EFRAG
European Financial Reporting Advisory Group

FEEDBACK REPORT

Exposure Draft *Insurance Contracts* ED/2013/7

Results of the field-test carried out by EFRAG, ANC, ASCG, FRC and OIC, in coordination with the IASB staff

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EXECUTIVE SUMMARY

Overall Introduction

1 EFRAG and National Standard Setters (ANC, ASCG, FRC and the OIC) have conducted a joint field test, in coordination with the IASB staff, on whether the new requirements are operational, what their impact would be and the costs and benefits associated with introducing them. The field test was focused on the practical application of the IASB Exposure Draft ('ED') *Insurance Contracts* requirements and was not intended to gather any opinions, but solely facts and objective data.

2 Thirteen (13) companies participated in the field test. While the objective of the field test was focused on the application of the IASB proposals, participants also provided opinions and views on the proposals. This input was taken into account by EFRAG in finalising its comment letter on the ED.

3 The participants' comments on the balance of costs and benefits and/or operational complexity of alternative approaches were included in this report because they fit within the remit of the field test (to gather facts and objective data).

Adjusting the contractual service margin

4 Unlocking the contractual service margin was considered technically feasible by many participants. The ED did not propose that changes in the risk adjustment be set-off against the contractual service margin on the ground of operational and reporting complexity. Participants in the field test were split on whether changes in the risk adjustment, which relate to future coverage, could be separated from changes in risk that relate to incurred claims without significant costs or operational complexity.

5 Most participants considered that, for participating contracts, splitting the changes in estimates of cash flows that depend on investment returns, when those changes arise as a result of changes in the value of underlying items, from the changes in other estimates, which relate to future coverage and other future services, would be operationally burdensome. Almost all participants suggested a fully unlocked contractual service margin, which in their view is not just more appropriate, but also easier and less costly to implement.

6 Most participants also expressed concerns about the proposal that the contractual service margin be calculated and tracked at a very granular level. This granularity adds significant operational complexity and cost without necessarily enhancing the reliability and quality of the accounts.

Mirroring approach

7 Almost all participants reported that they have experienced significant operational difficulties in applying the proposals to contracts that specify a link to the returns on underlying items. This was mainly due to the ED proposal to split the cash flows into those that vary directly and those that do not; a process that was identified as complex, impracticable and often arbitrary by participants. A majority reported that current actuarial models that are used for regulatory, financial and embedded value reporting use a combined projection of all cash flows. In addition, the scope of the exemption was unclear as the requirement to hold specific assets was open to broad interpretation. This uncertainty would likely lead to inconsistent application.

8 Almost all participants used approximation techniques, which they considered would lead to inconsistencies in their application. A majority of participants found the ED proposals unclear in relation to the types of contracts that could be categorised as those that specify a link to returns on underlying items.

9 A majority of participants mentioned that they were considering an alternative proposal that was being developed by the European insurance industry. Most of them noted that this alternative would result in a more faithful representation of underlying economics and performance of participating contracts without adding complexity. This alternative is based on a 'fully unlocked contractual service margin' model and is consistent with the overall building blocks model in the IASB ED. One participant reported that they had tested the alternative industry proposal on several portfolios, and had concluded that it was operationally feasible. Furthermore, they noted that the related benefits outweighed the costs.

10 Several participants reported that there was a lack of information in the proposals on how to reflect changes in the value of options and guarantees embedded in insurance contracts.

Presentation of revenue and expenses

11 Many participants reported that they were unable to test the revenue proposals because of their complexity. This was mainly attributed to: (a) the exclusion of the investment component, considered highly interrelated with the other components; and (b) the need to upgrade IT and actuarial systems in order to perform the testing. In their view, the costs to implement the changes outweigh the benefits.

12 Two participants reported that for non-life insurance, the estimation of revenue under the simplified approach would not be operationally difficult because no investment components are included in the premiums and the approach is consistent with current practice.

Interest expense in profit or loss

13 The key operational issues and concerns expressed by participants were related to:

(a) the requirement to calculate and store multiple discount rate yield curves; and

(b) for non-life business, the use of the locked-in rate at inception of the contracts. Participants currently use the discount rates on an accident year basis.

14 Participants were asked to provide information about how the presentation of interest and expense in profit or loss, and changes in the discount rate in OCI would interact with the requirements in IFRS 9. Feedback received from participants has been considered separately. Most participants expressed concern that the ED proposals on interest expense create an accounting mismatch, and objected to the requirement for mandatory OCI.

Effective date and transition

15 Many participants agreed that the modified retrospective proposal would reduce the cost of retrospective implementation.

16 A majority of participants agreed that the effective dates of IFRS 4 *Insurance Contracts* and IFRS 9 should be aligned. They noted that any other approach would lead to operational difficulties, significant costs due to the two major changes being implemented in a very short period, and unnecessary complexity arising from the redesignation of financial assets at each of the application dates.

Costs and benefits assessment

17 Participants expect benefits of the ED to outweigh costs for the following aspects in the proposals: adjusting the contractual service margin, effective date and transition, current estimate of future cash flows, risk adjustment, discount rate, and simplified approach.

18 Participants assessed that costs would outweigh benefits for the following aspects in the proposals: 'mirroring' approach (seven participants), presentation of revenue and expenses (nine participants), definition of portfolio and unbundling (eight participants), reinsurance assets (held by cedants) (three participants) and disclosures (five participants).

19 Participants provided split views on costs and benefits to be incurred from applying the proposals on interest expense in profit or loss. For some participants, the costs related to changing the IT and actuarial systems, and management and storing of historical discount rates would outweigh the benefits. For other participants, benefits arising from improved transparency and less volatility in profit or loss would outweigh the related costs.

20 Overall, some participants believed that for non-life insurance, the proposals would lead to an improvement in the transparency of the financial statements. The proposals on the contractual service margin were expected to increase comparability in the financial statements. However, for life insurance, many participants believed that the requirements would not lead to comparability between companies or transparency for the users of financial statements as the mirroring approach was complex, difficult to understand, and would not be applied consistently.

INTRODUCTION

Background

21 In July 2013, the IASB published the ED. The objective of the ED was to improve the transparency of the effects of insurance contracts on an entity's financial position and financial performance, and to reduce diversity in the accounting for insurance contracts.

22 At present, IFRS has no comprehensive standard that deals with the accounting for insurance contracts. IFRS 4 *Insurance Contracts*, published in 2004, is an interim Standard that permits a wide range of practices and includes a 'temporary exemption', which explicitly states that an entity does not need to ensure that its accounting policies are relevant to the economic decision-making needs of users of financial statements, or that those accounting policies are reliable. This means that companies account for insurance contracts using different accounting models that have evolved in each jurisdiction according to the products and regulations prevalent in that jurisdiction. As a result, there are substantial differences in the accounting policies used by different companies to account for insurance contracts.

