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25 October 2013

Dear Mr. Hoogervorst

## **Exposure Draft ED 2013/7 - Insurance Contracts**

Deloitte Touche Tohmatsu Limited is pleased to respond to the International Accounting Standards Board's (the IASB's) Exposure Draft *Insurance Contracts* ('the 2013 ED').

We remain fully supportive of the objectives that the Board is attempting to fulfil in this phase of the project. A comprehensive standard on accounting for insurance contracts will be of great benefit to investors and will improve financial reporting given the lack of an IFRS in this area. We are also supportive of the time spent with the Financial Accounting Standards Board (FASB, the Boards when together with the Board) in trying to achieve a converged solution. We note that the Boards continue to have different views on certain aspects and would urge them to focus on those differences as part of their joint re-deliberation of their exposure drafts in the coming months. Joint re-deliberations should not, however, detract from the IASB's objective of finalising a standard in the near term. The 2013 ED presents important improvements relative to exposure draft ED 2010/8 *Insurance Contracts* ('the 2010 ED'). We are generally supportive of the Boards' approach to unlocking of the Contractual Service Margin (CSM), the presentational split of interest expense from insurance contracts between profit or loss and other comprehensive income (the "OCI solution") and the new transition provisions. However, we have specific concerns about some of these aspects.

We believe that the unlocking of the CSM requires substantial improvements to allow for the faithful representation of the impact that insurance and participating contracts will have on insurers' performance. The key improvements are the removal of what we believe are inappropriate restrictions on the period over which the CSM is released to profit or loss and on the types of assumptions insurer should consider for unlocking. In addition, we believe that the CSM for participating contracts should be determined in line with the approach adopted for the recognition of fulfilment cash flows for those contracts, which include payments expected to be made to both current and future participating policyholders. The CSM would be taken to profit or loss in line with the insurer's fulfilment of its obligation to provide these policyholders with

participation in the returns from the associated underlying items.

Although we are supportive of the objective of reducing accounting mismatches, we are not supportive of the proposed “mirroring approach” for participating contracts due to its complexity, cost and departure from the pricing and product design that insurers apply and that should be represented faithfully in their financial statements. We recommend that the measurement for participating contracts be based on a single fulfilment cash flow calculation without decomposition of the contract’s cash flows and using the amended CSM calculation of the type noted above. In addition, to the extent that the durations of underlying items match the expected durations of participating contracts, the interest expense in profit or loss should use the rate derived from the yields of those underlying items (calculated as directed by the contractual terms and conditions or applicable law or regulations governing the participation of the “current or future policyholders” in the returns so generated).

We believe that the proposed measure of insurance revenue is not the most relevant amount for presenting long-coverage insurance contracts’ contribution to an insurer’s performance because it is not consistent with the measurement of insurance portfolios, we are not aware it is the metric sought by investors and it is not used by key management personnel for assessing performance and allocating resources of an insurer.

As noted above, we support the “OCI solution” for all insurance contracts but believe an entity should be able to make an irrevocable election at initial recognition of insurance contracts to recognise the change in carrying value associated with changes in discount rates to profit or loss. This is consistent with our preferred approach for the fair value option of financial instruments under IFRS 9.

The Board will need to consider the timing of the new IFRS for insurance contracts noting the delays in finalising IFRS 9. Different effective dates for these standards would unduly penalise those entities for which the parallel adoption of both standards is the only reasonable transition strategy. For those not impacted by the new insurance standard, early adoption of IFRS 9 is available. If the Board does not align the effective dates and the IFRS 9 effective date is earlier than the effective date for the IFRS on insurance contracts, then consideration should be given to transition provisions that allow potential redesignations of financial assets upon adoption of the insurance standard.

Given the diverse approaches currently used in measuring insurance contracts and the complexity of the contracts it addresses, the new IFRS for insurance will present a challenge for preparers, auditors and regulators and we expect there will be a high volume of interpretation issues in advance of the effective date. We would urge the IASB to address interpretations issues quickly and in advance of the effective date to maximise consistent application. The IASB may wish to consider continuing its outreach efforts with preparers and other stakeholders beyond the finalisation of the standard up to the effective date so that issues are captured quickly and addressed by the IFRS Interpretations Committee expeditiously.

The appendix of this letter contains our detailed responses to the questions for respondents posed by the Board.

If you have any questions concerning our comments, please contact Veronica Poole at +44 20 7007 0884 or Francesco Nagari at +44 20 7303 8375.

Yours sincerely

A handwritten signature in black ink, appearing to read 'V. Poole', is positioned above the typed name.

Veronica Poole  
Global IFRS Leader

## APPENDIX

### **Question 1—Adjusting the contractual service margin (paragraphs 30–31, B68, BC26–BC41 and IE9–IE11)**

*Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance 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?*

- (a) We agree with adjusting the contractual service margin (CSM) for differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services (otherwise referred to as 'unlocking'). However, under item (b) below we have recommended important amendments that we believe are essential for the Board's proposal to achieve its stated objectives. Overall we welcome the change in the recognition and measurement of the CSM from the 2010 ED because it now recognises the role of the CSM as unearned profit. Also, it will better reflect the economic substance of insurance contracts which we view as a payment received in advance for an obligation to stand ready to accept and handle a claim and to provide benefits to the policyholder or other parties associated with uncertain events adversely impacting the policyholder.

The unlocking of the CSM makes the accounting model in the 2013 ED more internally consistent because the CSM will now be recalculated at each reporting date in line with the revised estimates of the fulfilment cash flows.

Finally, we welcome the Board's agreement with the view expressed in our previous comment letter that on recalibration the CSM should not be negative. Accordingly, an entity must release to profit or loss any aggregate CSM in full for that onerous portfolio. Any subsequent favourable differences as a result of changes in assumptions would be recognised in CSM as described in paragraph 30(c).

- (b) We do not agree with restricting the unlocking of the CSM only to differences between the current and previous estimates of the cash flows related to future coverage and other future services as described in the 2013 ED. The proposed restriction would require an insurer to identify cash flows associated with insurance risk or risks associated with other future services and to separate them from those affected by financial and other risks. According to the 2013 ED, the difference between the current and previous estimates of cash flows arising from the latter set of variables would always be taken to profit or loss (paragraph 31 of the 2013 ED).

This identification process would be difficult to perform and we expect it to lead to divergence in application forced by the inappropriate nature of the requirement, because it is inconsistent with the view of insurance contracts as a bundle of rights and obligations generating cash inflows and outflows interrelated with each other. The approach proposed in the 2013 ED presents particularly serious

implications for the faithfulness of financial reporting for participating contracts which we have addressed in our response to Question 2.

