Appendix I

DAV comments on the Revised Exposure Draft, *Insurance Contracts (ED/2013/7)*

Question 1 - Adjusting the contractual service margin

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

(a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

(b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

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

Summary:

We support the definition of the contractual service margin (CSM) and the unlocking principle. However we do not agree with the limitations on unlocking the CSM. We require a CSM unlocked for prospective changes in profitability estimates including

- **changes in risk adjustment related to future services;**
- **changes in investment assumptions for participating contracts; and**
- **changes in the time value of embedded derivatives for contracts measured under ED.33 and ED.34.**
- **Initial and subsequent measurement of the CSM for reinsurance contracts held on individual loss basis should reflect the strong link with the measurement of the business reinsured**

Detailed Response

We agree that in subsequent measurement changes in estimates of future cash flows related to future services should be adjusted by the contractual service margin as long as it is positive. We believe this to be in line with initial measurement. The basic idea is that gains resulting from changes in estimates should not be recognized in the current period. Instead of recognizing the insurer's share as income of the current period the CSM should off-set the insurer's share of changes in estimates (including mortality, reinvestment assumptions etc.). As a result, the entire CSM would be recognized over the coverage period in line with the transfer of services which is consistent with the ED proposal. As in the Revenue Recognition Project, as outlined in ED/2010/6.BC77, we believe that increases and decreases of profitability should be reported in line with the services provided, specifically due to the significant potential of errors in measurement and lacking observable exit prices.

The CSM should represent the unearned profit under the contract, which is in absence of further indications for allocation to periods allocated to periods based on services provided in the particular period.

Having stated this, we note that the same arguments, some even more, apply to changes in estimate for future risk adjustments.

1. Issues relating to all types of insurance business

Changes in risk adjustments

One of the reasons of the IASB for excluding the risk adjustment from a floating CSM was that it might be burdensome to split changes in the risk adjustment between release of risk adjustment belonging to the services provided in the current period and changes in estimate of risk adjustment related to services of future periods. We are not aware that any actuarial body has ever stated concerns in that regard. The typical approach is that risks are considered period by period, specifically approaches like Cost of Capital are designed in that way. There is consequently no technical reason preventing a split of the movement of the risk adjustment in released risk adjustment for the period and changes in risk adjustments for future periods.

The reasons in ED/2010/6.BC77 (first ED Revenue Recognition) apply even more for the risk adjustment than for cash flows. The risk adjustment is the price for bearing deviation risk from the mean value. ED/2010/8 emphasized that by the summarized margin approach. Consequently, the amounts should be released in proportion of services provided. The argument of the IASB, that they are released over the life time of the contract in any way, does not cope with the requirement to release the amount in line with service. Further, the risk of errors in the risk adjustment does not differ substantially from the risk of errors in the cash flows. The risk adjustment by definition is subjective as it reflects the risk averseness of the insurer. There is little information on important parts of the risks born, especially the risk of changes in circumstances and the risk of misleading data. To report those changes immediately in P&L might not just result in irrelevant information but even more might bear the risk of manipulation. Further, there is practically no market information about the entity-specific risk adjustment.

A significantly different treatment of cash flows and risk adjustment is not recommendable as both of them are deeply interconnected in many cases. For example, it might be unclear whether it is more appropriate to increase the expected value or to increase the risk adjustment reflecting the risk that the expected value might be increased in future.

Ultimately, the split in expected value and risk adjustment is a pure technical procedure. None of both has a real economic meaning – e.g. IAS 37 does not require such split. Since insurance is a mathematical industry, it is reasonable for pricing and valuation purposes to

estimate the mean value in a first step as it is easier to identify mathematically and to concentrate all the highly vague issues like risk averseness in a second number. Economically, both together are the price. The split is simply a measure to optimize the available knowledge about the allocation of the consideration received over time: cash flows can be allocated to periods comparatively well, risk adjustment significantly worse and the CSM can only be allocated by chosen release patterns. To off-set cash flows against the CSM while risk adjustment is presented in P&L disregards the interconnection between these elements. It should be sufficient to disclose the different parts and their movement.

