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EFRAG  
Françoise Flores  
Chairman EFRAG TEG  
35 Square Meeûs

B-1000 Brussels

Dear Françoise,

### **ED/2013/7 Insurance Contracts**

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on EFRAG's Draft Comment Letter on the IASB's ED/2013/7 *Insurance Contracts* (hereafter referred to as the 'Re-ED'). We appreciate the opportunity to respond to EFRAG's Draft Comment Letter.

The ASCG would like to refer especially to EFRAG's questions raised regarding the *alternative approach* for participating contracts. We support this approach and would like to provide our reasons for advocating this approach. Furthermore, we want to emphasise that we do not agree with EFRAG's proposal to measure all assets that cover insurance liabilities at fair value through other comprehensive income (FVTOCI). This would lead to a factually industry-specific Standard, is not appropriate for all kinds of insurance contracts and would be accompanied with changes of corresponding Standards and thus lead to a long delay of the implementation of the Standard.

We would like to refer to the attached appendix which includes our responses to the questions raised by EFRAG. For our reasons and further details of our views, please see our attached comment letter to the IASB. If you would like to discuss our comments further, please do not hesitate to contact me.

Yours sincerely,

*Liesel Knorr*  
President

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Berlin, 22 October 2013



## Appendix A - Answers to the questions of EFRAG's Draft Comment Letter (DCL)

### Adjusting the contractual service margin

#### EFRAG's question to constituents – paragraph 14 of the DCL

Do you believe that the distinction between changes in estimates relating to future coverage or other future services and experience adjustments would involve a significant amount of judgement? If so, do you believe that the proposed guidance provides sufficient explanation on how entities make this distinction?

- 1 The ASCG agrees with EFRAG supporting the adjustment of the contractual service margin (CSM) and is supportive of EFRAG's view to adjust the margin to reflect changes in estimates of the risk adjustment associated with future coverage. In our opinion, the proposed guidance provides sufficient explanation on how entities make the distinction between changes in estimates relating to future coverage or other future services and experience adjustments. We are being told by our insurance working group that the necessary differentiation between experienced and future changes is operationally feasible for cash flows and also for the risk adjustment. However, there is a contradiction between the definition of the CSM as the unearned profit and the application guidance for the CSM as the Re-ED does not include the unlocking for changes in the risk adjustment relating to future coverage, options and guarantees and reinvestment assumptions. We support EFRAG's view to unlock the CSM also for changes in the risk adjustment relating to future coverage and the *alternative approach for participating contracts* to unlock the CSM also for all changes in estimates relating to future coverage or other future services in order to have a clear guidance for the adjustment of the CSM which would be consistent with the margin's definition as the unearned profit.

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

#### EFRAG's question to constituents – paragraph 56 of the DCL

Do you believe that the alternative approach described in Appendix 5 will lead to financial statements that provide relevant information that faithfully represent the entity's position and performance for contracts with asset dependent cash flows? Why or why not? If not, what would you recommend and why? Please consider whether the alternative approach eliminates or reduces accounting mismatches while reporting consistently contracts with similar economic features (i.e. contracts with asset dependent cash flows). Do you support the alternative approach wholly or partly? Please explain, which parts you support and which you do not?



2 Regarding the IASB's "mirroring approach" for participating contracts, the ASCG confirms some of EFRAG's concerns about the mirroring-principle. Our major concerns refer to the limited scope, the complexity and the feasibility of the decomposition of cash flows and the decision usefulness of this proposal. Instead, we support the *alternative approach* because it provides relevant information that faithfully represents the entity's position and performance for contracts with asset dependent cash flows. The reasons why the ASCG appreciates this proposal refer to the following advantages:

- The proposed model is built on a fulfilment value model in accordance with the general requirements of the Re-ED, instead defining an exception to this model.
- A single measurement model increases the comparability of insurance contracts and enables a similar accounting for economically similar contracts.
- The proposal leads to a significant reduction of complexity because there is no need to decompose the cash flows and the prospective measurement is applicable without historical assumptions.
- Considering the asset dependence through the cash flow projection and within the determination of the discount rate provides relevant information that faithfully represents the entity's financial position and performance and depicts the participating business adequately. The recognition of the interest expense in profit or loss using the yields as proposed in the *alternative approach* would depict best that asset dependence and consider reinvestment assumptions as well.
- The *alternative approach* provides understandable and useful information for users of financial statements due to the existence of just one measurement model and the elimination of the decomposition of cash flows. In addition, analysts are able to evaluate the entity's performance in the long-run because the prospective measurement requirements and the complete unlocking of the CSM enables a clear distinction between earned profits of the current period and changes related to future periods.
- Since the generation of asset returns is an integral part of participating contracts, changes in estimates regarding these cash flows should lead to an adjustment of the CSM. To meet the definition of the CSM as the unearned profit, changes in the value of options and guarantees as parts of the insurance contract should lead to adjustment of the CSM, too.

3 Regarding the possibility of accounting mismatches we would like to point out that for contracts where assets are measured at FVTOCI there would be no accounting mismatch. Furthermore, the use of an asset dependent discount rate which reflects the profit or loss



returns on underlying items for the determination of interest expense in profit or loss avoids a potential mismatch.

**EFRAG's question to constituents – paragraph 57 of the DCL**

Do you believe that for contracts with asset dependent cash flows, the effect of changes in financial assumptions should be accounted for in the contractual service margin resulting in a fully prospective contractual service margin? If so, why and how should this be done?

- 4 Yes, we believe that for contracts with asset dependent cash flows the effect of changes in financial assumptions should be accounted for in the CSM. As the CSM represents the unearned profit it should be adjusted for all changes in estimates that relate to future coverage or other future services including changes in financial assumptions. Since the generation of asset returns is an integral part of services under a participating contract, changes in estimates, including financial assumptions, must lead to an adjustment of the CSM to meet the margin's definition as the unearned profit.

**EFRAG's question to constituents – paragraph 58 of the DCL**

Do you agree that interest expense should be recognised in Profit or Loss based on a yield as proposed in the alternative approach? Why or why not?

- 5 We agree with the recognition of the interest expense in profit or loss in accordance with the *alternative approach*. For insurance contracts where liabilities are covered by certain assets and the liability is dependent on those asset returns, the asset dependence is most appropriately taken into consideration when taking asset returns as a basis for determining the discount rate. More specifically, the discount rate should reflect the profit or loss recognition of those asset returns (i.e. fair value or amortised cost depending on the measurement basis of underlying assets). For the part of the liability for which the duration of the liability exceeds the duration of the underlying assets, the discount rate is based on the expected reinvestment return that shall be determined consistently for cash flow projections and in the discount rate on current market information where available.