We propose a revised solution based on a number of amendments to the 2013 ED:

1. **CSM earning period** – Remove the requirement in paragraph 32 for the CSM to be earned “over the coverage period”. Instead the release of the CSM to profit or loss should be done “over the duration of the insurance contract” such that it includes both the coverage and the claims handling period. Paragraph B68(a) would then become redundant;
2. **CSM unlocking for prospective changes in future cash flows** – Remove the restriction by which the unlocking of the CSM for changes in future cash flows could only be done for changes that “relate to future coverage and other future services” (sub-paragraphs 30 (c) and 30 (d)(i)); and
3. **CSM unlocking for prospective changes in risk adjustments** – Require that prospective changes of the risk adjustment liability are accounted for against the CSM in a similar way as the changes of future cash flows (adding a new sub-paragraph in paragraph 30)

### **CSM earning period**

We continue to believe that the proposal in the 2013 ED to release the CSM over the coverage period establishes an inappropriate dividing line given that the insurer’s contractual obligations are not interrupted by the expiry of the coverage period. In our opinion the CSM should be released based on the pattern of transfer of services under the contract (or release from risk), consistent with the Board’s proposal but without the time restrictions for claims handling periods set in paragraphs 32 and B68(a).

The decision that the handling of incurred claims is not a service for which a portion of the CSM relates to seems to stem from the view that the service provided by the insurer is entirely associated with the coverage and the ‘standing ready to accept a claim’. However, insurers provide many services that go beyond the expiry of the coverage period. Indeed many insurers differentiate themselves in the market on the basis of the service they provide to the policyholder once the claim has been incurred. The reference in the 2013 ED to “other future services” indicates that there are other elements to which the CSM relates to other than coverage. However, B68(a) negates that handling of incurred claims is one of such services. This approach is contrary to the definition of an insurance contract whereby an insurer provides a service to a policyholder by accepting significant insurance risk, which is to compensate the policyholder if a specified uncertain future event adversely affects him. An uncertain future event is defined as one where there is at least uncertainty about the insured event’s probability of occurring, its timing, or the amount of compensation required when it has occurred. Accordingly, the uncertainty surrounding incurred claims is part of insurance risk which justifies requiring the CSM to be released based on a pattern of transfer of services under the contract, which combines the coverage and the claims handling periods. In other words, the service provided by the insurer is ‘the satisfaction of the obligation to stand ready to accept a claim and to handle it until its ultimate settlement’. The satisfaction of this obligation necessarily involves both coverage and claims handling periods. This also appears to be closer to the definition in the FASB ASU BC310.

In addition, the proposal to differentiate accounting for CSM between claims handling services and other services (including coverage) presents ambiguities. For example, on annuity insurance contracts that expose insurers to the longevity of a policyholder the pattern of service delivery extends beyond the coverage period. An annuity contract requires the insurer to settle its obligation for as long as the policyholder is alive and for a cumulative amount that could be significantly in excess of the consideration

the policyholder paid to acquire this right. The settlement period and the coverage period for these contracts are blurred and we would expect preparers to release the CSM over the period of settlement of the annuity. Consider an annuity awarded as a compensation for a long-term disability or a bodily injury. This is a common form of settlement of bodily injuries in several markets and a contractual feature of income protection policies. If such an annuity was awarded, the insurer would have already earned the entire CSM during the shorter coverage period of the insurance contract that protected the policyholder from the risk of injury and would account for the annuity liability only as a post-claim liability inclusive only of the expected cash flow estimate and risk adjustment. We do not believe this would be a fair representation of the insurer's performance under the contract.

Another instance where the inappropriate nature of this decision has been tested is paragraph 41(c) of the 2013 ED where the CSM for reinsurance contracts on liabilities for incurred claims (e.g. stop loss reinsurance contracts or retrospective reinsurance) is determined by introducing a modification to the CSM accounting requirements to avoid the recognition of an accounting profit on recognition of a reinsurance asset insuring contracts where the coverage period has already expired.

If our proposal is accepted we recommend that the release of the CSM over the combined coverage and claims handling period should extend equally to the contracts accounted under the simplified premium allocation approach (PAA).

In that regard we propose that at initial recognition the pre-claim liability in the PAA is split into two components. The first component would be attributed to the period of coverage (inclusive of an implicit coverage CSM) and the second would be an explicit component representing the CSM for the claims incurred liability. The split should be determined based on the insurer's expected transfer of services over the post-coverage period. The unlocking of the CSM will begin when the pre-claim liability (inclusive of the implicit coverage CSM component) is fully recognised unless the contract is onerous.

### ***Simple illustration of our proposal***

Assume an annual insurance contract with Currency Units (CU) 100 premium received on initial recognition. In our proposal the insurer would allocate a portion of that premium as the CSM attributable to post coverage period based on the margin expected for delivering claims handling services beyond the expiry of the coverage period (CU15). The insurer would recognise a PAA pre-claim liability for CU85 and account for it as currently required in the 2013 ED.

The earned premium will be CU85 and the incurred claims liability will be determined using the fulfilment cash flow calculation (as required in the 2013 ED) plus a CSM of 15 (based on our proposal) that will be released as the claims handling services are fulfilled and the changes in future assumptions are accounted for against it in a manner similar to that required under paragraph 30 of the 2013 ED for the coverage period of portfolios measured using the fulfilment cash flows.

In the event that during the coverage period the estimate for fulfilment cash flows triggers the onerous contract calculation, the CSM of CU15 will be released before recognising an onerous contract loss through profit or loss.

Given the desirability of convergence between IFRS and US GAAP, we would like to highlight that extending the period of the CSM release to the post-coverage period would bring the Board's proposals closer in this aspect to the FASB's building block approach where an insurer "shall recognize the margin determined at initial recognition as revenue in net income over the coverage and settlement periods as

the entity satisfies its performance obligation to stand ready to compensate the policyholder on occurrence of a specified event that adversely affects the policyholder”<sup>1</sup>.

### **CSM unlocking for prospective changes in risk adjustments**

In BC36-BC37 of the 2013 ED, the Board discusses the possibility of including changes in the risk adjustment as one of the inputs to the unlocking of the CSM and why it decided against it. We believe that the main reason was impracticability caused by the complexity of isolating the changes in the risk adjustment that relate to cash flows for future coverage and other future services. This is because an insurer would have been required to disaggregate components of the overall change in the risk adjustment for each period, to separately identify:

- I. the expiry of risk as coverage is provided;
- II. changes in estimates of risk associated with incurred claims; and
- III. changes in estimates of risk associated with future coverage.

This complexity would be removed if the CSM was to be unlocked for all changes in cash flows expected in future periods irrespective of whether they are associated with future coverage or claims incurred. Under this approach the period's change in the risk adjustment recognised in profit and loss would simply reflect the expiry of risk for in-force contracts and the release from contracts derecognised in the period. For example, it could be computed by calculating the period change in the risk adjustment assuming no change in the assumptions from the beginning of the period and simply rolling them forward to reflect the quantum of the risk adjustment liability associated with the insurance contracts still in-force at the end of the period. For new contracts initially recognised during the period the comparison would be made using initial recognition assumptions. The revaluation to the new set of assumptions for the new and remaining in-force contracts brought forward from the beginning of the period would be accounted for against the CSM.

