discount rates when it expects any changes in those returns to affect the amount of those cash flows”.*

(4) Presentation of specific embedded derivatives:

In this Section, the exemption for embedded derivatives is discussed, i.e. the requirement in paragraph 66(b) to present changes in the fulfilment cash flows of specific embedded derivatives in P&L.

Embedded derivatives, as defined in IAS39.10, often play an important role in insurance contracts to provide flexibility and security to policyholders. In insurance terminology, they are often referred to as Options and Guarantees. Examples include policyholders’ alteration rights and minimum benefit promises, as well as, caps, floors, leverages or other asymmetries.

Paragraph 66(b) refers to cash flows expected to vary indirectly with returns on underlying items. We assume that indirect varying means an alteration of the cash flow triggered by changes in the underlying item either above 100% or below 0% of the change in the underlying item (e.g., leverage, floor, asymmetry). Paragraph 34 requires disaggregation of a cash flow into a part which is proportional to the underlying item and a part which does not vary with the underlying item or varies indirectly, i.e. into its basic amount and its embedded derivative component. However, paragraph 34(b) does not require differentiation in measurement between the latter two.

We understand that all embedded derivatives within insurance contracts, to the extent not already separated under paragraph 10(a), are treated like any other cash flow in accordance with paragraphs 18-32. They are measured by applying the three building blocks from an entity perspective, as long as the measurement is consistent with relevant observable market prices (market variables) inherent in the embedded derivative, if any. All presentation requirements, including OCI, are the same for embedded derivatives as for other cash flows.

However, the Exposure Draft includes one exception, embedded derivatives, in contracts that meet the conditions of paragraph 33 that vary indirectly with an underlying item of cash flows under paragraph 34(a). For this sole exemption, the presentation guidance in paragraph 66(b) prescribes that all changes in the fulfilment value (i.e., changes in estimate of future cash flows, discount rates and risk adjustment) are reported in P&L, rather than in CSM and OCI, as applicable. Since this is explicit presentation guidance, it is not clear whether this overrides the measurement guidance in

paragraph 30(c) and (d) to off-set changes in estimates of future cash flows using the CSM. In any case, we do not agree with this exception for the following reasons:

- (1) If the embedded derivative can be separated, it should be separated. If not, a separation for presentation purposes is neither proper nor reasonable.
- (2) It is not consistent with the general treatment of non-separated embedded derivatives in host instruments under IFRS, which requires measurement and presentation in line with the host instrument (we see no violation of transparency herein, see paragraph BC53)
- (3) It is not consistent with current status of the Revenue Recognition Project
- (4) It is not consistent with the treatment of all other embedded derivatives in insurance contracts, even in very similar situations, e.g. minimum guarantees under participating contracts in paragraph 26(a), that do not fulfill paragraph 33 or 34(a)
- (5) The criterion in paragraph 33(a) is irrelevant for the economics of the minimum guarantee, as it is only applicable to contracts which use the mirroring approach.
- (6) All reasons for reflecting changes in estimates of cash flows in the CSM apply equally to the cash flows associated with the minimum guarantee.
- (7) If, as is reasonable, the changes in cash flows are off-set by a change in the CSM, the sole effect of paragraph 66(b) would be that changes in the discount rate are not reported in OCI. However, since the discount rate does not reflect any characteristic of the embedded derivative (since it is the illiquid risk-free rate), there is no reason to require a different presentation.
- (8) The measurement of embedded derivatives is independent from the particular measurement or carrying amount of the underlying item. The amount of the minimum guarantee relates to the condition that the insurer has to pay an amount in excess of returns from the underlying items under the legal and regulatory circumstances of the participation feature, not to the situation under IFRS for which the carrying amount of the underlying items temporarily does not cover the minimum guarantees. To this extent we agree with paragraph BC51-52.
- (9) Minimum guarantees as described in paragraph 66(b) also exist for mortality benefits, annuity benefits, surrender benefits, or other benefits not related to investments. These embedded derivatives do not depend on assets, but rather on insured events. Such embedded derivatives would also be covered by paragraph 66(b) although the embedded instrument might qualify as a stand-alone insurance contract.

As a result, we propose that either paragraph 66(b) be deleted, or that the rationale for this exemption be clarified. If the IASB does not agree with the suggested deletion of this paragraph, we believe a clarification is needed and propose that paragraph 66(b) only determines that changes in interest rates are not presented in OCI, and that the requirement does not affect the measurement of the cash flows in relation to the CSM.

Further, consistent with our proposed rewording of paragraph 34(b) to be applied to all other fulfilment cash flows we also propose that paragraph 66(c) should refer to all fulfilment cash flows other than 66(a). Some of those fulfilment cash flows might indirectly vary with returns of the underlying items. Thus, we propose that paragraph 66 be reworded as follows:

66 If an entity applies paragraphs 33–34 to a contract because the insurance contract requires the entity to hold underlying items and specifies a link to returns on those underlying items, an entity shall recognise:

- (a) changes in the fulfilment cash flows that result from applying paragraphs 33–34 (a) in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of the underlying items;*
- (b) ~~changes in the fulfilment cash flows that are expected to vary indirectly with those returns on underlying items in profit or loss; and~~*
- (c) changes in the all other fulfilment cash flows that are not expected to vary with those returns on underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), in profit or loss and in other comprehensive income in accordance with paragraphs 60–65.”*

Question 3 Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

IAA Comments

We support the earned premium approach for contract measured under the premium allocation approach.

A narrow majority of our members agree that the insurer should present insurance revenues and expenses in profit or loss and hence supports the earned premium approach for contracts measured under building block approach. They see the benefits of showing amounts that depict the consideration to the insurer in exchange for the promised services. The conceptual consistency with the proposals for revenue from contracts with customers is seen as a benefit of the suggested earned premium approach. This approach makes the timing and amount of revenue a function of actuarial models and is therefore less objective than more traditional approaches (premiums as revenues). We support the proposed approach nonetheless because it derives from the measurement model, which we support.

At the same time, a significant number of our members favour the summarized margin approach for contracts measured using the building block approach, for which we expressed qualified support in our comment letter on the first exposure draft. They do not find that the earned premium approach is an improvement to the proposals in the first exposure draft and believe that if users desire more traditional information about premium and expenses, as some have indicated, that information can be included in the disclosures or on the face of the income statement as allowed in the 2010 Exposure Draft.

We are not unanimously in agreement with excluding from presentation the investment component, as some of our members think that this treatment is at odds with the bundled nature of contracts and the measurement of the liability. Excluding the investment component also adds complexity to the development of the figures. We believe that the IASB should, considering benefit over cost, permit approximation methods and practical expedients to reduce the effort to an acceptable extent.

Notwithstanding our comments above some of our members continue to believe that presenting premium due in the statement of comprehensive income is superior to the proposed approach. Those members believe that premium due provides a better representation of the entity's sales and persistency than the earned premium approach.

Another issue is the requirement included in paragraph B89 and B90 of the Exposure Draft, with further comments in BC93-95, that insurers present, for presentation purposes, the insurance contract revenue and expenses associated with initial acquisition expenses over the coverage period in line with the pattern of services provided under the contract, rather than when the acquisition expenses are incurred. Although we understand the IASB's reasons in the form of consistency with the proposals in the Exposure Draft Revenue from Contracts with Customers, we do not support this proposal because of:

- The significant additional complexity it requires in tracking the deferred amount of revenue and expenses (on top of all other complexity required in deriving revenue and expense information); and
- The limited transparency it creates for users, who usually are interested to understand the actual expenses incurred without deferral effects.

In case the wording in B89 remains, we request explicit disclosures that reconcile actual expenses incurred during a reporting period - including the actual amount of acquisition cost - with the costs shown as incurred expenses in the profit and loss account.

Question 4 Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

- (a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and
- (b) recognising, in other comprehensive income, the difference between:
 - i. the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and
 - ii. the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

IAA Comments

In the ED 2010 question 3c was: "*Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are these concerns valid? Why or why not?*" In our response to that ED, we expressed agreement with these concerns, as we are concerned about volatility introduced by temporary changes in market sentiment, particularly as they relate to contracts of considerable duration.