**EFRAG's question to constituents – paragraph 59 of the DCL**

What should be the pattern of release on the contractual service margin for contracts with asset dependent cash flows?

- 6 The Re-ED requires entities to release the CSM in a systematic way that best reflects the remaining transfer of services that are provided under the contract. As the CSM reflects the remaining unearned profit, the release pattern of the margin should be generally based on the changes of the present value of expected future profits.



EFRAG's question to constituents – paragraph 60 of the DCL

Do you believe that the alternative approach is operationally more or less complex than the IASB's 'mirroring approach'?

- 7 We believe that the *alternative approach* is operationally less complex than the IASB's "mirroring approach". The "mirroring approach" is a separate model and with the decomposition of cash flows very complex, difficult to implement by insurers and also hard to understand by users of financial statements. As the *alternative approach* is based on a fulfilment model in accordance with the general building block requirements of the Re-ED and does not include a decomposition of cash flows, this measurement model is easier to apply and reduces the complexity significantly. In addition, the *alternative approach* increases the comparability due to the existence of a single measurement model. The fully prospective measurement simplifies the approach to transition significantly.

EFRAG's question to constituents – paragraph 61 of the DCL

Do you believe that the alternative approach, or a variant thereof, would be conducive to understandable and useful information for investors and their advisors?

- 8 In our view, the *alternative approach* is beneficial to provide understandable and useful information to users of financial statements. As the *alternative approach* does not include the decomposition of cash flows and is built on the general requirements of the Re-ED, it is more understandable than the "mirroring approach". Furthermore, considering the asset dependence through the cash flow projection and within the determination of the discount rate provides relevant information that faithfully represents the entity's financial position and performance and depicts the participating business adequately. The prospective determination of the margin considering all changes in estimates relating to future coverage or other future services provides useful information for investors as this provides information about the future profitability of the entity. The decision-usefulness of information is furthermore ensured by having current fulfilment values in the statement of financial position and an income statement that reflects the long-term nature of the business.

**Presentation of insurance contract revenue and expenses**

EFRAG's question to constituents – paragraph 87 of the DCL

Do you believe that the investment component would be difficult and costly to compute because they are not distinct and are highly interrelated with the insurance component with the insurance component?



- 9 Due to the broad definition of the investment component that is different from deposit elements used in current practice, separating investment components for the purpose of presenting revenue adds additional complexity. In addition, it is inconsistent to separate investment components for presentation purposes which are not separated for measurement purposes.

EFRAG's question to constituents – **paragraph 88** of the DCL

Do you believe that additional guidance is necessary to determine these amounts on a portfolio level?

- 10 No, we do not think that additional guidance is necessary to determine separated investment components on a portfolio level. As long as the portfolio of insurance contracts is homogenous the determination should be carried out according to the determination on an individual contract level. There should not be any difficulties that just arise on a portfolio level.

EFRAG's question to constituents – **paragraph 89** of the DCL

Do you believe that preparing and presenting revenue under the ED proposals would be difficult and costly?

- 11 We are being told by our insurance working group that preparing and presenting revenue under the Re-ED's proposals is complex and cost-intensive. Especially the separation of investment components would be costly.

**Interest expense in profit or loss**

EFRAG's question to constituents – **paragraphs 103 - 104** of the DCL

Under the IASB's proposals, the difference to be reported in OCI is determined by comparing the discount rate to measure the liabilities and, depending on the type of cash flows, the locked-in rate at inception of the insurance contract or an updated rate. Under IAS 19 *Employee Benefits*, the difference is determined by comparing the discount rate at the beginning of the reported period and the rate at the end of the reporting period. Some, including IASB Board member Stephen Cooper, hold the view that only the latter difference (i.e. the effect of changes in discount rates in the period of the change) provides relevant information (as is described in paragraphs AV5 and AV6 of the Basis for Conclusions), and that, therefore, only this difference should be reported in OCI.

Do you support the approach in the ED or should the interest expense recognised in profit and loss be based on a current discount rate for all type of cash flows? If so, should the discount rate be the rate at the beginning of the period, as in IAS 19, or that at the closing date?

- 12 We support the approach in the Re-ED to determine the amount reported in OCI by comparing the carrying amount of the insurance contract measured using the current rate and the



carrying amount of the insurance contract measured using the discount rate for the determination of the interest expense in profit or loss, which is the locked-in discount rate at inception of the contract that is updated in line with paragraph 60(h).

**EFRAG's question to constituents – paragraph 108 of the DCL**

Do you believe that the suggested approach described above will lead to financial statements that provide relevant information that faithfully represent the entity's financial position and performance for contracts? Please consider whether the suggested approach eliminates or reduces accounting mismatches in Profit or Loss and OCI.

13 We acknowledge EFRAG's aim and believe that this approach would avoid certain accounting mismatches and we believe that the use of OCI for liabilities is a very important component of an accounting approach for the long term business. Nevertheless, we do not believe that EFRAG's approach to prescribe a mandatory OCI for all kinds of insurance backing assets is the best solution for avoiding an accounting mismatch due to the following reasons:

- Measuring all assets that cover insurance liabilities at FVTOCI would virtually create an industry specific Standard which implies a fundamental break with the general principles of the IFRSs.
- For most cases the existing IFRS 9 / IFRS 4 solution with the use of OCI is adequate. However, we do not believe that the use of OCI is meaningful in all situations. Some contracts, for example unit-linked contracts or variable annuities, are managed on a fair value through profit of loss (FVTPL) basis. For those cases where the recognition of the effect of a change in the discount rate on the insurance liability in OCI is not suitable, the entity should have the option to recognise these changes in profit or loss in order to depict the asset dependence adequately.
- Identifying the assets backing insurance contracts will be very difficult in practice as often no ring fenced assets, which back insurance liabilities, exist.
- Given the advanced stage of the IFRS 9 project and the IFRS 4 phase II project, the realisation of EFRAG's proposal would cause significant delays which should be avoided.

**EFRAG's question to constituents – paragraph 109 of the DCL**

Are you aware of any circumstances in which, from your point of view, measurement of both insurance liabilities and the related financial assets at FV-PL be needed instead of, or combined with, measurement at FV-OCI? If so, please provide a description of the portfolios of insurance contracts concerned and how the asset-liability management strategy differs from other portfolios.



- 14 As already stated above, some products are managed on a FVTPL basis, in particular unit-linked contracts and variable annuities. To consider the asset dependence on a fair value basis and take into account the existence of certain business models, entities should be allowed to account liabilities at FVTPL when this helps avoiding an accounting mismatch. Thus, measuring these liabilities at FVTPL provides the most relevant information for the products.