The other arguments were:

- most changes in the risk adjustment would relate to the expiry of coverage;
- changes in the risk adjustment caused by changes in the assumptions are more transparently presented in profit or loss; and
- changes in the risk adjustment do not affect the amount of unearned profit relating to future coverage or services because they unwind over time.

Considering the first of the above points, it is difficult to accept that most changes in the risk adjustment would relate to the expiry of coverage across all or even a majority of insurance contracts. This especially would not be the case for contracts with long claims handling periods, where significant uncertainty remains over the ultimate discovery and amount of claims incurred and where inherent uncertainty of the variables affects all types of future insurance cash flows. In fact, the significant uncertainty affecting insurance cash flows is one of the justifications for separate recognition and measurement of the risk adjustment in the Board's insurance model beyond the coverage period.

Another reason cited in BC37 for not recalibrating CSM for changes in the risk adjustment is that if such changes are caused by changes in the assumptions, then showing them in profit or loss is more transparent. However, the change in the risk adjustment is shown as one figure and users would not be

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<sup>1</sup> Refer to paragraph 834-10-35-18 of the FASB Exposure Draft “*Proposed Accounting Standards Update - Insurance Contracts (Topic 834)*”).

able to isolate the effect of changes in the assumptions. Instead, we believe that accounting separately for changes in the amount of expected future cash flows (against the CSM or through profit or loss) and for the associated changes in the risk adjustment (always through profit or loss) generates an inconsistency that would dilute the relevance of reported results and distort the measure of unearned profit represented by the CSM balance carried forward.

A third reason given in BC37(d) for not unlocking the CSM for changes in the risk adjustment is that such changes do not affect the amount of unearned profit relating to future coverage or services because they unwind over time. This argument is flawed because, while over the life of the contract the risk adjustment should reduce to zero, that amount could eventually be reflected in revised estimates and actual cash flows.

### ***CSM unlocking for prospective changes in future cash flows***

For the reasons noted above we believe that the prospective unlocking of the CSM for changes in future cash flows should not be restricted except for changes in discount rates which flow from the Board's decision to require the presentation of the time value of money to be split between profit or loss and other comprehensive income (see also our response to Question 4).

We believe the CSM should also be adjusted for all delays or accelerations of repayment of investment components resulting in changes in cash flows in future periods and we recommend removing the restrictions set out in sub-paragraph B68(c). We do not concur with the view that the absence of this restriction creates financial results unrepresentative of economic reality because the unexpected delay or acceleration creates experience adjustments in profit or loss. In our opinion this would be justified given that the estimation of timing and amounts of future cash flows plays a central role in the overall integrity of the model. Additionally, the emphasis on experience variances provides useful information on the robustness of the insurer's method of deriving an unbiased estimate of expected cash flows, that is to say, a statistical mean of the scenarios that the insurer expects to crystallise from the risks insured.

At the end of each reporting period, the remaining amount of CSM to be released to profit or loss would equal:

- the CSM at the beginning of the reporting period;
- plus the interest accreted on the carrying amount of the CSM during the reporting period (see our response to question 4 on the proposed rate to be used for this accretion);
- plus the new CSM recognised for insurance contracts initially recognised during the period;
- less the CSM on insurance contracts derecognised during the period;
- less the systematic release to profit or loss for the period;
- plus or minus the changes in the present value of all expected future fulfilment cash flows arising from changes in assumptions at the end of reporting period; and
- plus or minus the change in the risk adjustment on contracts in-force at the end of the reporting period (other than the change in the risk adjustment liability recognised in the profit or loss during the period, as described above).

## **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?*

We do not agree that the “mirroring approach” described above achieves a faithful representation of the economics of a participating contract (with or without transfer of insurance risk) defined in paragraph 33 because the associated complexity of the application of paragraphs 34, 66 and B83-87 outweighs the benefits the Board intended and because the approach contains a number of flaws, as set out below, that could only be resolved by introducing additional complexity.

### **1. Treatment of embedded options and guarantees is not aligned with pricing and contractual terms**

The “mirroring approach” introduces a principle of measuring the component parts of a participating contract that is not aligned with the economics of the contract. The principle in question is that stated in paragraph B85:

*“An entity shall decompose the cash flows in a way that maximises the extent to which the measurement both:*

- expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and*
- maximises the minimum fixed payment that the policyholder will receive”*

The application of this principle would result in decomposing cash flows of a participating contract to isolate embedded options and guarantees in a way that is not aligned with the way insurers constructed and priced the contract. Using the example of the participating contract included in B86 the approach required by the Board to compute the fair value of options and guarantees using a written put on the 90% of the asset value would lead to over- and under-estimation of options and guarantees embedded in participating contracts when the contract has an embedded minimum guarantee interest rate that is higher than zero. Given the required separate accounting treatment of the embedded options and guarantees the faithful representation of the cost of those components would be distorted. In addition, our analysis of the pricing principles that insurers would have adopted to construct this type of contract is better represented by B86(a) which is a written call option on top of the premium paid by the policyholder which pays the profit made by the asset values over and above the value of the premium paid subject to a rebate to 90% of that overall profit and with a strike price of nil (to provide the guaranteed premium return). This configuration is not aligned with the accounting principles that the Board requires.

The principles in B85 also produce ambiguous results from a mathematical point of view when the contractual participation with the underlying items is simulated in a realistic scenario that includes:

- a guarantee that is higher than the return of premium (e.g. a positive interest rate guarantee);
- lapses of participating contracts and issue of new contracts participating in the same underlying item (see below on the issues surrounding initial measurement of the CSM);
- a variable level of profit sharing percentage as commonly found across several continental European markets; and
- the reference to an accounting value for the underlying item that is not in line with an IFRS recognised asset or liability (see below on the issues surrounding the nature of underlying items).

In order to implement the principles of B85 approximations (e.g. “best fit” techniques to resolve the accounting of positive minimum interest rate guarantees) would need to be introduced and new systems built adding substantial costs to the implementation of the new IFRS for participating contracts.

## **2. Impact of the interdependency of participating cash flows on the application of the “mirroring approach”**

The application of the “mirroring approach” requires that to the extent that a contract involves amounts that are not directly linked to the performance of the underlying assets (e.g. mortality and guaranteed elements) their carrying amount in the participating liability needs to be estimated using the fulfilment cash flows. The fulfilment cash flows would then be split between the components arising from cash flows indirectly linked with the underlying assets and those not linked at all.