As a result, we welcome the opportunity to recognise the effect of the change of the discount rates in OCI. However, we recommend that entities should also have the ability at the portfolio level to irrevocably recognise the effects of the changes in discount rates in P&L when doing so would result in more relevant information because it expects to eliminate or significantly reduce an accounting mismatch that would otherwise arise from recognising the gains and losses on assets and liabilities on different bases. We agree with the need for principles for allowing this, which we believe would be based on the business model. We would be happy to work with the IASB on the development of the principles.

In the following our detailed comments are organised in three sections: 1) Designation of the presentation, which also addresses the conclusions of the Board that an option should not be allowed; 2) Alternatives for the use of an option; and 3) Liability for incurred claims for non-life business

Please note that our comments on OCI at transition are included in our response to question 5.

Section 1 Designation of the presentation

We agree that accounting mismatches might not always be eliminated entirely but, because a variety of different business models exists, the ability to choose the presentation which best eliminates or reduces the mismatch would significantly ease this problem.

The ability to recognise changes in fair value in OCI is important for those entities that consider the discount rate change to be an irrelevant¹ change in the context of their business model, under which the insurance contract liabilities and associated assets are managed together and under which they invest in assets that give predictable cash in-flows and where either:

- the objective is to hold assets in order to collect contractual cash flows or
- assets are managed both in order to collect contractual cash flows and for sale, if the proposed FVOCI category in the IFRS 9 ED on Classification and Measurement becomes available.

In these business models, insurance contracts are typically managed at a more aggregate level together with associated assets. However, there is wide range of different business and asset liability models. In IFRS 9, its Classification and Measurement ED and in IAS 39 the IASB's aim has been to find the proper presentation for asset instrument and financial liabilities, given the purposes for which they are held.

At one end of this range are entities that opt for an amortised approach for assets (FVOCI). At the other extreme are business models where the entity uses asset instruments which are required to be classified at fair value through profit and loss (FVPL), debt instruments and equity instruments held for trading, investment property and derivatives (e.g. to hedge the interest risk). These latter entities may not associate the insurance liabilities and the assets; there may also be no allocation of the assets between liabilities and equity. In these entities the proposed mandatory presentation leads to an unduly complex presentation where there are accounting mismatches in both P&L and OCI and where economic mismatches are suppressed or distorted. This presentation is neither useful nor faithful for such entities.

There are also entities which hold equity instruments, not for trading but as long term assets against their very long liabilities and they are able to present the changes in the fair value in OCI. If, as is commonly the case, a significant fraction of the expected return on equity investments is capital appreciation, using FVOCI for such assets will introduce a systematic bias into P&L, since the liabilities will be valued on a basis that assumes interest accretion, while any capital appreciation is diverted into OCI. For example, consider an equity investment that yields 10% pa, all capital growth, in an environment where the cost of money is 4% pa. On the FVPL basis, P&L would show the 6% pa difference, between investment earnings and interest expense, as profit. On the FVOCI basis, there is no offset to the interest expense, unless the investment would be sold.

If the entity uses bonds to manage the cash flows of the insurance liability and the assets, the duration mismatch is reported in OCI. But if the entity manages duration mismatch with derivatives the duration mismatch is scattered between P&L and OCI. If the standard has a mandatory requirement to use OCI for the liabilities, it would penalize the use of derivatives and may discourage their use even though it would be good risk management.

Some entities actively trade their assets, whether to limit credit exposures, to refine durational/cash flow matching, or to actively manage the assets, in order to seek higher returns. It is not possible for those entities to get good accounting matching in P&L and OCI even though they classify their assets to be measured FVOCI. When sales and purchases of assets occur, the difference between holding and realised value is recycled from OCI to P&L, while there is no equivalent recycling for liabilities because this occurs only when the liabilities are derecognised (paragraph 65). It would also be possible for entities to manipulate P&L by realising assets selectively, on the basis of the differences between holding value and fair value.

FVOCI is most suitable for single premium contracts which is, for many entities, only a small portion of their business. If premiums are paid over a long time as regular premiums, the usefulness of OCI suffers when the discount rates applicable, when premiums are paid years

¹ We object the use of the phrase "the changes in the discount rate that are expected to unwind over time". That is not a valid reason to use OCI because no-one knows in advance whether changes will unwind or whether the change is a long-term trend. The correct reason is whether the change of the discount rate is relevant under the business model.

after inception, differ from those assumed at inception, and the assets bought from those premiums are classified as AC or FVOCI. The P&L then compares liabilities discounted by the discount rates at inception and assets accruing at a mixture of rates.

Our view is that a standard should help users to understand the business model the entity has chosen and should present results in a form consistent with that model. It should not require the entity to distort its results in order to comply with a different business model. Nor should it establish incentives for the entity to change its business model from what management considers most useful, in the context of its operating environment.

As a result, in summary, we believe that the most useful, relevant and faithful presentation is achieved if the entities can themselves choose to present changes in the insurance contract liabilities on a basis consistent with that applied to the corresponding asset values, and, if that choice is based on the business model underpinning the entity's asset/liability management, using similar criteria to those in IFRS 9. Comparability and the presentation of the underwriting performance are discussed below.

It should be noted that much of the discussion above, is of limited relevance to long-term liabilities for incurred claims in non-life insurance. These liabilities are addressed in section 3 below.

We understand the general reluctance of the Board to allow options. As expressed in BC142-5, the Board rejected FVPL. However, we consider that this conclusion was based on one-sided arguments that ignore the need for proper presentation of the difference defined in paragraph 64. In the following paragraphs we provide our comments on the arguments against allowing options as provided in paragraphs BC144 and BC145, under four headings: comparability and transparency; reporting underwriting performance; operational complexity; and invoking and revoking in the context of changes in the duration mismatch.

Comparability and transparency: Comparability in presentation is achieved in the draft standard at the expense of usefulness in some business models. If the options in IFRS 4 and 9 are used consistently the presentation is useful. If they are used inconsistently or an option doesn't exist in IFRS 4, as is the case for many entities in the draft standard, total liability changes are comparable between entities but the disaggregated results in P&L and OCI are useless.

We believe it is not reasonable to require disaggregation of the result into P&L and OCI for the sake of comparability, then having users being forced to combine the P&L and OCI to make valid comparisons because entities' circumstances have resulted in different elements going to OCI. Useful and incomparable P&L and OCI do not provide enhanced information – more is not always better.

There is no sense in requiring comparability in the P&L and OCI presentation of liabilities between entities when those same entities are required to have conflicting presentations of their assets, because of different business models. If the asset and liability presentations within the entity are in conflict, the usefulness of the result is seriously impaired. It is better to have the fullest possible comparability within the entity, at the expense of more limited comparability between entities.

Because there are different business models, the proposed OCI presentation is not relevant to all entities. Therefore, the best possible comparability does not simply mean that the same changes should be recognised in the same accounting items. We believe that better comparability is achieved if entities report matched P&L and OCI presentations of assets and liabilities, even though the changes can be found in different places in the reports of different entities.

Reporting underwriting performance: We share with the Board the objective of reporting underwriting performance. However, there are different views about what underwriting performance is. For some entities, the investment result is an integral part of the result and thus it should be reported in P&L, not separated out into OCI. On the other hand, many entities

already report their underwriting performance without investment performance in the notes. In the notes, the underwriting risk result, expense or combined results can be presented. We believe that it would be better to require disclosure of some of those results in the notes, when the entity selects FVPL.

Operational complexity: Apparently the Board assumes that an option to use FVPL would be operationally complex. However, this understanding arises from the assumption that the entity's business model incorporates a close association between the insurance liabilities and the assets. However, for many of the entities that prefer the FVPL presentation, there is no such association and, therefore, FVPL would be, in fact, simpler.

Reflection of duration mismatch: The discussion in BC144(a) reflects an important point but, in our view reaches the wrong conclusion. In BC144(a)(ii) it is noted that "Accounting mismatches would be reduced only if the entity exercises the option to measure all the assets at fair value through profit and loss." but takes this as an impediment to the FVPL option for insurance liabilities, rather than a requirement on insurers that wish to exercise the FVPL option. We note that the current insurance accounting standards in Australia (AASB 1023 General Insurance and AASB 1038 Life Insurance) both adopt an FV consistent approach to all insurance liabilities other than non-life insurance unearned premiums and both require Australian Insurers to exercise the FV options, wherever available.