EFRAG's question to constituents – **paragraph 110** of the DCL

Do you believe that EFRAG should suggest how the assets related to insurance liabilities should be identified? If so, what would you recommend and why?

- 15 We doubt that this approach would be practicable because there are many difficulties when assigning assets to liabilities. In general, the allocation is complex and complicated. It depends on the actual jurisdiction; and the assignment is not constant over time because of changing asset pools.

EFRAG's question to constituents – **paragraph 111** of the DCL

Do you believe that derivatives should also be accounted for using OCI? If so, how could objective evidence be gathered in respect of derivatives that only play a role in matching insurance liabilities?

- 16 We do not believe that derivatives should be accounted for using OCI outside hedge accounting. However, we would like to point out the necessity to amend the hedge accounting requirements.

EFRAG's question to constituents – **paragraph 112** of the DCL

Should any other assets apart from those included in paragraph 105 be measured at FV-OCI? Please explain why.

- 17 Although we do not support EFRAG's proposal, we strongly support the OCI solution for insurance liabilities. However, this needs to be anchored in respective Standards for assets. In particular under IFRS 9, we believe that the SPPI criterion is defined too narrowly, and thus we feel that some instruments regarded as "normal" lending transactions would be scoped out. We would like to refer to our comment letter to IFRS 9 for further details.



**EFRAG's question to constituents – paragraphs 113-114 of the DCL**

Do you agree that following EFRAG's approach, the IASB would need to develop an impairment model for debt instruments that do not meet the contractual cash flow characteristics assessment and investments in equities that would be measured at FV-OCI and potentially other assets? If so, what impairment model would you recommend and why?

Do you see any problems in recycling realised gains and loss on investments to contracts with asset-dependent cash flows (that are not under the scope of the IASB's measurement and presentation exception as discussed in Question 2)? If so, what solutions would you recommend? Please explain your answer.

- 18 Although we do not support the proposal to measure at FVTOCI assets that relate to insurance liabilities as described in paragraph 101(b) of EFRAG's DCL, we support the introduction of recycling for equity instruments as proposed by EFRAG, as this avoids an accounting mismatch that otherwise would arise if the OCI model is applied to insurance liabilities. For debt instruments there is no need to develop a separate impairment model. If recycling for equity instruments is introduced, an impairment model would need to be developed.

**EFRAG's question to constituents – paragraph 115 of the DCL**

Where should changes in the time value of options and guarantees not separated from insurance liabilities be recognised? Please explain your answer.

- 19 We support the recognition of changes in the time value of options and guarantees not separated from insurance liabilities as proposed in the *alternative approach*. The value of options and guarantees is included in the fulfilment cash flows using stochastic valuations. To include options and guarantees which are not separated according to ED.9-11 as a part of the fulfilment cash flows is in line with the Re-ED's requirements which determine that the fulfilment cash flows shall include all cash inflows and outflows.
- 20 The *alternative approach* treats changes in the time value of options and guarantees that effect future cash flows and future service as an adjustment of the CSM. This is consistent with how the margin is determined at inception and consistent with the treatment of the other parts of the fulfilment cash flows. As the CSM shall not be negative, the *alternative approach* entails an implicit loss recognition test as it is based on updated assumptions and reflects the current time value of options and guarantees. To ensure transparency, we believe a disclosure requirement for the time value of options and guarantees should be included in the Standard.



21 Appendix 5 contains two views on the recognition of changes in the time value of options and guarantees: the recognition of changes in the CSM (view 1) or the recognition of changes in OCI (view 2). Our reasons why we support view 1 are the following:

- Options and guarantees should be treated consistently with the other fulfilment cash flows and thus should be measured within the overall insurance contract obligation, using a current value approach.
- As the CSM reflects the unearned profit and should be adjusted for changes that relate to future cash flows and other future services, changes in the time value of options and guarantees that affect the future service should lead to an adjustment of the CSM, too. Thus, the CSM represents the unearned profit from the contract at contract inception and subsequent reporting dates. Recognising these changes in OCI is inconsistent with the definition of the CSM.
- The presentation of profitability of the contract might be misleading as OCI can become negative. Then, a contract or portfolio of contracts could still be presented as profitable (with a positive CSM), although the contract is onerous.

### **Effective date and transition**

#### **EFRAG's question to constituents – paragraphs 135-136 of the DCL**

Considering EFRAG's recommendation for entities where insurance forms a significant part of their activities (i.e. the effective date of IFRS 9 should be deferred until the effective date of the new insurance contracts standard), do you believe that:

- a) Those entities should always be required to apply the impairment proposals earlier than the other parts of IFRS 9; or
- b) Those entities should be allowed early implementation of the impairment proposals compared to the other parts of IFRS 9.

Do you believe the scope of the redesignations and reclassifications when the new insurance contracts standard is applied for the first time by entities for whom insurance forms a significant part of their activities, should be extended beyond IFRS 9 (e.g. investment properties)? If yes, please explain what items should be within that scope?

22 In general, we agree with EFRAG's view regarding transition and effective date. Regarding the interaction of IFRS 9 and IFRS 4 we believe that a single effective date for both Standards would be most beneficial for insurance entities or other entities having to apply the proposal. These entities would have the benefit of implementing both Standards at the same time, which minimises operational complexity. Furthermore, it would increase the comparability and understandability for financial statement users (this applies specifically to a business that is long term in nature. If the possibility of aligning the effective dates for both Standards was limited, thus leading to different effective dates, we strongly recommend granting entities



with insurance business the possibility of reclassifying financial assets upon adoption of the new insurance proposals. This would allow these entities avoiding accounting mismatches otherwise occurring if they were forced to keep their original designation (which had to be made not knowing what the final outcome of the new Standard on insurance would look like).

### **The likely effects of a Standard for insurance contracts**

#### **EFRAG's question to constituents – paragraph 139 of the DCL**

Do you believe that the IASB's response to the comments on the 2010 Exposure Draft balance the costs of applying these proposals with the benefits of the resulting information provided?

- 23 In general, the implementation of the new insurance requirements represents a significant investment for all stakeholders of the insurance industry, preparers as well as users of financial statements. Some proposals, such as the introduction of a FVTOCI measurement, increase the complexity of implementation in comparison to the 2010 ED's proposals. Nonetheless, in our opinion, we believe this complexity to be appropriate in order to adequately depict the insurance business, which is a complex business. The high costs associated with implementing and meeting the proposed requirements are justified if they make other non-GAAP measures redundant that are currently used in internal and external communication (such as Embedded Value). However, some of the IASB's proposals in the Re-ED cause unnecessary complexity where there is no corresponding benefit at the same time. Please find more details in our answer to question 6 in our comment letter to the IASB.