23 EFRAG and the National Standard-Setters (ANC, ASCG, FRC and the OIC) have conducted a joint field test, in coordination with the IASB staff, on whether the new requirements are operational, what their impact would be and the costs and benefits associated with introducing them[1]. The field test was focused on the practical application of the new requirements and was not intended to gather any opinions, but solely facts and objective data.

1 In setting up this field-test exercise, EFRAG and National Standard-Setters have coordinated with the IASB staff in order to avoid creating overlap in their respective outreach activities. In addition, the IASB has organised field work with non-European Union participants. The IASB's field work exercise focuses only on the five areas subject to re-exposure through a set of specific questions. These questions are the same as the questions included in Part 3 of this questionnaire.

24 During the field test, participants also provided opinions and views on the proposals in the ED. This input was considered separately.

25 In cases where participants also provided comments on the cost-benefit balance and/or operational complexity of alternative approaches, their input was included in this report as it fits within the remit of the field test (to gather facts and objective data).

Companies that participated in the field test

26 Thirteen (13) companies participated in the field test and are listed in Appendix A. The table below summarises the number of participants by country and the number of portfolios tested.

Table 1: Total participants by country and number of portfolios tested

		Number of portfolios:		
Participants by country:		*Life*	*Non-life*	*Reinsurance*
France	*2*	3		
Germany	*4*	3	3	1
Italy	*3*	3		
Spain	*1*	2		
UK	*2*	7		
	12	*18*	*3*	*1*

27 In addition, one participant did not select portfolios to perform the field test, but spent considerable time analysing the ED and has provided comments in the corresponding questions.

Terminology

28 In describing the findings, ‘some’ represents two participants, ‘many’ represents three to six participants. ‘Majority’ represents seven or more participants. The terminology is relative to the number of participants in the field test (i.e. 13 participants).

29 Not all the participants responded to all of the questions asked because some of them related to contracts that the participants do not hold. In addition, some participants chose to test some, but not all of the proposals.

DETAILED RESULTS

30 In total, there were 43 questions in the field test questionnaire split into five parts. Part one (Q1 and Q2) consisted of a description of the participants’ activities and contact information.

Part 2: Description of the portfolios subject to the field test (Q3 to Q6)

31 The participants tested eighteen life insurance and three non-life insurance portfolios/lines of business. One participant provided views for its active reinsurance line of business. One participant did not test the proposals on specific portfolios.

32 The eighteen life insurance portfolios/lines of business include different types of contracts (e.g. investment contracts with discretionary participating features, unit and index linked contracts, loan insurance contracts, UK-style with-profits, UK immediate annuities, US

variable annuities, and Jackson fixed annuities[2]). Those portfolios have different features (i.e. different insured events, relevant underlying risks, average duration, expected maturity and options and guarantees provided to policyholders).

33 The non-life portfolios include motor insurance contracts and long-term engineering business.

34 Detailed characteristics of the portfolios are provided in Appendix B.

Part 3: Assessing the changes introduced by the ED

Adjusting the contractual service margin (Q7 to Q8)

35 Four participants reported that, from a technical point of view, the unlocking of the contractual service margin was feasible. Some reported that a similar approach was required by current financial and solvency requirements.

36 Some reported that the distinction between changes in estimates that relate to the future and those relating to the past introduced complexity, but the benefits of doing so would outweigh the costs.

37 One participant noted that there was a wide range of information already available that could be considered when determining whether the contractual service margin should be adjusted, such as incurred claims statistics or regularly updated parameters (e.g. development patterns). Such information would also be collected for Solvency II purposes in order to understand the effect of assumption changes. There would be a need to do additional or more formal reviews, for example, trend analyses compared to current practice.

38 A majority of participants reported that for participating business, the contractual service margin was mainly impacted by the effects of changes in returns of underlying items. Under the current ED proposal, the contractual service margin is not unlocked for the effects of cash flows arising from these changes. The participants noted that a fully unlocked contractual service margin, adjusted for changes in estimates of cash flows that depend on investment returns, when those changes arise as a result of changes in the value of underlying items as well, would be more appropriate and easier to implement.

Changes in the risk margin should be reflected against the contractual service margin

39 Participants held mixed views on the operational difficulties in splitting the estimated risk adjustment into the three components: (i) a release from risk as the coverage period expires, (ii) changes in risk that relate to future coverage periods, and (iii) changes in risk that relate to incurred claims. Two participants reported that they expected no difficulties in performing the split and two participants reported that they were not able to split the risks that relate to future coverage periods and incurred claims. One participant reported that the split of the risk adjustment would add an additional layer of complexity.

Level of measurement of the contractual service margin

40 Many participants (four) noted that they interpreted the ED as requiring the contractual service margin to be calculated and tracked at a very granular level (i.e. by portfolio, year of issue and coverage period). They noted that this requirement, together with the requirement for portfolios to be similarly priced relative to the risks, adds significant operational

2 Those are fixed annuities which provide a minimum guaranteed rate of return over the life of the contract, which is the first year introductory rate. After the first year, the crediting rate is set at the insurance company's discretion subject to the minimum amount.

complexity and cost without necessarily enhancing the reliability and quality of financial statements. Participants applied the proposals at a portfolio level.

Operational difficulties

Life insurance portfolios

41 Participants who tested life portfolios reported the following operational difficulties in adjusting the contractual service margin for differences between the current and previous estimates of the present value of future cash flows:

(a) The proposals present an operational complexity in splitting the changes in cash flows between those that are unlocked in the contractual service margin (technical assumption changes) and those that are not unlocked (financial assumptions). (three participants)

(b) Historical data is needed in order to assess the adjustments to the contractual service margin. This would require additional effort compared to local and other current practices, mainly in long term portfolios with a duration of more than twenty years. (one participant)

(c) Current systems are not flexible enough for a timely restatement of the present value of future cash flows that are needed for the calculation of the adjusted contractual service margin at each valuation date. (one participant)

(d) The use of locked-in discount rates to value changes in estimates of future cash flows, and unwind the contractual service margin means that systems need to track results and perform calculations at portfolio level by year of issue. This is incredibly complex and would mean very significant systems changes to the systems used today by most insurers. (two participants)

Non-life insurance portfolios

42 Three participants reported that the contractual service margin was not applicable to their non-life business, because they observed that the simplified approach for measuring the liability for remaining coverage was an adequate approach for accounting and evaluation of their non-life business.

43 One participant reported that they expected operational difficulties in applying the proposals for:

(a) determining the discount rate at inception of the contract;

(b) establishing how to release the contractual service margin if interest is accreted on it;

(c) determining the discount rates for past underwriting years. The observable rates have to be adjusted for a liquidity premium depending on the characteristics of the insurance liabilities. This participant reported that liquidity premiums were not currently available.

44 In addition, this participant noted the lack of necessary planning data and related projection pattern as a key challenge for the implementation of the building block calculation.