The discussion in BC144(b) about the *irrevocability* of FVPL is based on a misunderstanding of its use. If there was the application criterion of "using the option reduces or eliminates an accounting mismatch" the criterion would not apply to entities providing only short-term benefits. The reduction and elimination will be consequences of the duration mismatches of the insurance contracts and assets. The changes of the reduction will give useful information about the duration mismatch to the user. We agree with the objective in BC144(b) but we don't see it as a reason not to approve the two possible presentations but rather as a misunderstanding of the purpose of the different presentations, which is not to show only beneficial figures. The mismatch that the Board discusses in BC144(b) seems to be real economic mismatch, not an accounting mismatch. We favour reducing and eliminating accounting mismatch but believe that economic mismatches should be fully exposed in P&L.

We discuss the costs and benefits of the mandatory FVOCI presentation under question 6. We note that the proposed presentation is much more costly than FVPL, and as a result, entities with business models more suitable for FVPL would have substantial costs and only get useless non-relevant presentation. Entities with business models more suitable for FVOCI have stated that the costs are worth paying.

Section 2 Alternatives for the option

When the need to eliminate the accounting mismatch arising from paragraph 64 has been discussed, at least two other solutions that don't need the option have also been considered. The solutions included (1) extending the FVOCI-presentation to all or several other asset classes and (2) using macro hedging in cases where interest rate swaps are used to hedge the interest risk. However, we cannot support these proposals at this stage, as it is unclear when the extension of IFRS 9 or macro hedging will become available, if at all. As noted above, extending the FVOCI-presentation to all or several other asset classes will not help those entities that actively trade their assets. In addition, these solutions should not be preferred over the ability to present the result in P&L. Macro hedging would mitigate only one aspect of the mismatches.

Section 3 Liability for incurred claims in non-life insurance

Non-life insurance contracts are generally short term, and the business model associated with such contracts is not an interest rate spread model. While investment income is considered in the performance evaluation of non-life insurance, the model is not a spread model due to the unpredictability of the amount and timing of claims. A typical approach is for non-life companies to manage the difference in durations between estimated claims pay-out and invested assets to a reasonable degree, while maintaining current liquidity to cover large settlements, catastrophic

events and similar volatility. In addition, fixed interest bonds offer a poor match to liabilities for incurred claims, such as workers compensation in some jurisdictions, linked to wage or medical cost inflation: while providing an imperfect match, equities may offer a better match.

Further, this issue is more pronounced for those non-life insurance and reinsurance products that have exceptionally long claim emergence and settlement periods, such as observed in workers compensation, excess liability, directors & officers and casualty excess of loss reinsurance. For many larger insurance and reinsurance companies, a large portion of their liabilities for incurred claims arise from these contracts. Claims for these coverages tend to emerge very differently from what was expected at contract issuance. There are often cases of initial claim recognition and a change in claim estimates many years, even decades, after the original contract was issued. For example, most liabilities for asbestos related claims were only recognized and established decades after the contract was issued. Similarly, the environmental liability claims that almost destroyed Lloyds late last century were not even envisaged when the policies were issued many years before. For such claims, it is often impossible to establish more than an arbitrary relationship to a particular policy year, policy or even insurer. In these cases, discounting using the yield curves that existed when the contract was deemed to have been issued produces irrelevant and useless information.

Likewise, claim estimates can change dramatically and claim settlement amounts can differ dramatically from the latest estimates, many years after the claim was incurred. In some classes of general insurance, the estimated outstanding claim liabilities for a given policy year can vary substantially from year to year, as those claims develop. In this context, discounting current changes in estimates using interest rates that existed in a different yield curve era has the potential to produce misleading income statement information.

Finally, using current rates is far simpler than having to track separate calculations, maintain differences through OCI and then work to explain such differences to users of the financial statements, particularly when such differences are almost certainly due to mechanical changes and not due to the economics of the business model. Passing all these changes through P&L would still allow for separation of underwriting and investment performance and provides information in a manner that is more consistent with the business model of contracts valued under the PAA. Information on the impact of successive changes in discount rates is better supplied in the form of disclosure of the difference between values discounted using the interest rates current at the start and end of each reporting period.

Restricting the interest rates under consideration for liabilities for incurred claims to those current at the start and end of the reporting period would be a major simplification. Disclosing interest expense in two parts: using starting rates; and showing the impact of the change, and passing the sum of these through P&L, would provide the information needed to compare against all asset presentations (AC, FVOCI and FVPL) and eliminate the need to track the impact of successive changes for recycling as claims are settled. Again, a major simplification.

For consistency of approach, this simplification could also be used for life insurance where the business model is not an interest spread model, in particular for life incurred claims.

If OCI is required we recommend that for practical reasons the discount rate should be locked in at inception of the claim rather than at contract inception.

Question 5 Effective date and transition

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

IAA Comments

The idea of requiring a Contractual Service Margin (CSM) on in-force business at time of transition is an excellent one and a significant improvement over the 2010 ED. It is essential that

there also be a reasonable treatment of the concept of impracticality. We are also concerned about the calculation of OCI at transition.

In the following paragraphs, we first discuss OCI at transition, followed by a discussion regarding practicality and the simplified approach and provide suggestions to avoid complexity and impracticality.

- 1. OCI Opening balance.** The OCI opening balance needs to take into consideration that the asset liability management (ALM) had been performed under a different accounting regime. ALM is a fundamental risk management tool, particularly for life insurance business, and it is used as a tool to help protect the solvency of companies. It also takes into account the accounting environment so that not only are the economic risks mitigated but the accounting income volatility is minimised, amongst many considerations. It is expected that the IFRS standard will have an impact on the way ALM will be conducted in the future and it may well impact the level of asset trading that will be performed. It will be impossible to second guess what that trading would have been had the new standard been in place in the past and impossible to undo past trading. To allow for both practicality of implementation and a comparable start, we believe that OCI on liabilities should be linked to the OCI on the asset side and not go back to initial recognition. Capital gains (or losses) on sold assets are not available anymore to match initial investment return expectations. Had the new accounting been in place, it is not clear that trading would have indeed occurred at the pace or of the nature that it has occurred.

As a result, we suggest changing paragraphs C3 and C5(c).

Paragraph C3 would become: “*At the beginning of the earliest period presented, an entity shall, with a corresponding adjustment to retained earnings (...)*

(e) recognise, in a separate component of equity, an equivalent amount for liabilities as is recognised as adjustment to the retained earnings for the assets backing the liabilities the cumulative effect of the difference between the expected present values of the cash flows at the beginning of the earliest period presented, discounted using:

~~(i) current discount rates, as determined in accordance with paragraph 25; and~~

~~(ii) the discount rates that were applied when the portfolios were initially recognised, determined in accordance with paragraph C6. and substitute the discount rate at initial recognition with the discount rate that would generate the adjustment to the retained earnings calculate hereby.~~

Paragraph C5(c) would become: “*...recognised in accordance with paragraph C6C3e*”. And you would delete paragraphs C6(c) and C6(d) which are not needed anymore.

This proposed wording not only addresses the issues we raised regarding OCI above, it also simplifies the calculation of the initial CSM, especially in markets where the initial observable yield curve does not exist. If the opening OCI is nil or close to nil (either because none of the assets are designated FVOCI or due to heavy trading), then the opening OCI is nil and CSM is calculated using current discount rates, in line with our proposal in our response to Question 1. If there has been no or little trading, the opening OCI on the asset side is the best indicator of the discount rates at initial recognition. For added practicality, we suggest to allow using for the in-force blocks a level discount rate rather than a complete yield curve.