The 2013 ED is silent on whether the risk adjustment part of the fulfilment cash flows should ignore the risks associated with directly linked cash flows due to the fact that they are economically matched. However, it is clear that the risk adjustment would be associated with both indirectly linked and non-linked components at initial recognition and during subsequent

measurement. Adding the fulfilment cash flows of both components (including the risk adjustment) at initial recognition would allow the calculation of the CSM when added with the portion of cash flows directly linked with the underlying item. For subsequent measurement the CSM would be taken to profit or loss as coverage and services are delivered. However, the 2013 ED stipulates that only the changes in assumptions from the non-linked cash flows would unlock the CSM in subsequent periods.

Our empirical evidence<sup>2</sup> suggests that the “mirroring approach” makes the determination of the subsequent measurement of the risk adjustment and of the CSM impossible without consideration of the value of the contract as a whole. The economics of participating contracts are such that the directly linked cash flows affect all the other elements and without considering them the CSM in subsequent measurement periods becomes arbitrary. In effect to faithfully measure the contract the insurer would need to calculate the fulfilment cash flows for the whole contract projecting the entire set of cash flows and then for presentation purposes to present separately the cash flows that are directly linked to the underlying items by using the carrying amounts of those items.

### 3. **Inconsistent CSM at initial recognition when the underlying items are not at fair value**

The initial recognition of contracts under the “mirroring approach” would not produce a faithful representation of the insurance contract because paragraph 34 requires the application of the “mirroring approach” at initial and subsequent measurement. At initial recognition the 2013 ED requires the measurement of the fulfilment cash flows and the CSM as the difference to prevent any profit recognition. The use of underlying items at a carrying amount other than fair value would result in a distorted calculation of the CSM.

For example, when a new contract is recognised in a portfolio where the underlying items are at cost and with a significant unrecognised unrealised gain this would result in a lower measure of the fulfilment cash flows at initial recognition (given that fulfilment cash flows would be measured using the underlying item’s cost) with the associated increase of CSM in compliance with paragraph 28. This problem could be avoided if the initial recognition requirement were removed and the initial measurement of such contracts was required to be performed using fulfilment cash flows. However, on “day 2” the subsequent measurement of the contract would make reference to the average accounting values of the underlying items and the prohibition to unlock the CSM for changes from underlying items (see B68(d)) would distort the profit or loss with the recognition of a gain arising from the reduction in value in the liability component representing the directly linked cash flows.

### 4. **Application to underlying items that are not recognised assets or liabilities under IFRS**

The range of underlying items also includes items that are not individual assets and the application of the requirement is not explained in the 2013 ED making the achievement of the ‘mirroring approach’ objective very difficult.

For example, one of the possible underlying items could be “the returns from a specified pool of insurance contracts or a specified type of insurance contract”. This would create a circular argument given that the underlying item could be the same as the fulfilment cash flows that need to be measured with reference to it.

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<sup>2</sup> Evidence available at your request.

## Our proposed alternative measurement basis for participating contracts

The alternative approach we propose amends the general fulfilment cash flows approach for all participating contracts as defined in paragraph 33 without requiring any alterations to the integrity of the calculations required for all contracts within the scope of the 2013 ED. The amendments we propose relate to a) the accounting for the time value of money and b) the principles for the subsequent measurement of the CSM of participating contracts.

### **a) Amendments to the discount rate for participating contracts**

- We recommend introducing a requirement to accrete interest on the cash flows that are directly linked with the underlying items using the yield that those items generate limited to the expected duration of those underlying items. This requirement could be introduced by means of a modification of the existing text of paragraph B73.
- The time value of money so calculated will be recognised in profit or loss using the yield of the underlying items calculated as directed by the contractual terms and conditions or applicable law or regulations governing the participation of the “current or future policyholders” in the returns generated by the underlying items: we shall refer to this rate as a “book yield” rate.
- The difference between the carrying amounts of the participating contracts calculated using the “book yield” rate and the carrying amounts of the participating contract calculated using the market-consistent discount rate set out in paragraph 26(a), if there is one, will be recognised in other comprehensive income. This is unless the entity elected on initial recognition for these contracts to present changes in interest in profit or loss (please refer to our answer to question 4).
- There is guidance in paragraph B73 explaining how to apply paragraph 26(a) on discount rates for asset-dependent cash flows. We believe this guidance should be amended to reinforce the principle that the current yields from the underlying items noted above are used to set the discount/accretion rates applicable to the carrying amount reported in the statement of financial position to the extent that their durations match the expected durations of participating contracts cash flows as determined under paragraph B66(k). This paragraph requires the cash flows to include all future payments for current or future policyholders. The discount/accretion rate for cash flows with a duration that exceeds that of the underlying items should be determined in line with the general requirements of paragraph 25 with their recognition through profit or loss and other comprehensive income as proposed in paragraph 60(h). Under this approach an insurer would be required to update the locked in discount/accretion rates for cash flows beyond the duration covered by the yields from the underlying items when the insurer expects any changes in the underlying items returns (e.g. changes in expected asset reinvestment rates) to affect the amount of those cash flows.
- To achieve the above, we recommend deleting paragraphs 34, 66 and B68(d) of the 2013 ED and reference to them.

We believe that this approach would be more appropriate for the different business models developed by insurers issuing participating contracts. For example, where the insurer’s obligation is based on the realised asset returns both the projected cash flows and the updated discount rates would reflect expected returns from the underlying items and use the discount rate derived from the “book yield” produced by the underlying items as directed by the contractual terms and conditions or applicable law or regulations. The difference with the current discount rates would be accounted for in other comprehensive income. If all the underlying assets are accounted at fair value through profit or loss then the updated discount rates for projected linked liability cash flows would equal to current rates resulting in no difference for those cash flows to be reported in other comprehensive income.

The proposed amendments would more effectively achieve the original objective of the “mirroring approach” to eliminate accounting mismatches between the measurements of the linked cash flows of participating contracts and underlying items when they are economically matched.

In addition, our proposal allows the continued use of the main accounting model for all insurance and participating contracts. This would ensure integrity of the measurement of the overall insurance and participating contract liabilities in the statement of financial position without compromising the faithfulness of the statement of profit or loss which would benefit from an approach that aligns the accounting for economically matched cash flows.

**b) Amendments to the CSM for participating contracts**

- For those contracts where the insurer is required to hold the underlying items we recommend that the CSM is adjusted for changes in the share of the returns on underlying items (see paragraph 33) that are not included in the fulfilment cash flows estimating payments expected to be made to current or future policyholders (as described in paragraph B66 (k) of the 2013 ED).
- This recommendation is based on our view that with this approach the new IFRS would faithfully reflect the insurer's unfulfilled obligation to current and future policyholders to ensure their participation in the performance of the underlying items. The fulfilment of that obligation would be accomplished only when the distribution to the policyholders is made. In other words, the insurer's participating share of the profit would only be released to profit or loss when the obligation to policyholders is fulfilled, i.e. when the bonuses are declared and the guaranteed element of the contract is increased.
- This would result in more meaningful measure of the unearned profit represented by the CSM and would more accurately reflect the service that an insurer is providing to participating policyholders, which is to provide participation in returns of the underlying items while achieving a long term return that balances the needs of the current and future policyholders.
- This proposal would be prospective and it would also eliminate the difficulties on transition for participating contracts because the CSM would be determined based on the value of the underlying items at transition compared with the fulfilment cash flows calculated based on paragraph B66(k).