### **Clarity of drafting**

#### **EFRAG's question to constituents – paragraphs 141-142 of the DCL**

Do you agree with the areas/paragraphs identified by EFRAG in Appendix 4?

Have you identified any other areas/paragraphs that need clarification? Please explain.

- 24 The ASCG identified the following areas where clarification is needed from our point of view:
- The proposals and the Illustrative Example 11 regarding the decomposition of cash flows are not clear.
  - We believe the drafting regarding the reversal of a negative CSM is not clear. It remains unclear if the entity has to reverse prior losses through profit and loss before reestablishing a positive margin or not.
  - A clear definition of the “time value of option and guarantees” would help avoiding misinterpretations of the proposals.



25 For further information please see our answer to question 7 in our comment letter to the IASB.

### **Gains and losses on buying reinsurance**

#### **EFRAG's question to constituents – paragraph 17** in Appendix 2 of the DCL

Do you agree with EFRAG's conclusion that day one gains and losses on buying reinsurance should be recognised over the coverage period? If not, please explain how those should be accounted for and what the supporting arguments for a different accounting treatment are.

26 In our opinion, for reinsurance bought, there are supporting arguments both for recognising gains and losses over the coverage period and for recognising these gains or losses immediately in profit or loss. Reinsurance entities argue that the Re-ED's proposals for reinsurance contracts on an individual loss basis do not depict the economic relationship between the reinsurance contract and the underlying insurance contract appropriately. In particular, the high dependence of the reinsurance contract on the underlying insurance contract is not taken into consideration adequately. We understand that five global reinsurance entities represented in the *CFO Forum* developed an *alternative approach for reinsurance contracts*: The proposal provides the determination of the contractual service margin based on the underlying business because of the 1:1 relationship of the reinsurance and the underlying insurance contract. The CSM of the reinsurance asset should reflect the reinsurer's share in the risk of the underlying business. In particular, determination of the CSM is based on the ratio of the risk adjustment that is applied to the CSM of the underlying contract. Furthermore, they argue that the gain or loss from buying reinsurance on an individual loss basis is definitive (except for the credit risk of the reinsurer, which is considered through the determination of the CSM) and should therefore be recognised immediately in profit or loss in order to avoid the possibility of accounting arbitrage.

27 We believe that the requirements for reinsurance contracts held should be dependent on the respective type of reinsurance contract. Contractual constellations might exist where the recognition of the gain or loss from buying reinsurance immediately in profit or loss is appropriate but others too where the gain or loss should be recognised over the coverage period. We believe that the accounting treatment of underlying primary insurance contracts should remain unaffected by the reinsurance contracts held (no derecognition). The requirements for the recognition of any gain or loss from buying reinsurance should always reflect the credit risk of the reinsurer. We suggest that the IASB carefully reconsider the guidance provided on reinsurance contracts held and ensure, that the economics of these transactions are reflected appropriately in the cedents accounts.



### **Disclosures of minimum capital requirements**

EFRAG's question to constituents – **paragraph 23** in Appendix 2 of the DCL

Do you agree with EFRAG's recommendation that the requirement to disclose information about the effects of each regulatory framework in which entities operate should be deleted in the final standard? Please explain your answer.

- 28 We do agree with EFRAG's recommendation that the requirement to disclose information about the effects of each regulatory framework in which entities operate should be deleted in the final Standard. In particular we support EFRAG's recommendation to delete the requirement for disclosure of the minimum capital requirement in the final Standard. The minimal capital requirements are not determined on a comparable basis globally and usually refer to underlying risks of a company or a group in total, not only to those resulting from insurance contracts. This approach would introduce an industry specific requirement not in line with the scope of the Standard, which deals with insurance contracts only.



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Hans Hoogervorst  
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Berlin, 22 October 2013

United Kingdom

Dear Hans,

### **IASB ED/2013/7 Insurance Contracts**

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on the Exposure Draft ED/2013/7 *Insurance Contracts* (hereafter referred to as 'the Re-ED'). We appreciate the opportunity to comment on this revised Exposure Draft.

The ASCG welcomes the IASB's decision to re-expose the 2010 Exposure Draft and appreciates the effort of the IASB to take into account concerns raised by constituents regarding the 2010 ED. Many changes made have lead to a good basis for the accounting of insurance contracts, but we believe that there are still a few yet important areas where changes are necessary in order to establish an appropriate and balanced Standard that ensures a faithful presentation for all types of insurance contracts and avoids unnecessary complexity.

We are supportive of many of the changes that the IASB incorporated in the Re-ED. We acknowledge especially the unlocking of the contractual service margin for future periods, the recognition of changes in the discount rate in other comprehensive income and the proposed retrospective approach to transition. Notwithstanding our general support, we have concerns about some proposals. Whilst we acknowledge the IASB's desire to finalise this long-lasting project and publish a globally harmonised Standard for insurance contracts as soon as possible, this should not come at the expense of discriminating against specific types of insurance contracts and the entities that write such policies. We understand that insurance is a highly regulated business and dealt with differently from one jurisdiction to the next, so a one-size-fits-all approach, especially as regards the life insurance business, might not suffice. We believe it is key that the IASB carefully consider the following issues and take the time necessary to address these concerns, so as to provide a suitable solution meeting the expectations of both preparers and users. Specifically:



- We support the IASB's decision to adjust the contractual service margin for changes in estimates of future cash flows. However, we believe that the unlocking of the margin should be implemented more fully in order to achieve a subsequent measurement that is consistent with the measurement at initial recognition and to meet the definition of the service margin representing the unearned profit for future periods. In particular, the margin should be unlocked for changes in the risk adjustment that affect future cash flows or future services. For participating contracts the margin should also be unlocked for changes in the fulfilment value of options and guarantees as well as for changes in the value of underlying items, e.g. for changes in reinvestment assumptions relating to future services.
- We appreciate the IASB's efforts to establish measurement and presentation requirements for participating contracts where liabilities are asset-dependent. Most of the life and health insurance business underwritten in Germany has participating features; therefore, an adequate accounting approach for these types of contracts is of utmost importance. However, we have significant concerns regarding the "mirroring approach"<sup>1</sup> as proposed. Our major concerns refer to the limited scope, the complexity and feasibility of the decomposition of cash flows and the decision usefulness of this proposal. We support the *alternative approach for participating contracts* (see Appendix 5 in EFRAG's Draft Comment Letter) because it establishes requirements that apply to all kinds of participating contracts and are built on the general building blocks approach of the Re-ED. Whilst this proposal is less complex than the "mirroring approach" proposed, it also provides more relevant information as it faithfully represents the entity's financial position and performance: The approach provides for current fulfilment values in the statement of financial position. Furthermore, a complete unlocking of the contractual service margin with a corresponding release represents the entire future profit of the insurance contract. The asset dependence is taken into account for all asset classes (including equities, real estate, bonds and others) through the cash flow projection and through the determination of discount rates. In addition, the requirements of this proposal are fully consistent with the attribute of the contractual service margin for participating contracts as well. In our opinion, the *alternative approach* establishes measurement and presentation requirements for participating contracts that depict the characteristics of this business adequately.