- 2. Practicality.** The retrospective calculation would require information about the original expectation and risk assessment as well as the initial interest rate curve. Because the CSM is impacted by changes in future expectations over time, one would have to reconstruct the evolution of changes in future expectations. CSM would then be reassessed at each year between the issue and the transition date based on the CSM of the prior year amortized for the year and adjusted for the PV of the impact from that year forward of any change in expectations. As expectations are meant to be current ones, such expectations could very well change every year or at least multiple times in the period up to the transition date. We note that some companies may still have access to their pricing assumptions for a large part of their history but many will not be able to track the evolution of how their expectations would have evolved over time except for what it has become as of the transition date and for

many that evolution could be quite hypothetical. Paragraph C5(b)(ii) allows this for the periods before the earliest period presented

As a result we suggest a modification to paragraph C6, as follows: '*In applying paragraph C5, an entity need not undertake exhaustive efforts to obtain objective information or to reconstruct complex past sequences of changes in assumptions but shall take into account all objective information that is reasonably available...*'

We also note a potential issue with contract classification and scope. I.e. it may be that contracts have been identified as insurance contracts under IFRS4, but that at the date of transition the contract is no longer an insurance contract. Reconstruction of the contract classification may be cumbersome and as a result we suggest using best efforts based on information available at reasonable cost.

3. **Simplified approach – Use of cash flows that are known to have occurred.** Paragraph C6 suggests using use cash flows that have occurred as a proxy for the period from initial recognition to transition. The projection from issue should not use actual cash flows that occurred but incidence rates for mortality, morbidity and lapse, with a proper gross-up to the in-force at time of transition. Actual cash flows on only contracts remaining in force would generate inappropriate gains for mortality products and inappropriate losses for disability and annuity products.

As a result, we suggest changing paragraph C6(a) into '*estimate the expected cash flows at the date of initial recognition at the amount of the expected cash flows at the beginning of the earliest period presented, projected backward consistently with the current portfolio experience expectations adjusted by the cash flows that are known to have occurred between the date of initial recognition and the beginning of the earliest period presented;*'

4. **Simplified approach – Use of the risk adjustment at the transition date.** The same issues as mentioned above apply here as well. We understand there is a concern that any other approach would be too complex. We agree that we should not try to assess the risk sensitivity of prior periods as this would be very subjective since very little of that information would be available. Therefore, we agree that we should start from the current assessment of risk. However we disagree that using a flat amount is appropriate. As contracts age and experience unfolds, the amount of risk often reduces and can reduce significantly for contracts that have long been in force. Our view is that the proposed approach is not reflective of the insurance business reality. We recommend using a risk estimation approach consistent with the approach at time of transition.

As a result, we suggest changing paragraph C6(b) into: '*estimate the risk adjustment at the date of initial recognition on a basis consistent with ~~at the same amount of the risk adjustment that is measured at the beginning of the earliest period presented.~~ The entity shall not adjust that risk adjustment to reflect any changes in the entity's degree of risk aversion between the date of initial recognition and the beginning of the earliest period presented;*'

5. **Simplified approach – Use of the average spread between an observable yield curve and the current yield curve to derive the past yield curves.** We hope that you will recognise the substantial improvement in comparability suggested in item 1 above. If you do not take our suggestion from item 1 above, we would at least suggest paragraph C6(d) to be improved. This paragraph states that if an observable yield curve does not exist, the discount rate should be based on an average spread, the average being determined over the last three years before the date of transition. While we agree with the concept of using an average spread, we are concerned that the period of observation for the spread is not defined strictly and as such it potentially leaves room for manipulation. Instead of an '*average over at least three years before the date of transition*, we would suggest a fixed period. We also believe 3 years to be too short as it gives too much weight to a specific year which might be abnormal. We recommend a longer period, for example, 7 years, being the average length of an economic cycle.

As a result, we suggest changing paragraph C6(d) into: “if the observable yield curve in (c) does not exist, estimate the discount rates that applied at the date of initial recognition by determining an average spread between an observable yield curve and the yield curve estimated in accordance with paragraphs 25–26 and B69–B75, and applying that spread to that observable yield curve. That spread shall be an average over ~~at least three~~ the seven years immediately before the date of transition.”

Effective Date

The new standard, as noted, will be quite complex to implement. Furthermore, many European and other companies are likely to be implementing new solvency standards at about the same time as the new accounting standard. We therefore urge that the Boards allow a minimum of three years from the approval of the standard until mandatory implementation. We further suggest that small and medium size companies be granted an additional year for implementation. Earlier implementation could be encouraged.

Question 6 The likely effects of a Standard for insurance contracts

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5? How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:

- (a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and
- (b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an on-going basis.

IAA Comments

Cost Justification

Overall, it is clear there will be significant costs to implement the proposed standard, both for transition and on-going. In particular, for long-term contracts, this extra cost may be justifiable in that it creates a standard that is consistent for all products where one does not currently exist. However, it should be noted that this standard is quite complex and the Board should consider ways to reduce complexity when it is not justifiable.

Many of our members on the other hand believe that the proposals for the accounting for non-life business overall, particularly those contracts with duration of 1 year or less include unnecessary requirements and therefore are more costly than justified.

Our responses to questions 1-5 deal in some detail with many of the places where we think the proposals require modification to avoid unnecessary implementation cost. The sections below highlight the most important of them:

Question 1 Adjusting CSM

- The proposal to use the average discount rate from inception for subsequent measurement of the CSM is an area where complexity and cost are introduced for limited or no perceived value. As stated in our response to question 1, use of not locked in discount rates in line with how other components of the liability are calculated would be simpler and less costly while maintaining the integrity of the measurement of the CSM balance.

- On the basis that simplification ultimately leads to reduced cost, changing the wording of paragraph B68, that would allow for investment impacts that impact cash flow timing (and indeed all components of future best estimate cash flows) to be treated consistently in determining CSM impacts would be beneficial.

Question 2 Contracts that require to hold the underlying item

- The proposal that requires decomposing the cash flows as a first step and subsequently measure on that basis are generally unnecessary burdensome if not technically impossible. In our response to Question 2, we have included suggestions to solve this.
- The requirement to split measurement based on market variables or carrying amounts in building blocks for presentation purposes is cumbersome and potentially not achievable. In our response to Question 2 in Appendix A item D we have suggested to expand the permission in paragraph B80.
- Any requirement to treat bonus allocations separately from the main contract is costly to implement.

Question 3 Presentation of revenue and expenses

Implementation of the Earned Premium or Summarized Margin approach to revenue may require significant changes to preparers systems, particularly the separation of the investment component. Whether this is justified will depend on whether users find the information more useful than a traditional presentation.

Question 4 Interest expense in profit or loss

- Some insurers do not think that the OCI is useful.
- There are some insurers for which the mandatory use of OCI causes substantial costs while still resulting in unfaithful presentation. This is one of our main arguments proposing that the use of OCI be optional for presentation.
- When the change of the time value of options and guarantees arising from the change of the change of the discount rate is presented in OCI calculating the time value will present a number of significant practical challenges for insurers in performing multiple stochastic measurements.

Question 5 Effective date and transition

- The retrospective calculations as suggested are such that most preparers will need to revert to the simplified approach.
- The proposals in the ED for OCI transition are cumbersome and in fact not doable. In our response to question 5 we have included a suggested for OCI at transition, which we believe is easy to implement.

Overall Costs

In this response, we will not attempt to estimate the costs of implementing the proposals. This is best done by preparers and auditors, both of whom will incur the major burden of the systems and personnel changes that will be required.

Comparability and Transparency

Overall the proposals for long term products will improve comparability significantly. Nevertheless, comparability is difficult to measure; in particular, comparability with entities other than insurers who issue insurance contracts is probably not materially affected.

The greater volume of disclosures will not compensate for the greater complexity of the standard. This is particularly true for claim reserves on short term contracts.