Active reinsurance

45 One participant reported that they would expect to use the simplified approach for virtually the whole of their reinsurance business written. However, they noted that they still needed to verify whether it gave a reasonable approximation of the building block approach. This participant reported that the ED did not prescribe whether the contractual service margin had to be adjusted before or after the determination of the OCI impact. In their view, different results can arise depending on when the contractual service margin is adjusted. This will deteriorate the comparability of results between different entities.

Mirroring approach (Q9 to Q12)

Portfolios made up of contracts that specify a link to the returns on underlying items that the participant is required to hold (paragraphs 33-34 of the ED).

46 Participants reported that ten portfolios, subject to the field test, would/could fall under the scope of the measurement and presentation exception for contracts that require the entity to hold underlying items and specify a link to the returns on those underlying items. The types of contracts in this category are investment contracts with discretionary participating features, unit-linked contracts, with-profit contracts and variable annuities. However, some participants reported that the scope of the exception was unclear as the requirement to hold specific assets was open to broad interpretation, and companies had difficulty in determining the cash flows that would be within its scope.

47 One insurer reported that their portfolio of 'matched business' would not fall under the 'mirroring approach' because the company is not required to hold a number of assets, as these could be changing in order to comply with asset-liability management requirements.

Portfolios made up of contracts with cash flows that are expected to vary directly with returns on underlying items that the participant is not required to hold (paragraph 60(h) of the ED).

48 Three portfolios were within the scope of the presentation exception to include in the profit or loss the effect of unwinding of the discount based on an updated discount rate for cash flows that are expected to vary directly with returns on underlying items, but the insurer is not required to hold the underlying items. The contracts in this category include certain types of fixed annuities and certain types of participating contracts, where the company is not required to hold the assets.

49 Appendix C provides details on the characteristics of the type of link to the underlying items. This also includes whether any options and guarantees are embedded in the contracts. In addition, appendix C also contains information on the type of discretion over the amount and/or timing of the surplus of the returns of the underlying items, and whether it is constrained by legal or regulatory requirements.

Operational difficulties in applying the proposals

50 All participants who tested life portfolios reported that they experienced significant operational difficulties in applying the proposals for contracts that specify a link to the returns on underlying items. Some participants reported they were either unable to complete this aspect of the field test, or not able to model any contracts at all.

51 Participants reported the following operational difficulties:

(a) Bifurcating cash flows into those that vary directly and those that do not, is a complex and often arbitrary process. This added significant complexity and costs to the existing

processes. The current actuarial models that are used for regulatory, financial and embedded value reporting use a combined projection of all cash flows (all of the participants who tested life portfolios).

(b) Options and guarantees should be measured separately even though they are not unbundled at the inception of the contract because they are closely related to the other components. Many respondents reported that embedded options were reflected in the fulfilment cash flows and valued under a set of stochastic scenarios, in order to reflect the potential effects on the liability (four participants).

(c) One participant noted that for solvency and non-GAAP purposes, the options and guarantees were measured using stochastic simulation, assuming that the entity holds 100% of the asset value. It would be difficult to decompose the value of the options and guarantees into fixed-type cash flows.

(d) Guarantees are interdependent with profit participation and the investment return for most types of participating contracts (all of the participants who tested life portfolios).

(e) For a majority of contracts the share of the underlying items changes and the options and guarantees change frequently over the life of the contract. The proposal would require determining the decomposition of the cash flows whenever there is a change that increases the operational difficulties.

Clarity of the proposals and consistency in the application

52 Almost all participants, who tested life insurance portfolios reported that they found the proposals specifying a link to the returns on underlying items to be unclear, and noted that there was a significant risk that the proposals would not be applied consistently. Almost all participants noted that they needed to use approximation techniques, which would lead to inconsistencies in the application.

53 Participants reported that the following aspects of the proposals were unclear:

(a) Paragraphs B85 and B86 of the ED, which prescribe how the company should decompose the cash flows, were found to be complex; and it was not clear how they could be applied to contracts with more complex structures (four participants).

(b) For particular features in the contract it was not clear if (and to what extent) the cash flows would be considered to ‘vary directly with returns on underlying items’ (two participants).

(c) The scope of the exemption was unclear as the requirement to hold specific assets was open to broad interpretation. This uncertainty would likely lead to inconsistent application (two participants).

(d) Even for a simple insurance contract, there were a number of interpretations on how the cash flows could be bifurcated, with each interpretation potentially resulting in a different measurement of the insurance contract liability (all of the participants who tested life portfolios).

(e) The ED was not clear on how the mirroring approach should be applied to participation features other than investment returns (e.g. results depending on mortality or costs) (one participant).

(f) Changes in options and guarantees were treated differently between contracts that were eligible for the mirroring approach (the changes in expected value of cash flows are recognised in profit or loss) and those that are accounted for using the building block approach (use of OCI for changes in discount rates and the unlocking of the contractual service margin) (a majority of the participants).

(g) The application guidelines were not clear on whether options and guarantees embedded in the insurance contracts were reflected at current value determined under a set of stochastic scenarios, in order to reflect the potential effects on the liability (one participant).

(h) Some think that most of their participating contracts fail the defined criteria, because the profit sharing credited to policyholders is at total discretion of management and there are no contractual rules.

Faithful representation of the underlying economics

54 Participants were asked whether the proposals resulted in faithful representation of the underlying economics for contracts that specify a link to the returns on underlying items. The feedback received from participants was considered separately. A majority of constituents expressed concerns about the narrow scope of the measurement and presentation exception, the complexity arising from the arbitrary decomposition of the cash flows, and the reduced comparability because of the difference with the general fulfilment cash flow model (building blocks model) that applies to all other insurance contracts.

Alternative proposal for participating contracts

55 A majority of participants who tested life portfolios noted that they were considering the alternative industry proposal being developed by the European insurance industry. Among them, the majority view is that the alternative proposal would result in a more faithful representation of underlying economics and performance of participating contracts with less complexity. This alternative is based on a 'fully unlocked contractual service margin' model and is consistent with the overall building blocks model.

56 One participant tested the alternative approach and reported that it would be less operationally complex than the IASB's approach. This was due to the alternative requiring no bifurcation of cash flows or the bifurcation of the changes in the contractual service margin between those relating to the changes in estimates of cash flows that depend on investment returns, when those changes arise as a result of changes in the value of underlying items, from the changes in other estimates, which relate to future coverage and other future services.

Presentation of revenue and expenses (Q13 to Q14)

57 Many participants (five out of ten who responded) reported that they were not able to test the revenue proposals because of the complexity, which was mainly due to the exclusion of the investment component that was considered highly interrelated with the other components. In addition, participants reported they needed to upgrade their IT and actuarial systems to perform the testing because of the need to track various components. Many participants reported that costs would outweigh benefits because of this complexity and system update requirements.

58 Two participants reported that for non-life insurance, the estimation of revenues in the simplified approach would not be operationally difficult because no investment components were included in the premiums and was consistent with current practice.