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<sup>1</sup> The term „mirroring approach“ refers to the requirements for contracts that require the entity to hold underlying items and specify a link to those underlying items.



- While welcoming the IASB's proposals regarding the recognition and presentation of interest expense in profit or loss and the recognition of changes in discount rates in other comprehensive income, we do not support the mandatory use of other comprehensive income. In cases where liabilities are dependent on returns on assets, which are measured at fair value through profit or loss (FVTPL) because these assets are either not eligible for measurement at fair value through other comprehensive income (FVTOCI) or the contracts are managed on a FVTPL basis, an accounting mismatch might arise. To reduce this accounting mismatch, an option to recognise the effect of changes in the discount rate directly in profit or loss for those liabilities should be introduced.

Please find our detailed comments on the questions raised in the Re-ED as well as comments on additional issues not covered by the questions in the appendices to this letter. If you would like to discuss our views further, please do not hesitate to contact me.

Yours sincerely,

*Liesel Knorr*  
President



## Appendix A – Answers to the questions of the Exposure Draft

### Question 1 - Adjusting the contractual service margin

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?

- 1 In general, the ASCG agrees with the proposal to recalibrate the contractual service margin (CSM) for changes in estimates that have an impact on future periods and supports the proposal to recognise changes relating to present or past events immediately in profit or loss as we suggested in our comment letter in 2010. We appreciate the principle of unlocking the CSM for changes in estimates of future cash flows related to future coverage and other future services because it ensures consistency with the definition of the margin representing the unearned profit at inception over the duration of the contract. Further, the adjustments of the CSM provide information about the future profitability of insurance contracts at each reporting date.
- 2 While we agree with the proposal in general, we believe that the underlying unlocking principle should be extended to encompass all changes in estimates related to future coverage or other future services. We do not agree with recognising changes in the risk adjustment immediately in profit or loss (ED.60(d)) since it contradicts the definition of the CSM. As the CSM represents the entire unearned profit, it should also be adjusted to reflect changes in estimates of the risk adjustment that are related to future coverage or other future services. We are being told by our insurance working group that the necessary differentiation between experienced and future changes of the risk adjustment is operationally feasible. The risk adjustment reflects a major service that the insurer provides, and changes of the risk adjustment affect future services and future profitability. If the entity expects changes in future profits because of changes in the risk adjustment, this should lead to an adjustment of the CSM.
- 3 We also have concerns regarding determination and subsequent measurement of the CSM for participating contracts, especially with reference to the treatment of options and guarantees as well as the recognition of changes in financial estimates. Since this relates mainly to the second question, we refer to our response to question 2.



- 4 In addition, we do not fully agree with the accretion of interest on the carrying amount of the contractual service margin (ED.30(a)). In our point of view, the accretion rate should be linked to the discount rate used to determine the interest expense from the unwinding of the insurance liability in profit or loss and, thus, not always remain locked in. Further, for insurance contracts where an entity may simplify the measurement of the liability for the remaining coverage using the premium allocation approach (PAA), there should be no accretion of interest on the CSM for contracts where the entity could use the PAA, but decides to determine the insurance liability under the building blocks approach (BBA). With a view to the principle of materiality the accretion of interest should be mandatory only for those contracts for which the interest accretion leads to a significant benefit. As the PAA results in a reasonable approximation of the BBA, there should not be any significant difference when omitting the accretion of interest under the BBA for contracts where the entity would be allowed to apply the PAA. Thus, paragraph 40 should be applicable, too, when the entity uses the BBA but is allowed to simplify the measurement under the PAA.

**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 (ie 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?



- 5 While we appreciate the IASB's efforts to provide an adequate proposal for participating contracts, we have significant concerns regarding the "mirroring approach" and do not support the proposal as drafted. In our opinion, the IASB's "mirroring approach" does not provide relevant information that faithfully represents the entity's financial position and performance, as the approach:
- Applies only to a narrow scope of participating contracts;
  - Increases the complexity because of the arbitrary decomposition of cash flows;
  - Reduces comparability as it differs from the general fulfilment cash flow model (building blocks model) that applies to all other insurance contracts; and
  - Allows only for a limited unlocking of the CSM which contradicts the definition of the CSM as the unearned profit.
- 6 We do not agree with the scope of the "mirroring approach". According to paragraphs 33(a) and (b) of the Re-ED, the "mirroring approach" should be applied only to those contracts that require the entity to hold underlying items and that specify a link between the payments to the policyholder and the returns on those underlying items. In our opinion, there is no need for different measurement models for participating and non-participating contracts. The general building block approach should be applied for all kinds of insurance contracts. For insurance contracts where the insurance contract liability is dependent on underlying items (e.g. asset returns), the entity should take that dependence into account when determining the discount rate used to present interest expense in profit or loss – something that is already required under paragraph 26(a) of the Re-ED. Not having a separate model for certain asset-dependent insurance contracts provides a principle-based accounting for insurance contracts and allows for similar accounting to be applied to economically similar contracts. For further details regarding features of participating contracts, please see our remarks on the *alternative approach* in paragraph 9.
- 7 Additionally, we have concerns as regards the requirement in B86 to decompose cash flows. In our view, and as first results from the field testing exercise in Germany are demonstrating, the IASB's proposal leads to insurmountable hurdles, especially when considering more complex insurance products. We do not support splitting the insurance contract liability into multiple components that are to be measured and presented differently. The proposed decomposition does not appear to be common in actuarial practice and seems very complex; also, we wonder whether it is used at all when assessing and managing the business. Furthermore, the proposed splitting seems to be artificial and enabling arbitrage. We do not understand why the IASB requires bifurcation of options and guarantees that are clearly and closely related to the other cash flows of insurance contracts and require them to be treated differently. Cash flows from options and guarantees should be treated the same as any other



cash flows arising from the insurance contract. Another difficulty is the necessary assignment of assets to liabilities. Apart from being highly complex for preparers we have doubts as to the decision usefulness of the decomposition proposals for users of financial statements. Due to the decomposition of cash flows the liability is no longer presented at its current fulfilment value. It is for these reasons that we do not agree with the proposal.