***Simple illustration of our proposal on the unlocking of the CSM for participating contracts***

Assume a single premium participating contract with Currency Units (CU) 100 premium received on initial recognition which requires the insurer to invest in an underlying internally held fund.

The returns of the fund are retained within it and distributed to contract holders on the basis of a 90 per cent basis of the return that the insurer declares distributable in a given year. This declaration mechanism could take different forms in practice e.g. the distributable amount is derived from gains/losses that are realised or is decided by an appointed actuary of the insurer. The insurer also guarantees the return of the premium plus a 1% minimum return.

Under our proposal at initial recognition the insurer calculates a fulfilment cash flow value of CU92 inclusive of the option and guarantees cash flows and the risk adjustment and a CSM of CU8.

In the subsequent period the underlying items have generated CU10 positive returns and the insurer has decided not to declare any benefit to the contract holders. Assuming all other variables are unchanged, under our proposal the fulfilment cash flows liability would increase by CU9 to provide for the expected payments that the insurer would be required to make to current or future policyholder from the returns

generated by the underlying items. This would increase the fulfilment cash flow liability for the participating contracts to a total of CU101 and the CSM would increase by CU1 to CU9 with a total liability equal to CU110. The value of the underlying items is CU110. The CSM change would be the result of the modified unlocking we propose:

	CU
Opening CSM	8
Less changes in expected cash flows	(9)
Plus changes in underlying items	<u>10</u>
Closing CSM balance	9

In the statement of comprehensive income of the insurer there will be income from the underlying items for CU10 and expense for change in the fulfilment cash flows for participating contracts for CU10, (including increase in the CSM of CU1).

In the following period the value of the underlying items is unchanged and the insurer distributes CU5 from the internal fund where the underlying items are held which is credited to contract holder for CU4.5 and to shareholders for CU0.5. The fulfilment of the obligation to make the contract holders participate requires the insurer to take to profit or loss CU0.5 of the brought forward CSM balance.

### **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?*

We do not support the proposals in the 2013 ED. As pointed out in the 2013 ED, insurance contracts are not purely service contracts or financial instruments and this was the key reason behind the impetus for the Board's decision to create specific guidance for insurance contract accounting. The 2013 ED continues to be founded on the concept of accounting for portfolios of insurance contract as a bundle of rights and obligations. The insurance revenue proposal appears to be inconsistent with this key principle, and it does not have the justification of a simplified method for departing from it. We believe that financial reporting for insurance contracts is appropriately focused on accounting from a whole contract measurement point of view and we do not believe that a revenue presentation can be reverse engineered from the measurement principles that have been established without reconsideration of the overall structure of the model.

The 2010 ED proposed a summarised margin in the statement of comprehensive income for insurance contracts accounted for under the fulfilment cash flows for which the simplified approach was not available. In our comment letter on the 2010 ED we communicated that (1) the lack of information on an insurer's volume of activity, (2) the difficulty to reproduce some of the more common key performance indicators and (3) the less than prominent display of cash based information, would result in de-emphasising financial information that investors find useful under current presentation practices. We also observed that during the comment period for the 2010 ED, investors' reaction to the proposed summarised margin presentation was mixed.

We continue to support the measurement of an insurance contract using the fulfilment cash flows. We also continue to welcome and support the link to the measurement model and the identification of the sources of profit under the summarised margin as amended for those contracts where the simplified approach for measuring the liability for the remaining coverage is available.

However, we believe that the new revenue metric proposed by 2013 ED would not be the most faithful representation of the contribution that insurance contracts with long duration coverage provide to an insurer's financial performance in the period. The Board's desire to develop a common presentation requirement for all types of insurance contracts should be measured against the different characteristics of the various insurance contracts. We believe that the Board should accept the co-existence of two different presentation requirements when these offer the most decision useful presentation of the contribution of short and long duration coverage insurance contracts to an insurer's performance in a given period.

Coupled with this fundamental concern we are of the view that the new insurance revenue is not the volume information requested by investors.

#### **Alternative Method: Summarised margin**

In response to the 2010 ED we proposed a methodology whereby an entity would present the summarised margin expanded to present elements of the initial calibration of the margin as separate lines

at the top of the statement of comprehensive income. This would have utilised the income statement driven by the insurance liability measurement proposed in the 2010 ED and would have presented a volume measure useful to the users because it would have shown the volume of contracts issued in the period and the associated margins (measured by the combined risk adjustment plus CSM).

The 2013 ED has included in paragraphs 81(b) the requirement to disclose the effect of the insurance contracts that are initially recognised in the period on the amounts that are recognised in the statement of financial position showing separately the effect on the expected present value of future cash inflows, outflows, risk adjustment and CSM. We support this disclosure requirement and recommend for it to be prominently disclosed in the notes.

We also have come to share the concern expressed by the Board that any volume measure presented on the face of the income statement would be viewed as revenue. The additional lines proposed in our 2010 comment letter are a volume measure that is not revenue and as such we consider that these measures should not be presented on the face of the primary income statement. We therefore modify our initial recommendation and recommend the presentation of the summarised margin as was presented in the 2010 ED.

## **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?*

We support the exploration of a methodology whereby all or portions of changes between the current discount rate and the discount rate determined at initial recognition of an insurance contract would be presented in other comprehensive income. We are of the view that considering the final IFRS on insurance contracts in conjunction with IFRS 9 (as amended) is the only pathway to achieve a faithful presentation of the insurance business model. However, we do not believe the proposal to require the presentation of part of the interest expense from insurance contracts through other comprehensive income ("the OCI solution") as set out in the 2013 ED fully captures the nuances of asset-liability management for many insurers. The results that would be presented in conjunction with IFRS 9 (as amended) will leave a substantial number of accounting mismatches not dealt with which would hinder the relevance of financial information prepared by insurers.

We would like to observe that the mechanics of the proposed utilisation of the "OCI solution" are complex and would require tracking of interest rate curve movements using systems that aggregate contracts in a similar way to the cohorts used in the life insurance industry. This complexity may result in greater cost for those insurers that are not equipped with systems that deal with cohorts of contracts and may be more difficult for them to track movements period after period.

Considering the OCI solution is mandatory and therefore significant implementation costs will be incurred, we believe the Board should consider whether accounting mismatches can be addressed more fully.

### **Interaction with financial instruments**

One of the Board's axioms on its insurance contracts project is to produce an IFRS that allows an insurer to faithfully represent in its financial results its ability to manage both the assets and liabilities in a way that seeks to match cash outflows to existing policyholders with inflows from investments and from new policyholders.