Operational difficulties encountered

Life

59 Apart from what has been stated in paragraph 51 above, one participant reported that the proposals involved a significant use of estimates.

60 Three participants reported that the benefits of the proposals would be low as investors would not recognise the revenue presented as a substitute for premium income, and would continue to use non-GAAP or existing volume measures in the notes such as written premiums and premiums for new business.

Non-life

61 Two participants reported that for their general insurance business, the allocation of expected premiums receipts over the coverage period would not present operational difficulties.

Interest expense in profit or loss (Q15 to Q17)

62 Six out of seven participants reported that the revised proposals applied to contracts measured under the general requirements of the revised ED, including annuity contracts, the fixed cash flow components of unit linked contracts, variable annuity contracts and with-profits contracts, but did not apply to cash flows that were expected to vary directly with returns on underlying items.

63 Five participants reported that because of the lack of historical data for the yield curves at initial recognition for existing contracts they made significant assumptions and took shortcuts. Some participants reported that these assumptions would give rise to distortions on the locked-in rates due to the simplifications used.

Operational issues

64 Participants reported the following operational issues and concerns:

(a) the requirement to calculate and store multiple discount rate yield curves, for each year of issue and each currency within the business. This increases the complexity of the valuation process. (three participants)

(b) the lack of historical data and the simplifications required would add complexity and impair the relevance of the information disclosed in the financial statements. (three participants)

(c) for non-life business, the use of locked-in rate at inception of the contracts was considered not feasible because companies do not store information about the locked-in rate at inception of the contract. Under the simplified approach only claims reserves are subject to discounting and therefore the locked in rate applies only to unpaid claims. The participants currently use the discount rate based on the period when the claim is incurred. (three participants).

(d) the information to be considered such as interest rates and the duration of the underlying assets adds to the complexity. The different measurement bases (one for the balance sheet and one for the profit or loss) would lead to operational difficulties. (one participant)

65 Only one participant reported that they did not encounter any operational difficulties in segregating effects of the underwriting performance from the effects of the changes in the discount rate that unwind over time.

66 One participant also reported that their methodology for estimating the risk margin was impacted by discount rates. They noted that the changes in the risk margin arising from the change in the discount rate would be reflected in the profit or loss, and this would lead to significant volatility in the operating result.

Linkage with IFRS 9

67 Participants were asked to provide information about how the presentation of interest and expense in profit or loss, and changes in the discount rate in OCI interact with IFRS 9. The feedback received from the participants was considered separately. Most participants expressed concerns that the ED proposals on interest expense create an accounting mismatch, and they objected to the requirement for mandatory OCI.

Effective date and transition (Q18 to Q20)

Issues in applying the transitional proposals

68 The following issues were identified:

(a) Significant costs would be incurred to adjust the IT systems, the training of staff and user understandability (one participant);

(b) Under the simplified approach only claims reserves are subject to discounting and therefore the locked in rate applies only to unpaid claims. The participants currently use the discount rate based on the period when the claim is incurred. (two participants);

(c) A fully retrospective basis would only be practicable for the most recent business sold (one participant); and

(d) How to determine the discount rate at transition. The ED proposal was considered as not understandable, and needed clarification (one participant).

(e) For countries with high inflation rates there would be only limited availability of reliable historical discount rate information (e.g. South America) (one participant).

(f) For active reinsurance, the main challenge would be the retrospective assessment of the contractual service margin for incurred claims up to the effective date (one participant);

69 One participant reported it was not practicable to make a reasonable estimation of the contractual service margin at initial recognition based on historical public and internal information. Therefore, this participant used an alternative to determine the contractual service margin. Another participant also used a proxy to determine the contractual service margin.

Modified retrospective proposal

70 Many participants (six out of seven who responded) reported that the modified retrospective proposal would reduce the cost of retrospective implementation.

71 One participant mentioned that, for reinsurance, operational difficulties were expected with the retrospective approach, even where there were simplifications of the estimations of historical data.

Reporting or operational issues if IFRS 4 and IFRS 9 were not aligned

72 A majority of participants (ten out of eleven who responded) agreed that the effective dates of IFRS 4 *Insurance Contracts* and IFRS 9 should be aligned. They noted that any other approach would lead to operational difficulties, significant costs due to the two major changes being implemented in a very short period, and unnecessary complexity arising from the redesignation of financial assets at each of the application dates.

Costs and benefits when compared to the 2010 exposure draft (Q21 to Q22)

73 The table below reflects the assessment of the costs and benefits of the revised proposals compared to the proposals of the 2010 ED:

Table 2: Costs and benefits of the revised proposals compared to the proposals of the 2010 ED[3]

	Costs			*Benefits*			*Will expected benefits outweigh expected costs?*	
Factors	*High*	*Medium*	*Low*	*High*	*Medium*	*Low*	*Yes*	*No*
Adjusting the contractual service margin	2	5	1	3	2	3	5	3
Mirroring approach	8	–	–	1	–	7	1	7
Presentation of revenue and expenses	3	5	1	–	1	8	1	8
Interest Expense in profit or loss	5	3	1	4	1	4	4	4
Effective date and transition	3	6	–	7	2	–	8	–

74 Table 3 below summarises the main types of costs and benefits that participants expect to encounter in order to implement the revised proposals compared to the proposals of the 2010 ED.

75 Common expected costs include:

(a) Significant IT costs including development of the actuarial models, risk and finance functions; and

(b) Educating, training staff and investor relationship.

3 Some of the participants provided comments on certain aspects of the cost and benefit analysis.

Table 3: Types of costs and benefits in order to implement the revised proposals compared to the proposals of the 2010 ED

Factors	Costs	Benefits
Adjusting the contractual service margin	• Storing data at a more granular level • Costs linked to the adjustment of the contractual service margin and adjustment of amortisation pattern	• Performance reflecting the long-term nature of the business • Reduction in volatility in profit or loss from changes in fulfilment cash flows (volatility from risk adjustment was not addressed) • Consistency of the unlocking of the contractual service margin
'Mirroring' approach	• Bifurcation of cash flows for participating contracts • Lack of comparability between the same type of contracts	• Consistent methodology, provided that changes in options and guarantees were treated consistently with other interest induced changes
Presentation of revenue and expenses	• Identifying the non-distinct investment components	• Comparability with other industries
Interest expense in profit or loss	• Storing data from prior years • Introducing undesirable accounting mismatches.	• Performance reflecting long-term nature of the business • Consistency with the aim that the profit or loss account should reflect a measure of result that would be relevant to the operating performance of the insurer • Transparency of other comprehensive income impact and thus avoiding accounting mismatches.
Effective date and transition	• Limited availability of reliable historical discount rate information for countries with high inflation • Data storage • Mismatches with IFRS 9 implementation date	• Comparability of in-force and new business contracts at transition and subsequently • Consistent contractual service margin measurement for existing contracts • User understandability

Transparency in the accounting for insurance contracts compared to the 2010 ED

76 Participants were asked whether, compared to the 2010 exposure draft, the 2013 ED would improve the transparency of the effects of insurance contracts and would reduce the diversity in the accounting for insurance contracts.