The CSM would no longer represent unearned profit (as it is meant according to its definition), if parts of the risk margin shown in the prior period were released although they are as unearned now as they were at contract inception. Subsequent measurement should not be based on different principles with such significant different outcomes.

Overall, the procedure in Revenue Recognition should be considered, where the consideration received is allocated to periods based on service provided, let us call the amount C(n). However, there is a lower limit of the liability based on the risk-adjusted expected present value of cash flows as determined under IAS 37, let us call it E(n). That means, the balance sheet amount is B(n) = max (C(n), E(n)). That is equivalent to B(n) = E(n) + max(0; C(n) – E(n)), i.e. risk-adjusted expected present value of cash flows plus the CSM. Under Revenue Recognition, any change of the risk adjustment under IAS 37 and any change of the discounting effect under IAS 37 is obviously off-set with the CSM as long as it remains positive, although the parts need not to be calculated explicitly for profitable contracts.

That is further in line with the Premium Allocation Approach (PAA). As well here, changes in risk adjustment (although the IASB assumes that they are unlikely to occur in such short periods) do not affect the total liability, as long as the risk-adjusted expected present value of cash flows does not exceed the total liability. Understanding the PAA as approximation of the Building Block Approach (BBA), the PAA approximates a BBA, where all changes in risk adjustment and discount rate are off-set with the CSM.

Changes in investment assumptions for participating contracts

We understand ED.B68 (e) that for example changes in reinvestment assumptions are precluded from being recognized in the CSM. For participating contracts this is inconsistent with the general unlocking of the CSM for changes in expectations of cash flows relating to

future coverage or other future services. This guidance also contradicts the definition of the CSM as unearned profit.

There are significant similarities between unit linked and other participating contracts. Under both unit linked and par business, premiums are invested in a fund and benefits are paid from the fund net of deductions which are taken over the coverage period. For unit linked contracts, explicit charges are deducted (e.g. % of the fund) while for participating contracts, deductions depend on the profit sharing formula (e.g. % of the bonus). In both cases, these deductions are an integral part of the insurance contract. In both cases, services include asset management, protection and administration and are provided over the coverage period. Changes in the value of underlying items and changes in reinvestment assumptions result in changes in estimates of future cash flows. In accordance with the ED, for unit linked business the CSM is unlocked for these changes and is recognized over the coverage period in line with the provision of services while for participating business these changes are taken to the P&L. This treatment of participating business is not consistent with unit linked business and is not consistent with the broader principles of the ED as these changes in estimates are not recognized in line with the provision of services.

The CSM should consistently be adjusted for changes in financial assumptions for participating contracts that relate to future periods. This includes changes in expected claims that result from expected returns from reinvestments as well as changes of corresponding discount rates. (It is essential for participating contracts that discount rates and expected returns from assets that modify the cash-flows to the policyholder are treated consistently.)

Changes of cash flows of embedded derivatives

We understand the ED that changes of all cash flows are off-set with the CSM when measuring the liability. That includes cash flows from embedded derivatives (indirectly varying) which are not separated. However, ED.66 (b), which is presentation guidance, requires that changes in the expected cash flows specifically of embedded derivatives, which refer to the underlying item of cash flows measured according to ED.34 (a), should not affect the measurement of the liability, particularly the CSM, but be reported in P&L.

At initial recognition the value of those embedded derivatives has been included in the fulfillment value and hence, in the calculation of the contractual service margin as future profit from the contract. Following the same argument in subsequent measurement, the change in the value of the embedded derivatives changes the future profit from the contract. Presenting this change in profit or loss would lead to artificial volatility which is not related to

the performance of the insurer. This is in contradiction to ED.26 (a) requiring the liability to reflect the dependency of amount, timing and uncertainty of cash flows wholly or partly depending on underlying items.

We do not see a reason for this very special treatment of such types of embedded derivatives, deviating from all other embedded derivatives. We refer to the reasons forwarded by the IAA in that regard, which we support. An additional argument, specifically from the German perspective is, that changes in the expectation of policyholders' share in surplus are off-set with the CSM, but the opposite movement of the cash flows of the embedded derivative of the asymmetry would go through P&L. That does not make sense. The interconnection between the policyholders' share in surplus and the value of the asymmetry needs to be considered to provide useful information.