If the board is looking for additional areas where proposals could be simplified to reduce costs, we suggest the following:

- Simplifying discounting requirements (e.g. allowing a level yield curve rather than always requiring use of a full yield curve, particularly for contracts with a duration of 1 year or less)

- Replacing the earned premium presentation with the existing incurred premium approach for both income and expense. Since this would not affect the bottom line, it should save costs without materially affecting comparability.
- Eliminate the requirement to decompose cash flows on participating contracts, allowing actuaries to use appropriate methods that produce reasonable results. This is commented on more extensively in our responses to the earlier questions.
- Allow OCI use to be optional on a one-time election for a portfolio. In addition to the reasons cited in the earlier discussions, it would simplify implementation for many companies, particularly those who use primarily the PAA approach.
- The CSM at transition may be cumbersome to calculate. We believe that the actuarial profession in each country could develop factors that could be considered a safe harbor determination.
- Remove the requirement to disclose acquisition costs for presentation purposes. We do not believe this provides useful information that justifies its cost.
- Remove the requirement to disclose the confidence level disclosure as it does not achieve the comparability the Board intends (as discussed in more detail in our Other Comments).

Question 7 Clarity of drafting

Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB?

If not, please describe any proposal that is not clear. How would you clarify it?

IAA Comments

We believe that generally the exposure draft is well written and we support the principles based approach. However, we also note many areas which are difficult to read and interpret. While we recognise that there are a number of areas where insurers will need to decide on the most appropriate approach in order to fulfil the principles as written, we believe that the text can be improved in order to facilitate a correct and efficient implementation. We have tried to identify many of them in previous sections of this letter.

More general comments include the following:

- There is frequent reference to sections of the paper by paragraph. In many cases, this should be replaced by a description of what is intended with paragraph numbers in parentheses. For instance, references such as “Unless paragraph 35-40 apply” in paragraph 29 should be replaced with words such as “unless a contract uses the PAA (see paragraph 35-40)”. This will simplify the intent and make understanding easier. There are many instances of this type of language that should be fixed.
- The definition section needs to be enhanced. Not only are there incorrect definitions (e.g. policyholder, we refer to suggestions under “Other comments”) there are many items that should be added. They included terms such as
 - Varies directly with
 - Varies indirectly with

The Exposure Draft produced by the Financial Accounting Standards Board includes more definitions, some of which should be included in this standard.

- There are a number of places in the Exposure Draft, Basis for Conclusions and Illustrative Examples, where the term “best reflects” or similar use of the word “best” appears. It is difficult in practice to demonstrate that an estimate or method is the “best” that is available. This can cause some issues in determining the extent of effort required. Preparers should not be held to a standard that is expressed in terms of “best” unless there is some known practical limit to the application of the word. Auditors, likewise, will have difficulty reviewing the preparer’s processes to ascertain if the estimates and assumptions are the best reflection of the circumstances, either in the view of the preparer or in the view of the users of the financial statements.

The Board should replace “best reflects” (paragraphs 32, 47(c), B89(a), B90(d), B91, IE16, IE17, IE Example 8) or “best represents” (paragraph 92) with wording such as “faithfully represents”. There are other uses of the term “best” in the documents that suggest “to the best extent possible” (BC147, D5) or other phrases including “best” with similar meaning (B48, BC102, BC144, BCA195).

- OCI is argued by "changes in the discount rate that are expected to unwind over time" and its modifications. We believe that is not a valid reason, as no-one knows in advance whether changes will unwind or whether the change is a long-term trend. We believe the correct argument is whether the change of the discount rate is relevant under certain business model in question.
- The reference to reassessment of risk for contract boundaries in paragraph 23 is not clear. It should be clarified as to what is meant by reassessment at points other than at outset.
- The ED defines fulfillment cash flows refers to a value rather than cash flows. We suggest the term be changed to fulfillment value and not reference cash flows.

We also urge that the IASB establish an implementation group to oversee implementation of the standard. This group would consists of preparers, auditors, users and actuaries. The group would accept questions from preparers and auditors encountered during implementation and propose responses to the board. This group would be temporary, lasting only until the effective date of the standard and would supplement the work of the IFRS Interpretations Committee. We suggest this because of the highly technical nature of this standard and the consequent need for experienced individuals to understand the issues.

Other comments

This section includes our comments on other items that we believe needs addressing.

1. **Disclosure of relevant significant aspects of the risk adjustment.**

We believe that disclosure of relevant significant aspects of the risk adjustment is important to its effective application. Nevertheless, we continue to disagree with the requirement provided in paragraph 84 that: “If the entity uses a technique other than the confidence level technique for determining the risk adjustment, it shall disclose a translation of the result of that technique into a confidence level (for example, that the risk adjustment was estimated using technique Y and corresponds to a confidence level of Z per cent).”

While we understand the arguments for comparability, we question whether this will be achieved by disclosing the confidence level. We fully agree with the statement in BCA102: ‘Although the usefulness of the confidence level diminishes when the probability distribution is not statistically normal, which is often the case for insurance contracts.’ In reality, for an appropriate risk adjustment confidence levels may differ by product. In addition, in the case of claims run-off the risk distribution may become wider and increasingly skewed and as a result the confidence level would differ. We refer also to the April 2009 IAA publication “*Measurement of liabilities for insurance contracts: Current estimates and risk margins*”. Next to what has been argued above, in that publication it is also stated that an appropriate methodology to develop a specific level of overall confidence has not yet been developed and it is unclear whether it can exist. While we agree that in moving to an entity specific view a degree of verifiability (as in IFRS 13 requiring market participant’s view) would not be present, we note that a cost of capital approach – even applying an entity’s view of risk - would still be market consistent.

Overall, we believe this disclosure requirement:

- a) results in considerable additional analytical work for those entities using another method in measurement in what is often a very short financial closing period
- b) may result in different confidence levels for different portfolios and/or years of duration, which may result in confusing, rather than useful information for users. In addition, if this is not the most appropriate approach, it may provide misleading information.

We would suggest other disclosures that may provide as much useful information and insight. These include the types and levels of uncertainty that go into the decision on the method(s) used, reasons for use of different methods in different types of portfolios, or risks, and key parameters). In addition, one might consider the CTE level applied and why it was chosen, the size of the risk adjustment in relation to the present value of expected cash flows, and the expected frequency at which the actual benefits/claims paid will exceed the present value of the expected cash flows for the portfolio, where it is practical to derive such numbers.

Nevertheless, if this disclosure is required, it is not clear at what level it should be measured: for the entity as a whole; by segment; or for individual portfolios. We believe the guidance for this disclosure should be clearer, to ensure greater consistency in disclosure and to promote more useful information. Since it is difficult to compare confidence levels that do not fully reflect diversification, this disclosure would be most consistent and meaningful if the disclosed confidence level is for the entity as a whole, on a net of reinsurance basis. Again, we do not agree with providing disclosure on confidence levels when another method is used.

2. Definition of policyholder

Appendix A defines policyholder as: 'A party that has a right to compensation under an insurance contract if an insured events occurs'

Because there can be a number of parties involved in an insurance contract: policy owner (the party entitled to exercise options under the contract); the premium payer; the beneficiary; and the insured person (object in certain cases), the term policyholder is often used in a manner inconsistent with the definition provided.

For example, rather than the beneficiary receiving benefits, the reference might be to the premium payer or contract owner. Conceptually, it is not necessary that the beneficiary receive such benefits since those need not be compensation for insured events. In the case of participating features, they might constitute a repricing feature: that is, a refund of an unused part of the premium.

The problem appears to be that the ED uses a well-defined term, the "policyholder", the legal counterparty of the insurer, in another context and, as a result, raises the danger of confusion.

Therefore, we recommend that the use of this word be reviewed. Preferably, the separate terms listed above (policy owner, beneficiary, premium payer, insured person or object) be used as appropriate.

3. **Use of term Unit of Account** – references in Basis of Conclusion to unit of account seem no longer consistent with the current ED. Unit of account is no longer a defined term and should be removed from the Basis of Conclusion.
4. **Interaction of effective date of IFRS 9 and the new standard Insurance Contracts** – We recommend that the effective date of IFRS 9 be the same as the effective date of the new insurance contracts standard. If this is not possible, entities should be allowed to redesignate their assets under IFRS 9 at the time they adopt the new standard for insurance contracts.