Under IFRS 9, as it may be amended following *ED 2012/4 – Classification and Measurement: Limited Amendments to IFRS 9* ("IFRS 9 with OCI"), recognition and measurement of financial assets depend on

their contractual cash flow characteristics and the business model in which they are managed. Insurers typically engage in asset-liability management programmes to minimise the effect of duration gaps between their asset and liability portfolios. We have gathered evidence that in applying the “OCI solution”, an insurer may not be able to reduce significant accounting mismatches that arise, even when the underlying variables are similar and cash flows from assets and liabilities are economically matched. This stems from the mixed financial asset measurement model compared with a mandatory “OCI solution” for insurance contracts.

For example, “IFRS 9 with OCI” and the proposed mandatory “OCI solution” would create an accounting model where accounting mismatches are unavoidable for interest rate risk exposures over long liability durations even if the cash flows are economically matched through derivative instruments. This is because derivative financial assets that back insurance liabilities closing the duration gap will always be measured at fair value through profit or loss.

The fair value option for financial instruments would also not be effective in dealing with this issue because of the mandatory application of the “OCI solution” to insurance contracts.

Conversely, an insurer that does not choose to manage duration risk and classifies its financial assets as at fair value through other comprehensive income, would recognise the effect of any duration gap in accumulated OCI.

We believe these two scenarios, when juxtaposed, do not adequately provide users with relevant information about the economic implications of the transactions. We have made suggestions, outlined below, to address some of these mismatch concerns.

### **A non-mandatory “OCI solution”**

We do not believe that the “OCI solution” should be required given it depends to a significant extent on the asset-liability management strategy the insurer has selected and how its financial instruments will be accounted for under “IFRS 9 with OCI”.

We believe the final IFRS should allow insurers to designate which insurance contracts will be accounted for using the “OCI solution” and which will be accounted by reflecting all changes in discount rate entirely through profit or loss. We recommend that an irrevocable, unconstrained designation should be made available at initial recognition of an insurance contract for the accounting treatment of their associated interest expense. We believe that this requirement is paramount in promoting consistency and comparability across reporting periods and market participants.

This example illustrates how our proposal would work in practice.

Insurer X underwrites a significant number of insurance contracts with expected cash flows at, or longer, than thirty years. In addition, it maintains a number of financial assets classified as at fair value through profit or loss (FVTPL) as a result of their underlying cash flow characteristics, and uses interest rate swaps to effectively manage long duration risk. As a result, Insurer X may decide to elect for each of these insurance contracts to reflect changes in discount rate entirely through profit or loss. We would recommend that if the Board accepts our recommendation, the application guidance should state that an insurer could designate groups of contracts together as they are initially recognised (e.g. by using contract coding for designation purposes).

An unconstrained ability for an insurer to elect to adopt a fair value option on those assets that would otherwise be classified differently is critical to ensure symmetry of application to financial instruments and insurance contracts and to effectively address accounting mismatches across different asset-liability management strategies. Our response to the *Exposure Draft ED 2012/4 – Classification and Measurement: Limited Amendments to IFRS 9* expressed a preference that the Board should retain a fair value through profit or loss option for debt instruments held that would otherwise be measured at amortised cost or fair value through OCI but that option be unrestricted (like proposed by the FASB for fair value through OCI assets). As the option can only be designated at initial recognition and is irrevocable we see little risk for the option to be subject to abuse and we did not support the need for entities to have to prove whether an accounting mismatch is eliminated or significantly reduced. Our preference is for entities that use the fair value option to instead disclose why they have chosen the option. The same disclosure requirement should apply to the designation for insurance contracts.

The policy choice on the accounting for time value of money of the fulfilment cash flows should apply automatically to the accretion rate required in the accounting for the CSM (see reference from our response to Question 1).

If the Board cannot support a proposal that recognising interest rate changes in OCI should be based on an insurer's contract by contract irrevocable election on initial recognition, we propose that guidance is introduced in the general hedge accounting provisions of IFRS 9 that would confirm the use of derivatives and non-derivative financial assets at FVTPL as hedging instruments in a fair value hedging relationship with insurance contracts. This would allow presenting in profit or loss changes in the insurance contracts' accumulated OCI reserve to the extent that they represent gains or losses attributable to the hedged risk.

Additionally, given that many insurers consider risk exposure on a continuous basis, at a portfolio level, using open portfolios, we ask the Board to consider successful practices in this area to inform their discussion on macro-hedging project.

## **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?*

We agree that, conceptually, a full retrospective approach is the most appropriate and accurate method of adopting the 2013 ED. In particular, we agree with the decision made by the Board in which if retrospective application is impracticable an insurer need not undertake exhaustive efforts to obtain objective information but should take into account all objective information that is reasonably available. This approach should facilitate the determination of a sufficiently large number of prior periods that would be restated on the first time adoption of the new IFRS. For all contracts issued prior to that period the new IFRS should not require the computation of a CSM and the insurance contracts would be recognised based on the fulfilment cash flows only (inclusive of a current measure of the associated risk adjustment liability).

We also encourage the Board to consider the practical expedient permitted by the FASB which allows an insurer to measure the CSM by aggregating contracts at the level of portfolio used immediately prior to transition. We support the practical expedient being allowed for insurers when full retrospective application is not practical.

We agree that a period of three years from the publication of the new IFRS is a sufficient period to allow the implementation of its requirements across all types of insurance organisations. We have provided additional comments on the basis for having reached this position in our response to Question 6.

Because financial asset management is a critical aspect of any insurer's operations, we would strongly encourage for the effective dates of the new IFRS on insurance contracts and IFRS 9 (as amended) to be aligned with earlier application permitted. If deliberation on the insurance project is delayed, we would recommend that the Board considers the effective date for the IFRS on insurance contracts for determining the effective date of IFRS 9 (as amended). In this way insurers would be able to implement both standards at the same time, while other entities for which application of the insurance standard is less significant would be able to apply IFRS 9 (as amended) without delay through the election of an early adoption. However, if the Board does not agree with aligning the effective date of the two standards, we recommend including in the new IFRS on insurance contracts (with a consequential amendment to IFRS 9) an option to reclassify financial assets when adopting the insurance standard for the first time. This option is meant to alleviate concerns that insurers would have to classify their investments without fully knowing the accounting requirements for insurance liability, hence running the risk of creating accounting mismatches.