77 Many (five out of nine who responded) participants believed that the 2013 ED was an improvement compared to the 2010 exposure draft.

78 Improvements compared to the 2010 exposure draft included:

(a) Recognition of effects from changes in discount rate in other comprehensive income;

(b) Unlocking of the contractual service margin;

(c) Recognition of the special nature and link between assets and liabilities for participating contracts (however, the approach was not considered appropriate);

(d) Ability to use the top-down method to derive the discount rate;

(e) Retrospective transition guidance; and

(f) The simplified approach not being mandatory for short duration contracts.

79 One participant mentioned that the ED did not improve transparency for users of financial statements without expert knowledge.

Part 4: Other questions on the exposure draft

Contract boundary, recognition, definition of portfolio (Q23 to Q26)

80 Many participants (five out of eight who responded) did not expect any operational issues with the contract boundary. However, one participant preferred the 2010 ED definition of contract boundary as the definition in the current ED differed slightly from current valuation models.

81 Many participants (six out of eight who responded) did not expect any operational issues with the recognition point.

82 Many participants (five out of eight who responded) expressed concerns about the definition of portfolio, including:

(a) The definition of portfolio may create too low a level of aggregation under both the general measurement requirements and the simplified approach, thus leading to complexity; and

(b) For participating contracts, it was not clear to what extent future premiums and direct costs could be included in the projected cash flows.

83 Many participants (five out of eight who responded) suggested that the IASB should clarify what constitutes a portfolio to improve the expense allocation analysis.

84 One participant did not agree that the pricing of insurance contracts should be the criterion for the definition of a portfolio. This participant noted that it was not clear how this criterion could be put into practice if insurance contracts, which were negotiated as a package, belonged to different portfolios (e.g. entities give a discount if customers buy a private liability insurance and an insurance of contents).

85 One participant reported that there were difficulties in how future recurrent single premiums should be treated when determining the fulfilment cash flows.

Unbundling

86 Two participants believed that the ED did not give clear enough guidance on the unbundling of asset management services.

87 A participant reported that the scope of IFRS 4 caused concern around the unbundling of components from an insurance contract. An example is if, within a group, a banking subsidiary issued a loan and the insurance subsidiary underwrote a residual insurance

contract, both would be contained in one contract. Under the unbundling criteria of the ED, the whole contract would be treated as an insurance contract.

88 One participant reported that for some annuity contracts, where the insurer offers a guaranteed payment for a fixed period after inception of the contract (i.e. there is no insurance risk), the guaranteed payment could be considered as an investment component and should be unbundled for measurement. This participant considered that those components were highly interrelated and therefore they did not unbundle the two components in the field test. However, more clarification for this particular case would be necessary.

89 Another participant considered that unbundling was complex and costly from a systems perspective, and the benefits did not outweigh the costs. However, this participant has yet to test the unbundling proposals in detail.

Accretion of interest on the contractual service margin

90 A majority of participants (seven out of nine who responded) reported that they selected long-term business portfolios for the field test. They noted that accretion of interest on the contractual service margin had a significant impact on such portfolios, and might be significant for other portfolios that had not been tested. Only one participant reported that the accretion of interest was not significant for the portfolios tested.

91 One participant reported that the relative significance of accretion of interest on the contractual service margin would vary by portfolio.

Current estimate of future cash flows (Q27)

Significant differences between the future cash flows to be used under the IASB's approach and those used in current accounting

Life insurance

92 Most participants reported that they were using local GAAP for their life portfolios.

93 Participants outlined the following current accounting practices that differ significantly from the ED:

(a) Prudence was incorporated into many of the assumptions used to calculate the cash flows (two participants);

(b) The insurance liabilities were discounted with an interest rate that is independent from the market (i.e. locked-in assumptions) (four participants);

(c) Premiums were not separated between investment and risk components (one participant);

(d) Current accounting uses demographic and financial assumptions, without surrenders in the premium calculation, while the ED introduces the use of surrenders, second order mortality tables, financial scenarios and discount curve. (one participant);

Non-life insurance

94 Participants outlined the following current accounting practices that differ significantly from the ED :

(a) Claims reserves were determined based on the prudence principle, and not on actuarial reserving methods. (one participant)

(b) There was no separation between the current estimate of future cash flows and risk adjustment. (one participant)

(c) There was no consideration of discount effects on the claims reserves (the new IFRS would require a robust pay-out pattern for discounting purposes). (two participants)

(d) Further changes refer to the required obligatory consideration of change of discount impact in the other comprehensive income and the related use of locked-in historical interest rate curves. (one participant)

Active reinsurance

95 One participant outlined the following current accounting practices that differ significantly from the ED:

(a) Their liability for incurred claims does not consider the time value of money

(b) Estimations of future expected cash flows (premiums and claims) do not include the settlement period

(c) There is no differentiation between pre-claims liability and liability for incurred claims.

Practical simplifications used in the estimations of current estimates of future cash flows

96 A majority of participants used Solvency II based cash flows in the field test. However, due to time constraints, they did not adjust the Solvency II cash flows to conform with the requirements of the ED. Adjustments need to be made to reflect differences between Solvency II and insurance contracts phase II cash flows regarding the contract boundary, the expenses considered in the cash flows, and the unbundling of investment components and embedded derivatives.

Operational issues in calculating the current estimate of future cash flows

97 Participants reported operational difficulties in calculating the current estimate of future cash flows with respect to:

(a) operational difficulties from the requirement to disaggregate cash flows for contracts that require the entity to hold underlying items, and specify a link to returns on those underlying items (two participants).

(b) potential impacts arising from the need to have different systems within the company to share relevant data within the company (one participant).

(c) concerns about the exclusion of policyholder tax flows from the measurement of the current estimate of future cash flows (one participant).

Clarity of the application guidance

98 Participants reported that:

(a) the ED was not clear on how the correlation between inflation and interest rates should be determined. This participant observed that, according to paragraph B60 of the ED, a stochastic approach to determine the correlation should be used. However, this

participant believed that a stochastic approach would be very complex to implement. (one participant)

(b) the ED was not clear on how changes in the liability arising from experience in the year should be treated. This participant had treated those as a movement relating to the year. (one participant)

(c) the ED implied that the policyholders' share of the unallocated surplus on participating business would not be included in the estimation of future cash flows. The intention was that these cash flows should be included in future liabilities. The wording of the ED should clarify that this is what was intended. (one participant)

Risk adjustment (Q28)

Technique used to determine the risk adjustment

99 Eight out of ten participants reported that they intended to use a cost of capital technique to determine the risk adjustment, and they would use this technique for different portfolios. Many participants reported that they used the technique in the Solvency II framework. Two companies reported they had used a cost of capital of 6%.