- 8 Another key concern relates to the limited unlocking of the CSM for changes in underlying items. We do not agree with the proposal in ED.66(b) to recognise changes of options and guarantees, which do not need to be separated under paragraph 10, in profit or loss. In our view, this is not in line with the general requirements to adjust the CSM for changes in estimates of future cash flows that are related to future coverage and other future services. In addition, we do not agree with not unlocking the CSM for changes in underlying items, especially for changes in reinvestment assumptions. Changes in reinvestment assumptions relating to future services should result in an adjustment of the CSM, as this affects the future profitability of the entity.
- 9 We support the *alternative approach for participating contracts* (see Appendix 5 of EFRAG's Draft Comment Letter; hereafter the *alternative approach*) that the insurance industry developed for participating contracts. See also Appendix C where the *alternative approach* is described based on the four building blocks. The key advantages of the *alternative approach* over the proposals in the Re-ED as we see them can be summarised as follows:
- The proposed model is built on the general measurement requirements of the Re-ED and is therefore easy to implement and increases comparability across the insurance industry;
  - The proposal establishes a single measurement model for all kinds of insurance contracts; economically similar contracts are accounted for in the same way, and there is no scope distinction into participating and non-participating contracts;
  - The proposal leads to a significant reduction of complexity, because there is no need to split the liability; prospective measurement is applicable without historical assumptions;
  - The proposal regarding the CSM establishes a clear segregation between the earned profit and the expected future profit through the prospective measurement and adjustment of the CSM. Thus, it is possible for users to evaluate the entity's performance in the long run, as the approach provides for a complete unlocking of the CSM for any changes in estimates relating to future coverage or other future services;
  - The definition of the CSM as the unearned profit is maintained for participating contracts as well;
  - The proposal simplifies the approach to transition as there is no need to determine historical figures since it is based on a prospective measurement;



- The *alternative approach* also avoids accounting mismatches due to determining an asset-based discount rate and through consideration of asset returns in the cash flow projection.

10 Although we see merits in the *alternative approach*, we believe that there are still some aspects where it needs to be developed further should the IASB follow our recommendation to pursue that approach. First of all, guidance is needed in order to clarify which contracts are deemed to be in the scope of participating contracts and therefore have to reflect the asset dependence using an asset-based discount rate. It should be clarified in which cases the insurance contract liability is dependent on underlying items when there is no contractual link in order to facilitate a consistent application of the *alternative approach*. Secondly, the determination of reinvestment assumptions, which are necessary in order to determine the expected asset returns for contracts for which the liability duration exceeds the asset duration, needs to be clarified, too. Specifically, principles to ensure an unbiased determination of reinvestment returns are needed in order to ringfence the proposal.

**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?

11 We appreciate the IASB's decision to consider the request for presenting volume information when developing a proposal for the presentation of revenue in the income statement. We also welcome the aim for consistency with the revenue recognition project.

12 Generally speaking, the aim of presenting a certain revenue number should be to provide relevant information to the user reflecting the nature of the business. Feedback from discussions with users and preparers of financial information show that for different types of insurance products a different rather than the same type of revenue figure seems appropriate:

- Entities whose main business is the property and casualty insurance tend to accept the proposed definition of insurance contract revenue as their traditional numbers would continue to be disclosed and as most of them would probably use the simplified approach anyway.
- On the other hand, entities that provide mainly life insurance products do not tend to support the proposed presentation of revenue. From their point of view, the proposed



approach for presenting revenue does not provide relevant information for the user. In addition, we hear complaints about determining the proposed number being a very costly exercise due to the decomposition of investment components.

Hence, balancing the needs for providing relevant and comparable information for users of financial statements and having a balanced cost-benefit ratio, a single number for presenting revenue does not seem achievable for all kinds of insurance products.

#### **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?

13 We agree with the proposal to recognise the interest expense in profit or loss determined using discount rates that applied at the date that the contract was initially recognised. We also agree with recognising the difference between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised in OCI for those contracts where the liability is not asset-dependent. We are supportive of the proposal to recognise these changes in OCI, as this balances the wish to present insurance liabilities at a current value, yet at the same time preserving the information content of the income statement as a depiction of the performance of the period. This reflects the long-term nature of the insurance business.

14 For contracts where the liability is asset-dependent the discount rate shall be updated according to ED.60(h), when the entity expects any changes in those returns. We support this approach as this achieves an alignment between the projected cash flows and the discount rate used. The discount rate used to recognise the interest expense on the insurance liability in profit or loss should be updated to reflect the corresponding revenue recognition of



the underlying assets. This avoids an accounting mismatch in profit or loss, even if a mixed measurement basis exists for contracts with asset dependent liability cash flows.

- 15 As was already mentioned in our answer to question 2, we do not support a mandatory use of OCI. The FVTOCI category does not apply to a number of asset classes (e.g. equity instruments, non-plain vanilla debt instruments, property, etc.). If a large proportion of the assets backing an insurance liability was not eligible for measurement at FVTOCI, but would instead be measured at FVTPL, there would be a need to recognise any changes in the discount rate of the corresponding liabilities in profit or loss, too, in order to avoid an accounting mismatch. Furthermore, some contracts, such as unit-linked contracts or variable annuities, are managed on a FVTPL basis. Recognising the effect of a change in the discount rate on the insurance liability in OCI does not appear appropriate in these cases. Thus, we suggest adding an option to recognise changes in the discount rate of insurance liabilities in profit or loss under the condition that doing so would avoid an accounting mismatch and taking the high degree of asset dependence into account.
- 16 Another possibility to avoid accounting mismatches might be to consider the use of hedge accounting. We suggest considering the implications for insurers and other entities having to apply the new requirements stemming from the insurance project when developing the proposals for macro hedge accounting.

**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?

- 17 We support the proposed retrospective approach to transition. A retrospective application of the Standard provides relevant information as it allows comparability between existing and new business. The ASCG also supports the simplified retrospective approach when the entity cannot apply the Standard fully retrospectively, as this facilitates transition. Although the retrospective approach to transition enhances comparability, it increases the complexity at the same time. We point out that the complexity arises mainly from the proposed decomposition of cash flows under the “mirroring approach”, as this requirement would have to be implemented retrospectively as well. In addition, not to unlock the CSM for any changes that affect the future service complicates a retrospective determination of the margin. Thus, we strongly suggest a complete unlocking of the CSM as proposed in the *alternative approach* (both for changes in the risk margin and for changes of the value of options and guarantees) to further facilitate transition. There would be no need to determine historical information.