Appendix A

Recommendations regarding other topics related to question 2

The following are our further comments on question 2, organized in 6 sections:

- A. Additional thoughts on consistent treatment for all participating contracts
- B. The mirroring approach – criteria, terminology and suggested rewording of paragraph 33 and 34.
- C. Treatment of the allocation of bonuses/dividends
- D. Replicating portfolios
- E. Equity of mutual entities
- F. Universal Life Contracts, Index-Linked Contracts and Unit-Linked Contracts

These suggestions are partly made in case the IASB does not follow our recommendations for more fundamental changes in the text above and assumes that the basic structure of the ED continues to be applied. As a result, these suggestions for improvements are not necessarily our favoured approach.

Section A – Additional thoughts regarding consistent treatment for all participating contracts

If the IASB does not agree with the rationale for our proposal in Section (2) above, certain features in some participating contracts would lead to similar conclusions. This is due to the fact that the insurer's share in a past statutory surplus in many jurisdictions is ultimately determined at the time the surplus is allocated to policyholders. Allocations are granted in such a way that both the insurer's and policyholders' shares are spread over times of volatile surplus. Such insurers believe that the profit presented under IFRS should reflect this spreading.

Both the value of the minimum guarantee and the ultimate policyholders' share of surplus typically depend on the annual statutory (or contractually determined) accounting results. Often insurers have the ability and the intention to smooth the effects on the policyholders over several years. For example, amounts set aside in statutory books for policyholders' participation might be used later to cover losses that otherwise would be borne by the insurer. Losses otherwise borne by the insurer might be carried forward in its statutory books to be off-set by subsequent surplus. The insurer may deviate from the percentage that was expected to be applied to the surplus of a period in order to subsequently smooth unexpected future gains or losses. Thus, although the cash flows vary directly with the returns on underlying items, the determination of policyholders' and insurer's actual shares involves a multi-year process based on statutory accounts with significant spreading effects.

Examples include the following participating contracts:

- in some mutual entities, with a certain minimum percentage, which is nevertheless not made use of, since the insurer intends to return to policyholders all the surplus except a certain fixed amount to be retained;
- based on an asset-share model, where the split is determined at the end of each contract duration similar to the process followed for unit-linked contracts, but where the insurer has more flexibility in determining its share; and
- where the actual share is determined on an annual basis, and therefore movements within quarters are contractually smoothed.

All these cases are assumed to be in the scope of paragraph 34(a), since it is expected that the ultimate liability varies directly with statutory results, except for a relatively minor amount of uncertainty concerning the exact ultimate or annual percentage (e.g. whether policyholders ultimately receive 93% or 95% of the total surplus).

The IFRS measurement of an insurance contract usually only differs temporarily from the measurement in the statutory accounts, i.e. any difference will disappear no later than when the contract is derecognized. However, asymmetries that are based on statutory values, and decisions about the percentage share in surplus based on statutory amounts and collective liabilities could require the consideration of the results from several periods to ultimately achieve the same amount as under the statutory accounts. For example, if accumulated but not yet allocated policyholders'

share in past IFRS-surpluses can be used to off-set subsequent losses, an anticipated loss under IFRS should be off-set in that period, while in the statutory financial statements the liability is released in later years, when the loss occurs in the statutory statements.

In some cases, policyholder outcomes are spread, either within a cohort or over time. This would reflect a real feature of these insurance contracts, not an accounting artifice. We believe that, in such cases, paragraph 34(a) permits the estimate of the effects of future spreading, under the contractual terms of the linkage between liabilities and underlying items, to be included in the liability measurement in the current period. If the insurer is contractually able to equalize the statutory results over the entire contract duration or at least over many years, this can be reflected in the choice of the share for the applicable IFRS-period. If the insurer is contractually able to equalize across the quarters of a year, the equalization or loss-reducing capacity of subsequent quarters can be considered. We recommend that this be confirmed in the Basis for Conclusions.

Section B - The mirroring approach

In this Section, we discuss and propose certain modifications to the wording in paragraphs 33 and 34 while not affecting the principles underlying the proposal in the ED.

We believe that the underlying principle as outlined in paragraph B83 should be included in paragraph 34 (a) to clarify the objective. Otherwise, a potential inconsistency between paragraph B83 and paragraph 34 may exist. Paragraph B83 specifies requirements that eliminate accounting mismatches between the cash flows from an insurance contract and underlying items when the terms of the contract cannot result in any economic mismatches by the insurer. However, this cannot be inferred directly from the current text in paragraph 34. For example, there are contracts where the death benefit is 105% of the linked assets. The excess 5% is not matched with the assets and should therefore not be covered by paragraph 34(a). We believe that it should indicate the principle behind the mirroring approach – as a result we propose that paragraph 34(a) should be reworded accordingly.

a) “requires” in paragraph 33(a)

We recommend replacing “requires” by “cannot avoid”. Our understanding of paragraph 33(a) is that it relates to those cases where specific assets or liabilities are identified by the contract as underlying as, for example, in unit-linked or investment-linked contracts. However, we believe that the criterion should also apply to product designs where holding the underlying item is by the nature of the underlying item unavoidable, but not explicitly legally required. Replacing “requires” by “cannot avoid” serves the same purpose regarding the reference included in paragraph 34(a), i.e. to eliminate the possibility that the insurer can manipulate the measurement by holding or not holding the underlying item.

b) “assets and liabilities of the entity as a whole” in paragraph 33(a)

We understand and welcome the reference to assets and liabilities of the entity as a whole as step in the right direction to address contracts that refer to entire classes of assets and liabilities held by the insurer, without requiring the identification of individual assets or liabilities. Since the contract refers particularly to all held assets or liabilities of a certain class (e.g. liabilities for mortality) there is no need to require that the insurer holds them. We believe that the guidance provided should be more general in nature. We suggest that the linkage could refer to any business segment of the entity as an underlying item.

c) Terminology in paragraph 33, 34(a), 66(b) and 26(a)

We believe the terms “depend on”, “vary with” “vary directly with” and “vary indirectly” in the ED and its Basis for Conclusion should be clarified, as follows:

- Depend on/vary with: The item follows the underlying item in an incremental manner or in steps; no fixed percentage relationship is required, it can be discretionary or affected by future circumstances.
- Varying directly with: An item is expected to follow the underlying item based on a fixed positive percentage not higher than 100%. “Expected to vary directly with” means that the

percentage of policyholders' share in the returns on the underlying item (e.g. expected to be 90%) might vary in a certain range around the expected percentage (e.g., in the range of 88% to 91%) or the expected percentage may change in the future (e.g., rising from 90% to 92%). Reasons for such changes can include changes in circumstances or consequences of the application of discretion.

- Indirectly varying with: A relationship that creates an embedded derivative by caps, floors, leverage, negative correlation etc. regarding an underlying item.

d) *Mirroring technique for services within the contract itself*

Services within a contract are those, where both, cash inflows and cash outflows are contractual cash flows (e.g. mortality coverage) under the insurance contract. These services differ from investments as underlying items, as they do not have a separate carrying amount that can be easily used to apply paragraph 34(a). For example, if the underlying item is, according to paragraph 34(a), the obligation to provide mortality coverage, a circular definition in measurement is created.

e) *Discretion inherent in the linkage of contractual cash flows to underlying items*

Some have interpreted paragraph 34(a) to also cover certain discretionary deviations from the expected percentage (refer to the proposed definition of "varying directly with" in (c) above). This can arise where the contractual guidance according to paragraph 33(b) allows for some discretion in determining the share or discretionary percentage in excess of the minimum share in the underlying item. If in such cases the execution of this discretion implies that the total share in the underlying item is expected to vary directly with returns on the underlying item, the total share would be subject to mirroring.

We suggest that this should be clarified as in many countries discretionary add-ons to the legally required share, where such add-ons are expected to follow the development of the underlying item, have an important impact on the remaining insurer's share.