100 One participant intended to use different techniques for different portfolios. Another participant responded that they would use a confidence level technique for their property and casualty portfolio. The same participant noted that, for their active reinsurance business, they considered using other methods of valuation e.g. Value at Risk or cost of capital.

The level at which diversification benefits are reflected in the risk adjustment amount

101 Two out of seven participants reported they computed the risk adjustment at a company level and then assigned it to the sub-portfolios of the IFRS measurement, i.e. the diversification benefits are considered at company level.

102 One participant reported that they had not yet determined the level at which diversification would be allowed. However, this participant noted that allowing for diversification benefits between countries/business units would involve significant operational challenges and could impact the way in which the business was managed.

103 Another participant reported that they allocated group-wide diversification benefits to the risk adjustment in line with their economic capital methodology. Their economic capital methodology calculates the risk margin on a net of reinsurance basis. They noted that calculating gross and reinsurance risk margins on a separate basis as per the ED would significantly increase complexity and result in significant development expense.

104 One participant, who tested an active reinsurance portfolio, reported that they would determine the diversification benefits over the full reinsurance business, and expected that the effect of diversification on the risk assessment would be considerable. From their perspective, the evaluation of the risk adjustment would be the most difficult aspect of applying the ED, as they did not include effects of diversification at the moment.

Operational issues in calculating the risk adjustment

105 One participant reported that it would be operationally very challenging to calculate the risk adjustment precisely during normal IFRS reporting timeframes, and it was expected that approximation techniques would be used (i.e. roll-forwards from calculations at earlier valuation dates with adjustments for changes in market conditions).

Clarity of the application guidance

106 One participant required more guidance and clarification on the following two aspects:

(a) The reference figure of the confidence level corresponding to the risk adjustment should be defined in detail (paragraph 84 of the ED).

(b) Determining in more detail the required relation between the risk adjustments at different aggregation levels.

Discount rate (Q29)

Operational issues in calculating the discount rate

107 Three out of ten participants did not report major operational issues in applying the 'top-down' approach. The 'top-down' approach is similar to the one applied in their local regulation, and although it is expected that small differences may exist, they believe that there should be no significant difficulties.

108 In a 'bottom-up' approach, two participants reported that difficulties might arise regarding the choice of the relevant risk-free rate to be used and the illiquidity premium adjustment. Therefore, the process of proper justification of the rates used under the respective approach would be important.

109 Three out of ten participants reported that currently there was no method available to determine the liquidity premium in a 'bottom-up' approach, and the guidelines were very broad so the results could vary a lot depending on the assumptions. Those participants suggested that the determination of the 'liquidity premium' should be more transparent.

Clarity of the application guidance

110 Four out of the five participants who commented on the clarity of drafting reported that the deductions in a 'top-down' approach were not fully clear.

111 Three participants noted that more clarity was needed on the meaning of 'market premium for liquidity' in paragraph B74(a) of the ED. Those participants noted that paragraph B74(a) introduced new requirements which were difficult to interpret.

112 One participant noted that further clarification was needed on the way the discount rate reflected asset dependency when a link existed between assets and liabilities (paragraph 26(a) of the ED). This participant noted that credit risk was generally partially passed to policyholders in participating contracts while paragraph B70 of the ED stated that counterparty risk should be excluded from the discount rate as not relevant for the insurance contract cash flows.

Simplified approach (Q30 to Q32)

113 Two participants reported that the simplified approach would be used for their property and casualty business. One participant indicated that they were unclear on the level of proof that would be required to demonstrate that the simplified approach would produce a reasonable approximation to the building block approach.

114 Many participants (all three who responded) agreed that the simplified approach provided a simpler way of measuring the insurer's liability for remaining coverage.

115 The following difficulties were identified:

(a) deriving a risk-based premium earnings pattern (one participant);

(a) difficulties with respect to determining whether an onerous contract existed (two participants);

(b) the unit of account for determining the locked-in discount rate for the presentation of interest expense under the simplified approach was not clear (one participant);

(c) additional implementation guidance would reduce flexibility.

Reinsurance assets (held by cedants) (Q33 to Q35)

116 Two participants stated that they priced and managed their portfolio of protection business on a net of reinsurance basis. There would be significant additional complexity and systems development required to account on gross and net bases. Estimation of the risk margin would also be on both a gross and ceded basis (in Solvency II it is estimated only on a net basis).

Differences compared to current accounting for measuring the reinsurance assets

117 One participant reported that the difference between their current accounting and the ED would be substantial. Some key differences would be due to the inclusion of the risk adjustment and contractual service margin being computed separately for insurance and reinsurance contracts.

Disclosures (Q36 to Q37)

118 Three out of eight respondents expected a substantial increase in the workload because of the disclosure requirements. One participant noted that, while they expected challenges in producing the disclosures, they saw benefits in the improved quality of information.

119 Six out the eight participants who commented on disclosures reported that the requirement to disclose the equivalent confidence level would result in operational issues and would be complex to apply. Furthermore, participants noted that the confidence levels were unlikely to be comparable between companies due to differences in the underlying methodology and assumptions.

120 A majority of participants reported that the reconciliations would be complex to perform. Requirements that were identified as challenging and/or costly to prepare were:

(a) The requirement to identify a separate investment component (two participants).

(b) Sensitivity analysis, particularly with respect to non-life business (one participant).

(c) Complexity of contractual service margin (two participants).

(d) The definition of revenue proposed in the ED cannot easily be reconciled to tangible elements such as the premium written or cash received (one participant).

121 Overall respondents reported that the disclosure requirements were clearly drafted.

122 One participant reported that the proposals were unclear on how reinsurance would be reflected in the disclosure as risk margin was only meaningful on a net of reinsurance basis.

Part 5: Assessing the impact and costs and benefits of the insurance contracts standard (Q38 to Q43)

123 Below is a table that reflects the assessment of the costs and benefits of the IASB proposals for accounting for insurance contracts compared to current accounting:

Table 4: Costs and benefits of the insurance contracts proposals compared to current accounting[4]

	Costs			*Benefits*			*Will expected benefits outweigh expected costs?*	
	High	*Medium*	*Low*	*High*	*Medium*	*Low*	*Yes*	*No*
Adjusting the contractual service margin	5	3	1	3	3	3	5	3
'Mirroring' approach	8	–	–	1	1	6	1	6
Presentation of revenue and expenses	4	5	1	1	2	7	1	8
Interest Expense in profit or loss	7	2	1	3	2	4	4	4
Effective date and transition	5	5	–	5	2	1	5	2
Contract boundary, recognition point, definition of portfolio and unbundling	4	4	2	1	1	6	3	5[5]
Current estimate of future cash flows	3	2	3	2	4	1	4	2
Risk adjustment	2	4	2	2	3	1	4	1
Discount rate	2	5	2	3	2	2	7	1
Simplified approach	–	3	2	1	2	1	3	1
Reinsurance assets (held by cedants)	2	1	1	–	1	2	1	2
Disclosures	4	4	–	1	2	2	1	4
Other areas	1	–	–	–	–	1	–	1

124 Table 5 below summarises the main types of costs and benefits that participants expect to encounter in order to implement the revised proposals compared to current accounting.