- 18 As regards the effective date of this Standard, we recommend setting a date no sooner than three years from the date of publication given the huge task that insurers face when implementing the requirements.
- 19 Regarding the interaction of IFRS 9 and IFRS 4 we continue to believe that a single effective date for both Standards would be most beneficial for insurance entities and other entities having to apply the proposal. These entities would have the benefit of implementing both Standards at the same time, which minimises operational complexity. Furthermore, it would increase comparability and understandability for financial statement users (this applies specifically to a business that is long term in nature).
- 20 On the other hand, we understand that the IASB is conscious not have the two Standards leapfrog each other and that IFRS 9 is meant to provide an answer to the challenges stemming from the financial crisis. Hence, if the possibility of aligning the effective dates for both Standards was limited, thus leading to different effective dates, we strongly recommend granting entities with insurance business the possibility of reclassifying financial assets upon adoption of the new insurance proposals. This would allow these entities avoiding accounting mismatches otherwise occurring if they were forced to keep their original designation (which had to be made not knowing what the final outcome of the new Standard on insurance would look like).

**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 ongoing basis.

- 21 In general, implementation of the new insurance requirements represents a significant investment for all stakeholders in the insurance industry, preparers as well as users of financial statements. Some proposals, such as the introduction of a FVTOCI measurement, increase the complexity of implementation in comparison to the 2010 ED's proposals. Nonetheless, in our opinion, we believe this complexity to be appropriate in order to adequately depict the insurance business, which is a complex business. In addition, the costs associated with implementing and meeting the proposed requirements are justified if they make other



non-GAAP measures redundant that are currently used in internal and external communication (such as Embedded Value).

22 However, we believe that some of the IASB's proposals in the Re-ED may cause unnecessary costs where there is no corresponding benefit at the same time.

- According to paragraph 84 of the Re-ED, an entity must disclose a translation of the result of the technique used to measure the insurance contracts into a confidence level. As already mentioned in our comment letter in 2010, we have significant concerns regarding the requirement to translate the insurer's risk adjustment into a confidence level for disclosure purposes. The ASCG acknowledges the IASB's reasons for this proposal, namely to provide comparability. Nevertheless, we do not support that for the following reasons: The requirement represents a rule and contradicts a principle-based Standard; further, it is evidently not in line with paragraph B81 where the Standard does not contain a requirement to specify the technique used to determine the risk adjustment. We understand from the industry that the IASB's proposal represents a significant workload for entities for no equivalent increase in benefits. We would therefore suggest the IASB just require disclosure as well as a description of the methods chosen. Such a description would include quantitative information at an appropriate level of aggregation in the notes in order to provide users with information on the underlying risk averseness.
- In many cases, the proposed method of determining the lock-in discount rate that applied when the contract was initially recognised does not seem appropriate. We are being told that locking in the discount rate at contract inception on an individual contract basis would not be possible using generally accepted property-casualty reserving techniques, as this is inconsistent with how the data is aggregated and modelled (most often on an accident year basis). In the property-casualty business systems for claims and systems for existing contracts are often managed separately. The PAA will therefore be applied broadly, since it does not require any cash flow estimations at inception. This advantage would get lost, if locked-in interest rates at inception were to be applied. Therefore, we recommend the IASB loosen the requirements around the "lock-in" of the discount rate for the liability for incurred claims under the simplified approach in order to avoid unnecessary complexity and to alleviate implementation. Feedback obtained from our working group suggests that the costs for implementing new systems to be able to determine the locked-in rate would be enormous and not accompanied with a corresponding benefit due to the short coverage period for those contracts. We suggest considering providing more flexibility in the determination of the discount rate, e.g. using the discount rate



that applied at the time when the claim is incurred. This would seem an appropriate simplification to avoid disproportionate costs.

- With regard to the second question, we would like to reemphasise that the decomposition of cash flows required under B86 does not appear to be proportionate and does not seem to come with a corresponding benefit for the user of financial statements.

#### **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?

23 Some of the examples in the ED should be revisited, as they are very detailed (and, thus, are contrary to a principles-based approach), do not always depict real-life case and are hard to understand:

- Parts of the Standard are written in a style that is almost incomprehensible even to an informed reader familiar with the business. Especially entities that are not mainly insurance entities but have to apply the Standard to some parts of their business are likely to have serious difficulty when applying the Standard. The language used is very industry-based and therefore hard to understand for non-insurance entities (this specifically applies to the description of the “mirroring approach”).
- As stated previously, the decomposition of cash flows is not clear. The way splitting up of the liability in Illustrative Example 11 is done appears to be illogical and counter-intuitive. We refer to our general concerns provided in our answer to question 2.
- We believe the drafting regarding the reversal of a negative CSM is not clear and could be improved. It remains unclear whether an entity must reverse prior losses through profit or loss before re-establishing a positive margin or not. We support re-establishing the CSM prospectively when the entity forecasts future profits again, which seems to be less complex from an operational point of view. It is also more aligned with the principle that changes of future cash flows related to future coverage or other future services are not recognised in current period profit or loss, but are deferred via the CSM.
- Lastly, the Standard does not provide a definition for “options” and “guarantees”, yet uses this term widely. While it seems that the Re-ED partly refers to the “time value of option and guarantees”, a clear definition would help to avoid misinterpretations of the proposals.



## Appendix B – Other issues not covered by questions of the Exposure Draft

### *Scope – Fixed-fee service contracts*

- 1 The proposals may extend the scope of the Re-ED to contract types for which, in our view, an application of IFRS X *Revenue from Contracts with Customers* would be more appropriate (and that have not been considered to be within the scope of IFRS 4 *Insurance Contracts* by constituents, hitherto). In many industries with products specifically designed to meet specific customer needs – this particularly applies to construction contracts as defined in IAS 11 *Construction Contracts* – it is common practice that the relevant manufacturers also provide the associated long-term maintenance. Such long-term maintenance – including the provision of spare parts – requires services specifically tailored to the customised products. This, together with the fact that such maintenance contracts typically have long durations and are material in terms of volume, results in transaction prices being calculated individually for each contract. In other words, transaction prices reflect the risks that are associated with individual contracts. Therefore, one might take the view that the scope exception in paragraph 7(e)(i) does not apply and, accordingly, such contracts are in the scope of the Re-ED. This is because we think that the individual pricing on a contract level does even more reflect the associated risks compared to a pricing on an individual customer level (as discussed in paragraph 7(e)(ii)).
- 2 In our view, scoping such contracts into the Re-ED does not appropriately reflect the economic substance of the contracts, because it is not a predominant purpose of such contracts to ‘insure’ the customer against defects of the maintained product. Instead, the purpose is to minimise downtimes of the product by providing ‘preventive maintenance’. That is, the objective of the maintenance contract typically is to avoid and not to repair defects. Hence, due to the nature of the services to be provided to customers, an application of IFRS X *Revenue from Contracts with Customers* seems more appropriate. Furthermore, the proposals in the Re-ED seem to imply that comparable services may be treated differently. Service contracts for ‘standard products’, for which risks are typically assessed on portfolio level rather than on contract level seem to meet the criterion in paragraph 7(e)(i). It is not clear to us why these contracts should be treated differently from the above-mentioned service contracts for assets designed and manufactured according to specifications by the customer, even if comparable services were provided.
- 3 In order to avoid the consequences described above we suggest considering to delete the relevant criterion in paragraph 7(e)(i) or to find a language that does not result in scoping such contracts into the Re-ED.