Recommendation: Reflecting and combining the above comments, we suggest the following wording for paragraphs 33 and 34 respectively:

33. *An entity shall apply paragraph 34 if the contract*

- specifies a link between payments to current or future policyholder and the returns on underlying items; and*
- the contractual terms of the linkage or the nature of the underlying item are such that the entity cannot avoid holding the underlying items as long as the contractual linkage remains in effect.*

34. *When paragraph 33 applies, the entity shall, at initial recognition and subsequently:*

- measure the fulfilment cash flows from which the entity does not expect to suffer any economic mismatches, i.e. that are expected to vary directly with returns on underlying items referred to in paragraph 33, to eliminate any accounting mismatch between the fulfilment cash flows and underlying items at the carrying amount of the related underlying items (meaning that paragraphs 18–27 do not apply); and*
- measure all other fulfilment cash flows in accordance with paragraphs 18–32. Such cash flows include fixed payments specified by the contract, embedded derivatives in the insurance contract, such as policyholder's options or guarantees of minimum payments that are not separated in accordance with paragraph 10.*

This [draft] Standard does not prescribe a technique for complying with the measurement requirements of this paragraph.

Section C - Treatment of the allocation of bonuses/dividends

The allocation of surplus under participating contracts can include the following steps:

- emergence of surplus under statutory accounts;

- determination of policyholders' and insurer's share under statutory accounts; and
- allocation of bonuses/dividends to individual policyholders, by paying out or purchasing further services.

The ED is not clear on:

- when to measure such amounts;
- for which insurance contract or contracts; and
- when and where to recognize the CSM resulting from the purchase.

To further explain the issue, we distinguish between:

- a. The contributing contract, the contract to which the change in the underlying item is immediately associated in applying paragraph 34(a) since it contributes to the surplus and its terms and conditions require that the amounts belong to its policyholders; and
- b. The receiving contract, the contract that ultimately benefits from those amounts by receiving additional benefits on behalf of the contributing contract.

The receiving contract can be the contributing contract itself, another current contract or a future contract. This implies that although the liability is based on the terms and conditions of the contributing contract, the liability is collective in nature since the receiving contract is not yet known. At allocation, the allocated amount reduces the collective liability associated with the contributing contract and increases the liability associated with the receiving contract usually with a smaller amount. The obligation under the contributing contract to allocate such amounts to policyholders is then fulfilled. Under the terms of the receiving contract, that amount is usually used to purchase further coverage or other services. The purchased coverage or other services will usually have a lower value than the obligation under the contributing contract to allocate amounts to policyholders. This produces a gain at allocation of the amount to the receiving contract.

Some believe that the obligation under the contributing contract should be determined including the profits expected to be retained by the entity from allocation to the receiving contract. That implies that the entire expected profit resulting from services to the receiving contract is reflected in the CSM at the outset of the contributing contract. They argue that the liability should be determined based on the ultimate expected cash flows to be paid by the insurer even if these cash flows are significantly affected by the terms and conditions of the receiving contract. Typically such a measurement significantly increases the percentage of insurer's share in surplus and so avoids an overstatement of the fulfilment cash flows.

Others believe that the obligation under the contributing contract shall be determined based on the expectations of the amounts of the underlying items that will be allocated in the future to receiving contracts. They believe that the CSM from purchasing additional coverage or other services under the terms and conditions of the receiving contract belongs to the receiving contracts since the CSM results from its terms and conditions and services provided under that contract.

Both believe that in measuring the receiving contract after such an allocation of an amount from such a collective liability used to purchase additional coverage or other services in accordance with the contract, the allocation should be treated as a contract modification, where the difference between the allocation and the fulfilment cash flows of the purchased services increases or decreases the CSM.

Recommendation: Since the impact to the initial CSM of a contract depends upon when the CSM of future purchases is recognized, we believe clarification is needed.

Section D - Replicating portfolios

While paragraph 80 provides guidance that in the case of replicating portfolios no decomposition between building blocks is needed, there is no similar guidance for other cases of measurement that are based on market variables or carrying amounts.

As stated in paragraph B46, the cash flows of a replicating asset or portfolio (of assets) *exactly* match the contractual cash flows in amount, timing and uncertainty. It can be concluded from paragraph B46, that the price of such an asset or portfolio needs to be observable in or directly

derivable from a market, i.e. to be a market variable. It is therefore a level 1 or 2 reflection of the fair value of the cash flows (IFRS 13). We do not believe that this “exactly” match criterion will often be achievable in the insurance business, except in the case of some rare unit- or investment-linkage or other cases where contracts directly and explicitly refer to market variables.

The main distinguishing characteristic of applying a replicating portfolio or market prices for market variables is that otherwise an entity-specific view is required, is not applied (paragraph B44), since the objectivity of observed market prices takes precedence over the measurement attribute (paragraph BCA29).

The second distinguishing characteristic of applying a replicating portfolio is indicated in the last sentence of paragraph B80; the risk adjustment is not reported separately but is inherent in the movement of the discounted cash flows. We believe that this exception should be expanded to also cover alternative calculations of the value of the replicating portfolio, as permitted in paragraph B80, and to any other calculation that is fully based on market variables. Otherwise the technical approach would have a direct impact on measurement and presentation. It is unclear whether guidance regarding interest rates, specifically presentation in OCI or unwinding of discounts in P&L applies. This suggestion also applies to cash flows measured under paragraph 34(a). The entire presentation of such measurement based on an observed amount for the total is not clear from reading the ED.

Recommendation: Although we agree with the principles of market variables and replicating portfolios, we recommend that the exemption from explicitly reporting risk adjustments in paragraph B80 be expanded to permit alternative calculation techniques as permitted in paragraph B47 and to other calculation approaches that are fully based on market variables or carrying amounts. In addition, we suggest including guidance on the presentation of the time value of money, as this is also missing for measurement under paragraph 34(a).

Section E – Equity of mutual entities

In some jurisdictions, there is a distinction between policyholders’ rights to a certain share in surplus from participating contracts in their capacity as policyholders and their rights in their capacity as members to any remaining amount. This distinction is made even in the absence of specific rights of policyholders or members to any remaining amounts. In other jurisdictions, for example in Sweden, there is no such clear distinction. In general, the insurance contracts grant the community of policyholders in their capacity as policyholders a right to the entire surplus of the insurer. However, in both cases, the insurer has the ability to retain amounts permanently and to offset any losses that occur, using those retained amounts.

Given that the meaning of equity is still an unresolved issue under IFRS, the equity-character of some of these amounts cannot be determined precisely. We do not believe that financial reports of mutual entities should be significantly restructured until such time as there is an applicable definition of equity. Amounts that are not paid out for the foreseeable future on a going concern basis and which are not interest bearing, could be seen as having a present value of zero. This would solve the issue of the measurement of such amounts. We urge the IASB to move forward in its conceptual development to clarify the meaning and treatment of equity.

Recommendation: The IASB should introduce interim guidance for this specific case, as follows:

Amounts of underlying items that, under going concern, are not expected to be paid in the foreseeable future to policyholders should be exempted from the mirroring approach and be measured on the basis of expectations.

Subject to the following criteria:

- a) *There are no limitations forcing the entity to distribute the amounts within a certain time.*
- b) *The entity does not expect to make any distribution in the foreseeable future and wishes to avoid any distribution for the future.*
- c) *The amounts are fully available to be used for covering any loss of the entity.*
- d) *The above applies regardless of whether the entity will earn further surplus in the future or not.*

Section F - Universal Life Contracts, Index-Linked Contracts and Unit-Linked Contracts

This section includes our understanding of the treatment in the Exposure Draft in respect of these contracts.