125 Common expected costs include:

(a) Significant IT costs including development of actuarial models, risk and finance functions; and

(b) Educating and training staff.

4 Some of the participants provided comments on certain aspects of the cost and benefit analysis.

5 This assessment is mainly due to the portfolio definition and the unbundling proposals.

Table 5: Types of costs and benefits to implement the revised proposals compared to current accounting

	Costs	Benefits
Adjusting the contractual service margin	• Storing data at a more granular level than the portfolio • Costs linked the adjustment of the contractual service margin and adjustment of the amortisation pattern • Determination of specific information and data on cash flows compared to previous reporting periods	• Performance reflecting the long-term nature of the business • Reduction in volatility in profit or loss from changes in fulfilment cash flows (volatility from risk adjustment was not addressed) • Avoiding potential mismatch effects
'Mirroring' approach	• Disaggregation of cash flow components • Lack of comparability between the same type of contracts	• Consistent methodology, provided that changes in options and guarantees were treated consistently with other interest induced changes • Avoiding potential mismatching effects
Presentation of revenue and expenses	• Identifying the non-distinct investment components • Modification of the public and internal reporting	• For non-life insurance, better understanding of discount impact • Increase in clarity on the representation of the true profit embedded within an insurance contract
Interest Expense in profit or loss	• Storing data from prior years • separation of discount rate changes in other comprehensive income result • Asset liability management	• Performance reflecting long-term nature of the business • Transparency of other comprehensive income impact and avoiding accounting mismatches • A more consistent approach in measuring the liability and financial assets when applying IFRS 9 to financial assets • Avoids volatility in profit or loss from changes in discount rates
Effective date and transition	• Limited availability of reliable historical discount rate information for countries with high inflation • challenges of retrospective application for use of interest rate curves for the OCI impact assessment of Non-life business • Data storage and recovery of past data • Mismatches with IFRS 9 implementation date	• Comparability of in-force and new business contracts at transition and subsequently • Consistent contractual service margin measurement for existing contract • Increased usefulness for users of accounts • Emergence of profits more in line with provision of services
Contract boundary, recognition point, definition of portfolio and unbundling	• If a more granular level is required for portfolios • Unbundling of annuities would be onerous, if applicable	• More accurate valuation of insurance obligations
Current estimate of future cash flows	• Complex calculation steps for separation of discount rate change in the OCI, lack of underwriting year data for non-life business	• Consistent measurement of the insurer’s obligations towards policyholders • More predictive estimates
Risk adjustment	• Cost of calibrating and maintaining economic capital models, reconciliation of results, calculating economic capital for new business	• More accurate valuation of insurance obligations • Some increase of transparency • Enhanced information for users of accounts
Discount rate	• Keeping and analysing data from previous years, estimating illiquidity premium	• More accurately representation of the time value of the money in the liabilities and illiquidity premium • Provides relevant information to users

Table 5: Types of costs and benefits to implement the revised proposals compared to current accounting

	Costs	Benefits
Simplified approach	• Cost are mainly related to development of systems and actuarial models	• Less complex than the building block approach • May allow better articulation of short-term life contracts
Reinsurance assets (held by cedants)	• Complex calculation steps for separation of discount rate, lack of underwriting year data • Maintenance of the contractual service margin	
Disclosures	• Extensive information and data details • Reconciliation of gross / ceded technical reserves • Disclosing confidence level information	• Comparability • Improved information to users
Other areas	• Long-term investment 'liability driven' business model not fully recognised under the ED	

Do the proposals improve the transparency of the effects of insurance contracts?

126 Participants were asked whether the proposals as a whole would improve the transparency of the effects of insurance contracts, and would reduce the diversity in the accounting for insurance contracts.

127 Many (six out of ten) participants, who commented on this issue, expected that the proposals would improve the transparency of the effects of insurance contracts.

128 Two participants believed that for non-life insurance, there was an improvement in the transparency of the financial statements. The proposals on the contractual service margin were expected to increase comparability in the financial statements between contracts accounted for under the general and simplified approach.

129 However, for life insurance, many participants believed that the requirements would not lead to comparability between companies as the proposed 'mirroring' approach was complex, difficult to understand, and would not lead to consistent application. Therefore, there would not be transparency for the users of the financial statements.

APPENDIX A – LIST OF PARTICIPANTS IN THE FIELD TEST

Participant	Country
Allianz SE	Germany
AXA	France
BNP Paribas Cardif	France
CNP Assurances	France
DZ Bank AG	Germany
Generali	Italy
Legal & General Group PLC	UK
MAPFRE, S.A.	Spain
Poste Vita	Italy
Prudential PLC	UK
R+V Versicherung AG	Germany
Talanx AG	Germany

1 One participant did not wish its name to be disclosed.

APPENDIX B – CHARACTERISTICS OF PORTFOLIOS SUBJECTED TO THE FIELD TEST

Characteristics of the investments backing the portfolio

2 Participants reported the following characteristics of the investments backing the portfolios when such investments were specifically allocated to the portfolios, and how participants expected to measure them under IFRS 9 *Financial Instruments*:

(a) A majority of the participants reported that their investments backing the portfolios were mostly debt securities, which were classified as 'available for sale' under IAS 39. Most expect that those would be classified under the fair value through other comprehensive income (FVOCI) category in IFRS 9. Some participants reported that the classification would be based on the business model consideration (hold and sell).

(b) Other categories of assets: equities and real estate are expected to be classified under fair value through profit or loss (FVPL) or FVOCI (depending on the final IFRS 9 standard and possibility of recycling the other comprehensive income reserve), while debt instruments other than fixed rate bonds will be classified at FVPL category (unless FVOCI category is extended to a wider range of assets).

(c) One participant (a UK insurer) assumed for the purpose of the analysis that, under IFRS 9, assets held in a unit-linked fund or investments held in separate account funds, would be classified as FVPL, irrespective of the underlying asset types.

(d) Two participants (UK insurers), which tested different annuity contracts, reported that the assets held to back the portfolio (predominantly bonds) would be valued as FVOCI (albeit in practice there might be assets that failed the criteria). Derivatives would be valued at FVPL.

(e) One participant who tested UK-style with-profits assumed that, under IFRS 9, the assets, which back the with-profits fund, including government and corporate bonds, equities (UK and overseas), property, derivatives, cash and alternative assets would generally be classified as FVPL. However, there is the possibility that debt securities, which account for approximately 45% of the UK with-profit investments, might be categorised as FVOCI. This would be counterintuitive with the way the fund and policyholder benefits are managed on a fair value basis.