**Question 6—The likely effects of a Standard for insurance contracts**

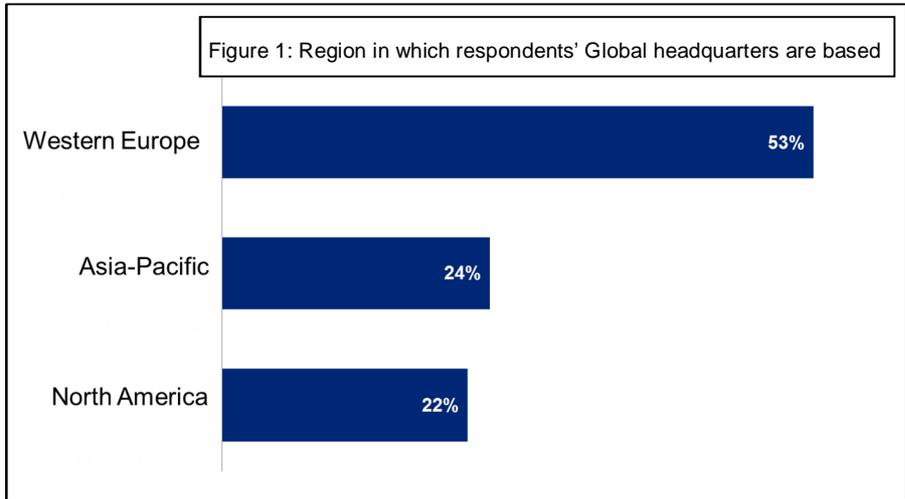
*Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?*

*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.*

Deloitte member firms commissioned a new survey of insurance decision-makers with knowledge of the approach their organisation will take on the adoption of the new IFRS and asked for their opinions on the arrival of a new IFRS for insurance contracts. This survey was conducted on Deloitte member firms’ behalf by the Economist Intelligence Unit (“the EIU”) during August and September 2013 and it built on the equivalent survey they conducted for us during 2012. The full report will be released in November.



The geographic coverage of this study has been increased to include major North American, Western European and Asian insurance markets. Nearly 300 respondents participated. The survey was designed to capture both life and non-life insurers (with a target of 50% per sub-group) and aimed to include a sufficiently representative range of sizes measured

by their written premium net of reinsurance (see figure 1).

We asked the EIU to investigate which aspects of the new IFRS would present a particularly material challenge to respondents’ organisations. Among other challenges, three of the five areas covered in questions 1 to 5 of the 2013 ED are included as a concern by responding insurers.

Through the survey, respondents highlight the impact and benefits the new IFRS for insurance contracts will have on their organisation; give an indication of the scale of their entities’ global budget (including internal cost) they are expecting to allocate to prepare for the adoption of the new IFRS; and confirm their expectation of their timeline for adoption.

The comprehensive findings from this extensive survey of insurers attitudes towards, and preparedness for, the new IFRS for Insurance Contracts will be free for download. Readers of this letter can view the early findings and register their interest in receiving the detailed report upon release by visiting [www.deloitte.com/IFRSSurvey2013](http://www.deloitte.com/IFRSSurvey2013).

## **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?*

There are a number of areas where the text of the 2013 ED could be clarified. We have listed below those that in our opinion were particularly important.

### **SCOPE**

#### **Definition of an Insurance Contract – Significant insurance risk**

We note the introduction of paragraph B19 and are supportive of the intention for the introduction of this paragraph (as expressed in BCA156(c)) to more closely align the application of the definition of significant insurance risk with practice under US GAAP.

Reducing diversity in the accounting for insurance contracts is a critical objective of the 2013 ED. However we are concerned that a literal interpretation of the current wording of paragraph B19 would lead to a reclassification of a number of contracts that are widely accepted as containing significant insurance risk. We do not believe that this was intended.

Paragraph B19 states that: "...a contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows that is paid by the issuer can exceed the present value of the premiums."

A common feature in some jurisdictions is a "return of premium on death" guarantee, also referred to as a "guaranteed minimum death benefit". Typically the presence of such a feature is sufficient to classify the contract as an insurance contract as it can result in a death benefit that exceeds the amount payable on survival. Paragraph B23 in the Exposure Draft (and its equivalent, paragraph B26 in the current IFRS 4) seems to indicate this is the correct classification. A similar conclusion can also be drawn from paragraph B9.

Consider for example a contract with a single premium of CU 10,000 invested in a 'linked' investment fund which drops to CU 7,000 as a result of an adverse market movement shortly before the maturity date of the policy. If the policyholder were to die the day before maturity, he would receive a benefit of the original premium, CU 10,000. If however the policyholder were to survive another day, he would receive a maturity benefit of CU 7,000.

As noted above, in terms of paragraph B23 and B9, the presence of this benefit would appear to be sufficient to classify this as an insurance contract. However since the benefit which is contingent on the insured event does not exceed the premium we are concerned that the current wording of paragraph B19 may be interpreted as to imply this benefit does not introduce significant insurance risk.

We also note that the introduction of paragraph B19 introduces a degree of quantitative guidance to the assessment of significant insurance risk compared to the current text of IFRS 4 when the classification principle explained in BCA165 states that IFRS 4 and the 2013 ED does not include quantitative classification guidance.

We recommend either additional clarification to the current wording of paragraph B19 to address the example above, or alternatively the removal of paragraph B19 in line with the principle stated in BCA165.

## MEASUREMENT

### Measurement on initial recognition of an insurance contract

#### *Contractual service margin*

We believe that the 2013 ED does not sufficiently explain the calculation of the CSM and there are a few areas where clarification would be helpful.

We recommend that the 2013 ED explains that the calculation of the CSM at a portfolio level on initial recognition is the result of the calculation of the fulfilment cash flows for contracts issued in the current financial period. The initial recognition of a CSM or onerous contracts' loss is bound by that time period. That is to say that the calculation of the CSM on initial recognition does not take into account the CSM of contracts issued in the prior periods. Without this clarification on initial recognition an insurer may be able to avoid recognising as onerous new insurance contracts issued in the current period with expected negative fulfilment cash flows (i.e. outflows plus risk adjustment are higher than inflows) if brought forward CSM from contracts issued in prior periods is sufficient to absorb the onerous contracts loss produced by the new contracts.

#### *Time value of money*

We recommend replacing the guidance text in paragraph B71 on determining discount rate for unobservable period with the text paragraph BCA81 to highlight the overall principle and to avoid the risk of examples being interpreted too restrictively.

Delete B71:

*“For example, the entity may need to determine the discount rates applied to cash flows that are expected beyond the period for which observable market data is available using the current, observable market yield curve for shorter durations. Another example would be the estimate of the credit risk premium that is included in the spread of a debt instrument using a credit derivative as a reference point. An entity assesses the extent to which the market prices for credit derivatives includes factors that are not relevant to determining the credit risk component of the market rate of return so that the credit risk component of the overall asset spread can be determined.”*

And replace with the following from paragraph BCA81:

*“The IASB noted that if there are no observable inputs for determining the discount rate, the entity should use an estimate that is consistent with the IASB’s guidance on fair value measurement, in particular fair value measurements categorised within Level 3 of the fair value hierarchy. When applying that guidance, an entity would adjust an observable input that relates to an instrument whose characteristics differ from the characteristics of the liability being measured. Furthermore, because forecasts of unobservable inputs tend to put more weight on long term estimates than on short-term fluctuations, this counteracts concerns that current-period fluctuations in discount rates exaggerate the volatility of very long-dated liabilities.”*

### Subsequent measurement

We recommend that a new definition is introduced in Appendix A to capture the key concept set out in paragraph 32 for the subsequent measurement of the CSM:

***Release pattern of the CSM:*** the systematic way that best reflects the remaining transfer of services that are provided under the contract

We recommend that the CSM is recognised within a portfolio by grouping contracts that belong to that portfolio and that have been issued within the same annual financial period (or a shorter period within that annual period) which present similar or not materially different expected durations (a necessary common characteristic to apply the requirement of paragraph 32 as amended based on our recommendation from our response to Question 1) and a similar “release pattern”.