- In general, universal life contracts do not specify a link to the returns of an underlying item. As a consequence, paragraph 34(a) does not apply. Even paragraph 26(a) may not apply, since the insurer might not expect to apply discretion as to which cash flows depend on returns on underlying items (refer to paragraph B73). In 2005, representatives of the IAA provided an educational session to the Board discussing such features regarding untested minimum requirements of regulators, i.e. whether exercising discretion in an unreasonable manner could result in regulators taking action to enforce a certain minimum return to policyholders. However, insurers have not yet been tested regarding the use of unreasonable crediting rates. Nevertheless, we understand the combined guidance in paragraphs 26(a) and B73, to justify the application of paragraph 26(a) to such cases since the insurer generally intends to pay a crediting rate in a manner generally consistent with the long term development of the investment returns.
- Applying paragraph 60(h) (revised as proposed above) would result in any change to the crediting rate (resulting from a change in the underlying item) to trigger a change in the discount rate shown in P&L to the current rate, therefore affecting the split between interest shown in P&L and OCI. The more direct the crediting rate response to changes in underlying assets the smaller would be the impact to OCI. An annual review of the crediting rate would essentially eliminate any OCI.
- Other universal life contracts might link the crediting rate (bonuses/dividends) to a market index (e.g., the S&P 500). Here, paragraph 26(a) will usually be applicable. Any unexpected movement of the underlying item, immediately reflected in expected returns to policyholders, would cause the discount rate shown in P&L to be triggered which would avoid presentation in OCI. Since the insurer will be usually unable to precisely hold the contractual underlying item itself, the contract would not meet the criteria indicated in paragraph 33.
- If insurers are obliged to hold the units under a unit-linked contract, paragraph 34(a) may apply. That means that the directly linked part of the obligation in these contracts would be measured at the carrying amount of the units, not necessarily at fair value through P&L. Otherwise paragraph 26(a) would apply, or alternatively the measurement approach based on a replicating portfolio.
- There are usually deductions or additions to the fund, which may be fixed or operate in a fixed relationship with – normally – the fair value of the fund. Those deductions or additions are measured separately (in some countries these contracts can be participating and hence separation is required according to paragraph 34(a)). They reduce the benefits to policyholders, i.e., there is a greater amount from premiums considered in measurement to contribute to the initial CSM. The policyholders' share in the units is the carrying amount of the units minus the expected present value of future fees measured in line with the normal building block measurement guidance, including applicable adjustments to the CSM. It is necessary to estimate the future development of the fund, if fees depend on the fund value. This is would be discounted using the building block discount rate.

Recommendation: We suggest that the proposal for such contracts should be clarified in the final standard. Our response to Question 2 provides the principles we believe should be applied.

Appendix B

Full Member Organizations - 64

Caribbean Actuarial Association
Consejo Profesional de Ciencias Económicas de la Ciudad Autónoma de Buenos Aires (Argentina)
Actuaries Institute Australia (Australia)
Aktuarvereinigung Österreichs (AVÖ) (Austria)
Institut des Actuaire en Belgique (Belgique)
Aktuarsko Drustvo U Bosni I Hercegovini (Bosnia and Herzegovina)
Instituto Brasileiro de Atuária (IBA) (Brazil)
Bulgarian Actuarial Society (Bulgaria)
Canadian Institute of Actuaries/Institut Canadien des Actuaire (Canada)
China Association of Actuaries (China)
Actuarial Institute of Chinese Taipei (Chinese Taipei)
Asociación Colombiana de Actuarios (Colombia)
Institut des Actuaire de Côte d'Ivoire (Côte D`Ivoire)
Hrvatsko Aktuarsko Drustvo (Croatia)
Cyprus Association of Actuaries (Cyprus)
Česká Společnost Aktuárů (Czech Republic)
Den Danske Aktuarforening (Denmark)
Egyptian Society of Actuaries (Egypt)
Eesti Aktuaaride Liit (Estonia)
Suomen Aktuaariyhdistys (Finland)
Institut des Actuaire (France)
Deutsche Aktuarvereinigung e. V. (DAV) (Germany)
Hellenic Actuarial Society (Greece)
Actuarial Society of Hong Kong (Hong Kong)
Magyar Aktuárius Társaság (Hungary)
Félag Islenskra Tryggingastærðfræðinga (Iceland)
Institute of Actuaries of India (India)
Persatuan Aktuaris Indonesia (Indonesia)
Society of Actuaries in Ireland (Ireland)
Israel Association of Actuaries (Israel)
Istituto Italiano degli Attuari (Italy)
Institute of Actuaries of Japan (Japan)
Japanese Society of Certified Pension Actuaries (Japan)
The Actuarial Society of Kenya (Kenya)
Latvijas Aktuaru Asociacija (Latvia)
Lebanese Association of Actuaries (Lebanon)
Lietuvos Aktuariju Draugija (Lithuania)
Persatuan Aktuari Malaysia (Malaysia)
Colegio Nacional de Actuarios A. C. (Mexico)
Association Marocaine des Actuaire (Morocco)
Het Actuarieel Genootschap (Netherlands)
New Zealand Society of Actuaries (New Zealand)
Den Norske Aktuarforening (Norway)
Pakistan Society of Actuaries (Pakistan)
Actuarial Society of the Philippines (Philippines)
Polskie Stowarzyszenie Aktuaruszy (Poland)
Instituto dos Actuários Portugueses (Portugal)
Russian Guild of Actuaries (Russia)
Udruženje Aktuara Srbije (Serbia)
Singapore Actuarial Society (Singapore)
Slovenska Spoločnosť Aktuarov (Slovakia)

Slovensko Aktuarsko Drustvo (Slovenia)
Actuarial Society of South Africa (South Africa)
Col.legi d'Actuaris de Catalunya (Spain)
Instituto de Actuarios Españoles (Spain)
Svenska Aktuarieföreningen (Sweden)
Association Suisse des Actuaires (Switzerland)
Society of Actuaries of Thailand (Thailand)
Institute and Faculty of Actuaries (United Kingdom)
American Academy of Actuaries (United States)
American Society of Pension Professionals & Actuaries (United States)
Casualty Actuarial Society (United States)
Conference of Consulting Actuaries (United States)
Society of Actuaries (United States)

Appendix C

Members of the IAA Insurance Accounting Committee

Chairperson:

Francis Ruygt

Co-Vice-Chairpersons:

Micheline Dionne
David John Finnis
William C. Hines

Members:

Gunn Albertsen	Den Norske Aktuarforening
Victor Hugo Cesar Bagnati	Instituto Brasileiro de Atuária (IBA)
Daniel N. Barron	Israel Association of Actuaries
Guy Castagnoli	Association Suisse des Actuaire
Antonella Chiricosta	Istituto Italiano degli Attuari
Simon R Curtis	Canadian Institute of Actuaries/Institut Canadien des Actuaire
Alexander Dollhopf	Svenska Aktuarieföreningen
Ann Duchêne	Institut des Actuaire en Belgique
David John Finnis	Actuaries Institute Australia
Xing Feng Gong	China Association of Actuaries
Rokas Gyls	Lietuvos aktuariju draugija
Jozef Hancar	Slovenska Spolocnost Aktuarov
Maximilian Happacher	Deutsche Aktuarvereinigung e. V. (DAV)
Armand Maurice Ibo	Institut des Actuaire de Côte d'Ivoire
Satyan Jambunathan	Institute of Actuaries of India
Dragica Jankovic	Udruzenje aktuara Srbije
Burton D Jay	Conference of Consulting Actuaries
Ad Kok	Het Actuarieel Genootschap
Christoph Krischanitz	Aktuarvereinigung Österreichs (AVÖ)
Yin Lawn	Actuarial Institute of Chinese Taipei
Kristine Lomanovska	Latvijas Aktuaru Asociacija
Ana Maria Martins Pereira	Instituto dos Actuários Portugueses
James B Milholland	Society of Actuaries
Brian Joseph Morrissey	Society of Actuaries in Ireland
Yoshio Nakamura	Institute of Actuaries of Japan
Marc F Oberholtzer	Casualty Actuarial Society
Manuel Peraita Huerta	Instituto de Actuarios Españoles
Andreja Radic	Hrvatsko Aktuarsko Društvo
Nithiarani Rajasingham	Singapore Actuarial Society
Ravi Clifton Rambarran	Caribbean Actuarial Association
Thomas Ringsted	Den Danske Aktuarforening
Jaanus Sibul	Eesti Aktuaaride Liit
Henry W Siegel	American Academy of Actuaries
Maxime Simoen	Institut des actuaire
Mateja Slapar	Slovensko Aktuarsko Društvo
Pentti Soininen	Suomen Aktuaariyhdistys
Arseny Leonidovich Timakov	Russian Guild of Actuaries
Peter Andrew Withey	Actuarial Society of South Africa
Derek John Wright	Institute and Faculty of Actuaries
Jana Zelinkova	Ceská Společnost Aktuárù
Jesús Alfonso Zúñiga San Martin	Colegio Nacional de Actuarios A. C.