The main sources of profitability of the portfolios

3 Participants reported the following main sources of profitability of the portfolios subjected to the field test:

(a) For participating business – financial (based on investment spreads or fee-based income according to the features of the policies) and technical (mortality results, surrender penalties and expense results);

(b) For unit-linked business – asset management fees;

(c) For immediate annuities – risk protection and the investment spread between the rate of return on underlying assets and the rate credited to policyholders;

(d) For UK-style with-profits – asset management fees, insurance benefits, and provision of investment growth on a long-term supportable basis;

(e) For loan insurance contracts – technical margins (i.e. when technical risks are fully covered by premiums); and

(f) For US variable annuities – margins in the mortality and expense charges, asset management fees and charges for guarantees.

Do the portfolios selected cover the entities' most significant business?

4 Almost all participants reported that the portfolios selected in the field test covered the most significant business in terms of total premiums and reserves. Only one participant reported that they had selected a portfolio that did not represent the most significant business in terms of premiums or reserve volume. However, they noted that this portfolio represented a type of business where the selection of the model (general model versus the simplified approach) would need to be assessed in detail.

Measurement and presentation of portfolios

Life insurance portfolios

5 The insurance portfolios/lines of business subject to the field test, fall in the following measurement and presentation categories:

(a) under the general measurement and presentation requirements (four portfolios). The type of contracts which fall under this category are UK immediate annuities, lifetime pension annuities and loan insurance contracts.

(b) the measurement and presentation exception for contracts that require the entity to hold underlying items and specify a link to the returns on those underlying items (ten portfolios). The type of contracts which fall under this category are investment contracts with discretionary participating features, unit-linked contracts, with-profit contracts and variable annuities.

(c) the presentation exception to include in profit or loss the effect of the unwinding of the discount rate based on an updated discount rate for cash flows that are expected to vary directly with returns on underlying items (three portfolios). The type of contracts which fall under this category are some types of fixed annuities and some types of participating contracts, where the company is not required to hold the assets.

6 One participant reported that they were encountering significant difficulties in the interpretation of the scope of 'the measurement and presentation exception for contracts that require the entity to hold underlying items and specify a link to the returns on those underlying items'.

7 A majority of participants expected that a significant portion of their life business would be measured under the 'mirroring' approach.

Non-life insurance/Reinsurance

8 All participants who tested non-life portfolios reported that those contracts would be measured according to the simplified approach. One participant reported that their reinsurance business would also fall under the simplified approach.

9 One participant provided only opinions on their interpretation of the ED, and how it was expected to impact their business without selecting a specific portfolio. Those opinions have been considered by EFRAG in finalising the comment letter to the IASB.

Impact of reinsurance on the portfolios tested

10 Almost half of the participants have not considered the impact of reinsurance in the field test. The others reported that the impact of reinsurance was not significant.

APPENDIX C – CHARACTERISTICS OF LIFE INSURANCE PORTFOLIOS UNDER THE MEASUREMENT AND PRESENTATION EXCEPTION

Portfolios made up of contracts that specify a link to the returns on underlying items that the participant is required to hold (paragraphs 33-34 of the ED).

1 The following are some characteristics on the type of link to the underlying items, any options and guarantees embedded in the contracts and the type of discretion over the amount and/or timing of the surplus, whether that surplus is constrained by legal or regulatory requirements, and how the contribution principle is applied.

(a) German contracts with participating features – the local German regulation requires life insurance companies to hold assets covering insurance liabilities; and there is a regulatory rule, which regulates the participation of policyholders in investment income and other profit sources. Typically, the bonus allocation increases the guaranteed level of benefits.

(b) Italian participating contracts –the policyholders are entitled to the maximum between the guaranteed yield and a percentage/portion of the return of assets belonging to segregated funds. Typically the financial profit sharing is calculated on amortised cost basis, and includes current income for investments and realised gains and losses based on the segregated funds carrying amount. Insurer discretion relies only on setting the asset mix and on timing of realisation. The contract specifies the rules for profit sharing/fixed margins retained by the insurer.

(c) Unit Linked – these contracts specify a link to the returns on underlying items. The policyholder is entitled to returns directly linked to the performance of the underlying assets, the unit funds chosen. For French unit-linked contracts the insurer is required by the contract and the regulation to hold the assets related to the unit linked elected by the policyholder. The policyholder is also entitled to receive 100% of the unit linked performance (net of fees).

(d) US Variable Annuities – these contracts specify a link to the returns on underlying items. The policyholder is entitled to returns based on the performance of the underlying pool of assets chosen, the separate accounts. Guarantees are provided in the form of Guaranteed Minimum Withdrawal Benefits (GMWB) and Guaranteed Minimum Death Benefits (GMDB).

(e) UK-style with-profits – these contracts specify a link to the returns on underlying items that the participant is required to hold. The policyholder is entitled to returns based on the performance of a specified pool of assets. Once bonuses are added, they are guaranteed. There is discretion over the investment strategy adopted and the amounts and timings of bonuses declared. This discretion is governed by regulation and the Principles and Practices of Financial Management (PPFM). The PPFM describes how the with-profits business is managed, including the nature and extent of the discretion available.

(f) French investment contracts with discretionary participating features – these contracts specify a link to underlying items that the company/group is required to hold: the policyholders are entitled to the performance of the underlying pool of assets with an average credited share of 95% and the French regulation requires that insurance contracts be backed by financial assets. Discretion is given to the company/group with regard to the profit distributed to the policyholders as long as it exceeds 95% of the financial revenues of the assets backing the portfolio, discretion is also given on the

timing of profit allocation during the 8 years following its calculation. One participant reported that for the part of the contract invested in general account assets, the participation benefit account is based on realised investment income of the whole general fund. It does not include unrealised gains on underlying assets.

Portfolios made up of contracts with cash flows that are expected to vary directly with returns on underlying items that the participant is not required to hold (paragraph 60(h) of the ED).

2 The following are some characteristics on the type of link to the underlying items, any options and guarantees embedded in the contracts and the type of discretion over the amount and/or timing of the surplus, whether that surplus is constrained by legal or regulatory requirements, and how the contribution principle is applied.

(a) US fixed annuities – the existence of a crediting rate is considered sufficient to justify the existence of a link between the cash flows and the returns on underlying items, but this link is not contractual. Once interest is added, it is guaranteed. Also there is a guaranteed minimum crediting rate. The amount of interest added in addition to guaranteed minimum is completely at the company's discretion i.e. there is no formula method for the crediting rate.

(b) Profit sharing business – One participant reported that for their profit sharing business, the link was produced because the contract clauses specified that 90% of the exceeded amount between the asset return and the guaranteed interest must be attributed to the policy. However, the entity had to identify the assets backing the portfolios, but had no requirement to hold the determined assets as these could be changed on company discretion to choose the more suitable investment policy and the possibility of choosing the moment to realise the investment gains. The return obtained for the profit sharing was calculated at amortised cost. Thus, in case of gains in the assets, these gains would be recorded at the time of sale of assets.