We recommend that the group of contracts described above is defined as a CSM cohort and that the following definition is added to Appendix A:

***CSM cohort:*** the CSM attributable to a group of contracts that have been issued within the same annual financial period (or a shorter period within that annual period), that present similar or not materially different expected durations and that will use a similar release pattern

We recommend that the final IFRS should explain that the unlocking of the CSM is carried out at a portfolio level and that on unlocking the adjustment to the portfolio CSM should be allocated to each cohort in that portfolio proportionally. This can be allocated, for example, in proportion to the level of each of the cohorts’ CSMs outstanding at the beginning of the period or in proportion to the level of each cohort’s expected future cash outflows. The allocation basis ultimately needs to be consistent with release of the CSM to profit and loss at the cohort level.

***Simple illustration of our proposed clarification for the unlocking of CSM at a portfolio level***

Consider a portfolio with 4 cohorts (A, B C and D) with estimated cash flows expected to be settled over 1, 2, 3 and 4 years respectively.

At the beginning of the period the portfolio has CU 100 of CSM. This includes:

CU 10 for Cohort A (with 1 year of expected future cash flows),

CU 30 for cohort B (with 2 years of expected future cash flows),

nil for cohort C (with 3 years of expected future cash flows), because this cohort was determined to be onerous on initial recognition, and

CU 60 for cohort D (with 4 years of expected future cash flows).

Suppose that during the period there has been a change in assumptions that would reduce liability fulfilment cash flows in future periods resulting in a positive change to the CSM of CU10 for the whole portfolio. The insurer’s accounting policy is to allocate the CSM proportionally to the level of CSM outstanding for each cohort. Accordingly, the CSM of the portfolio would increase by CU10. That amount would be allocated as: CU 1 to cohort A , CU 3 to cohort B, nil to cohort C and CU 6 to cohort D. The CSM for each cohort would be released over the cohort’s expected coverage duration (unless our recommendation set out in our response to Question 1 is adopted) based on the systematic way that best reflects the remaining transfer of services provided under the contracts in that cohort.

We recommend that the key concepts of the portfolio definition are supported by dedicated application paragraphs. In particular, we recommend that the requirement for insurance contracts to be grouped based on them being 'priced similarly relative to the risk taken on' be clarified to confirm that the Board intended this criterion to apply on a relative rather than absolute basis. The clarification should also state that the assessment of this criterion is applied at initial recognition only for contracts that have been issued within the same annual financial period (or a shorter period within that annual period). This clarification will avoid the unintended creation of new portfolios simply due to the movement of market forces in a particular period shifting the relative prices above or below previous levels for all contracts insuring the same risk.

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

During our discussion with preparers and other auditors we discovered that there are different interpretations on which contracts would be caught by the definition of paragraph 33. For example, the analysis of UK "with-profit" contracts has led to different conclusions on their treatment. It is our understanding that the Board's intention was to include these contracts in the scope set by paragraph 33.

Paragraph 33 could be clarified as follows:

"An entity shall apply paragraph XX [deleted reference to be replaced with a new one if our recommendations set out in our response to Question 2 are accepted] if the contract:

- (a) requires the entity to hold underlying items such as specified assets and liabilities, an underlying pool of insurance contracts, or if the underlying item specified in the contract is the assets and liabilities of the entity as a whole; and
- (b) specifies a link between the payments to the policyholder and the returns on those underlying items. A link with the underlying items exists when there is a requirement for an entity to consider the current or future value of the underlying items or their returns in determining the basis of payments to the policyholders. A link exists irrespectively of whether the entity's determination of payments to policyholders requires the exercise of discretion.

The entity shall determine whether the contract specifies a link to returns on underlying items by considering all of the substantive terms of the contract, whether they arise from a contract, the law or regulation."

## **Simplified approach for measuring the liability for the remaining coverage**

We recommend that paragraphs 38 and 40 are clarified to indicate that the interest income from a material financing element should be applied to the premium received in order to separate that amount from the release of the liability and accounted for as interest income such that the earned premium does not include the impact of that financing element.

Paragraph 38

*If either of the criteria in paragraph 35 is satisfied, an entity may measure the liability for the remaining coverage as follows:*

- (a) *at initial recognition, the carrying amount of the liability for the remaining coverage is:*

- i. *the premium, if any, received at initial recognition inclusive of the portion that reflects the time value of money from a financing element as described in accordance with paragraph 40;*
  - ii. *less any payments that relate to acquisition costs, unless paragraph 39(a) applies;*
  - iii. *plus (or minus) any pre-coverage cash flows;*
  - iv. *plus any onerous contract liability recognised in accordance with paragraph 36 and measured in accordance with paragraph 39(c).*
- (b) *at the end of each subsequent reporting period, the carrying amount of the liability for the remaining coverage is the previous carrying amount:*
- i. *plus the premiums received in the period inclusive of the portion that reflects the time value of money in accordance with paragraph 40;*
  - ii. *minus the amount recognised as insurance contract revenue for coverage that was provided in that period (see paragraph B91);*
  - iii. *plus any onerous contract liability recognised in the period in accordance with paragraph 36 and measured in accordance with paragraph 39(c);*
  - iv. *plus (or minus) the effect of any changes in estimates that relate to any onerous contract liability recognised in previous periods, measured in accordance with paragraph 39(c);*
  - v. *plus or minus any adjustment to reflect the time value of money in accordance with paragraph 40.*

## Paragraph 40

*If a contract has a financing component that is significant to the contract an entity shall adjust the liability for the remaining coverage to reflect the time value of money using the discount rates specified in paragraph 25, as determined at initial recognition. The effect of the financing component should be reported as interest income or expense within profit or loss. However, the entity need not adjust the liability for the remaining coverage to reflect the time value of money if the entity expects, at contract inception, that the time between the entity providing each part of the coverage and the due date for the premium that relates to that part of the coverage is one year or less.*

## MODIFICATION AND DERECOGNITION OF AN INSURANCE CONTRACT

### Derecognition of an insurance contract

We recommend a clarification that for the derecognised contracts all of the CSM and all of the Risk Adjustment liability are both released to profit or loss.