Reinsurance contracts held

- 4 We are aware of concerns raised by reinsurers that the Re-ED's proposals for reinsurance contracts on an individual loss basis do not depict the economic relationship between the reinsurance contract and the underlying insurance contract appropriately. In particular, the high dependence of the reinsurance contract on the underlying insurance contract is not taken into consideration adequately. We understand that five global reinsurance entities represented in the *CFO Forum* developed an *alternative approach for reinsurance contracts*: The proposal provides for the determination of the contractual service margin based on the underlying business because of the 1:1 relationship of the reinsurance and the underlying insurance contract. The CSM of the reinsurance asset should reflect the reinsurer's share in the risk of the underlying business. In particular, determination of the CSM is based on the ratio of the risk adjustment that is applied to the CSM of the underlying contract. Furthermore, they argue that the gain or loss from buying reinsurance on an individual loss basis is definitive (except for the credit risk of the reinsurer, which is considered through the determination of the CSM) and should therefore be recognised immediately in profit or loss in order to avoid the possibility of accounting arbitrage.
  
- 5 We believe that the requirements for reinsurance contracts held should be dependent on the respective type of reinsurance contract. There might be situations where recognition of the gain or loss from buying reinsurance immediately in profit or loss seems fully appropriate, whilst there might be other contracts where the gain or loss should be recognised over the coverage period. We believe that the accounting treatment of the underlying primary insurance contracts should remain unaffected by the reinsurance contracts held (no derecognition). The requirements for the recognition of any gain or loss from buying reinsurance should always reflect the credit risk of the reinsurer. We suggest that the IASB carefully reconsider the guidance provided on reinsurance contracts held and ensure that the economics of these transactions are reflected appropriately in the cedent's accounts.



## Appendix C – A brief summary of the key features of the *alternative approach*

(For a complete description please refer to Appendix 5 in EFRAG's Draft Comment Letter)

### 1. *Projection of future cash flows*

- 1 To determine the insurance contract liability in cases where it depends on underlying items, the entity determines the contract liability prospectively at each reporting date. If the insurer's cash outflows are dependent on what the entity earns on the asset side – regardless of whether participation is contractually determined or discretionary – this dependence should be taken into account when determining the insurance contract liability. In other words, the entity should consider all expected contractual or discretionary benefits when determining the liability. If the insurer expects changes in the returns of the assets, the entity has to adjust the cash flows on the liability side, too, if they are asset-dependent. Thus, any asset dependence is considered when projecting the cash flows on the liability side. For those liabilities where the duration exceeds the assets' duration, the entity has to make reinvestment assumptions and consider them when determining the insurance contract liability.
- 2 The value of options and guarantees is included in the fulfilment cash flows using stochastic valuations. Including options and guarantees as part of the fulfilment cash flows (unless they are not separated according to Re-ED.9-11) is in line with the Re-ED's basic requirement to include all cash inflows and outflows when determining the fulfilment cash flows. Options and guarantees are part of the service of the insurer and are therefore recognised through the cash flow projection and treated consistently with the other parts of the fulfilment cash flows.

### 2. *Discount rate to reflect the time value of money*

- 3 The discount rate used for unwinding the time value of money into the income statement should be unlocked for asset-dependent liabilities in order to reflect that asset dependence, as is already envisaged in the Re-ED. Cash flow projections and discount rates need to be aligned to avoid a distortion of results. In the *alternative approach* the asset dependence is also taken into account when determining the discount rate. If the entity expects changes of the amounts to be allocated to the policyholder in future periods this should result in an adjustment of the discount rate as well. In practice, there are many contracts where the duration of the assets is shorter than the duration of the liabilities. The *alternative approach* reflects this as follows when determining the yield curve used for discounting: For that part of the liability that is matched with an underlying item (same durations), the entity has to determine the discount rate depending on the asset returns; for the part of the liability for which the duration of the liability exceeds the duration of the underlying assets, the discount rate is based on the expected reinvestment return based on current market information where



available. If the entity expects any changes of the asset returns, it adjusts the discount rate to reflect these changes. Thus, the cash flow projection and the determination of the discount rate are made on a consistent basis.

### 3. Risk adjustment

- 4 The determination of the risk adjustment for contracts with a link to underlying items does not differ from the risk adjustment determined for non-participating contracts. The general requirements of the Re-ED apply.

### 4. Contractual service margin

- 5 The *alternative approach* requires a prospective measurement of the CSM. Considering that the CSM represents the unearned profit, it has to be adjusted for changes that affect future cash flows and the future profitability of the insurer. Changes in asset returns or crediting rates are going hand in hand with changes of the shareholder's portion of the asset returns. For example, falling interest rates on assets result in a decreasing asset return for future assets that has to be split between the shareholder and the policyholder. As these changes affect future cash flows as well as the future profitability of the insurer, the CSM must be adjusted for changes in returns on underlying items, including reinvestment assumptions, retained by the insurer. Recalibrating the CSM for prospective changes in estimates meets the definition of the CSM as the unearned profit. Since the generation of asset returns is an integral part of services under a participating contract, changes in estimates regarding these cash flows must therefore lead to an adjustment of the CSM.
- 6 As the CSM must not be negative, the *alternative approach* encompasses an implicit loss recognition test as it is based on updated assumptions and reflects the current time value of options and guarantees. To enhance transparency a disclosure requirement for the time value of options and guarantees should be included.
- 7 Under the *alternative approach* the entity accretes interest on the CSM based on an updated discount rate in the same way as the entity recognises interest expense in profit or loss for the other components of the liability. Since the unlocking of the discount rate includes assumptions on reinvestment rates, the CSM based on that discount rate enables a reflection of future profit expectations.