Instead, we recommend that all embedded derivatives are measured and presented consistently with the other cash flows of the contract.

Determination of the CSM in case of other cash flow changes

ED.49 (b) (i) requires recognition of bilaterally agreed additions to an insurance contract to be accounted for as new contract. If this requirement has to be applied as outlined in the ED this would lead to severe technical difficulties as well as to meaningless results for a significant part of our business, e.g. health insurance in Germany and Austria.

Considering contracts with a deep interdependence between the cash flows of the basic contract and the addition, there is technically and conceptually little justification for such a treatment. The separate treatment causes particularly technical complexity in treating separately what belongs together. This is a major issue in health insurance where contract modifications (e.g. modifying the retention or tariff-changes) and premium adjustments are (frequently used) contractual features and rights (not meeting the criteria in ED.49 (a)). In some cases, such modifications are even triggered by legal requirements (e.g. contribution changes in civil servants' insurance). Whenever contracts are modified according to these features and rights, all reserves accrued so far remain within the (modified) contract and are taken into account when determining the premium of the changed contract – without distinguishing whether extra benefits are added by the modification or not. Hence the original and the modified contract are highly interrelated. The new premium is calculated in total, a split between previous and new benefits would be arbitrary. If the modified contract contains additional benefits they are an integral part of the modified contract which is managed, calculated and legally viewed as one unity.

As another example, the insurer would typically consider in pricing of the addition, that the administration cost are already covered by the original contract. On a merged basis, the actual administration expenses associated systematically to the contract would not be increased (cost per piece), since it is administered as one contract, and the profitability would remain unchanged. But on a separate basis, associating the full piece cost to the addition would make it onerous.

Hence, in order to avoid arbitrariness, inconsistency and technical impracticability, the treatment of additional benefits should consider the legal view on the contract as well as the degree to which modification and original contract are interrelated.

Applying a fully prospective calculation and a fully floating contractual service margin as suggested (see our answer to Question 2, too) all issues concerning contract modifications would be easily resolved as a by-product and a consistent, appropriate and less complex accounting for contract modifications could be achieved.

Treatment of onerous contracts which recover again

In case of onerous contracts (CSM = 0) ED.30 (c) can be seen as a requirement to establish a CSM immediately after any improvement of the present value of future cash flows. The amount of the CSM established should correspond to the improvement. We do not agree with that. We believe and would ask the IASB for clarification in the final standard, that no CSM should be recognized to the extent the improvement recovers past losses; the improvement will be in so far be reported as gain in P&L.

Technically, the preferred approach is less complex. Technically it permits to have one CSM, which can be positive or negative, but is reported only if positive. The ED approach requires carrying forward the CSM and the loss. Further, the preferred approach appears to be more intuitive especially as it is line with Revenue Recognition and with the PAA. Assuming there is a carrying amount of the transaction price of 100, if the value of the obligation according IAS 37 would increase to 110, a loss of 10 would be reported. After improvement of the situation, where the IAS 37 amount falls to 90, the carrying amount under Revenue Recognition would be again 100, not 110 as in the approach of the ED described above. Under the preferred approach it would be again 100. We do not believe that a permanent overstatement of the liability – simply because somewhere in the past there was a loss event which is recovered – provides meaningful information. The CSM would not be future profitability arising from premiums calculated at the outset of the contract but a profitability

arising from a changes in estimation shown somewhere in between first causing a loss and later an increase of the CSM.

Accretion of interest to the CSM

While we agree, that interest should be accreted to the CSM, we do not agree, that the historical interest is appropriate. Accretion of interest simply defers the release of the CSM to some extent. Therefore it is a kind of additional consideration of additional abilities of the insurer to earn money with the deferred profit.

Hence, applying the historic interest rate as applied at outset is an additional complexity which requires that data of the initial recognition date need to be retained for the entire duration.

Furthermore, under a full floating CSM this approach does not make sense, since the changes of the CSM are based on items discounted with the current rate, i.e. the idea of a full matching at outset is broken.

2. Issues regarding reinsurance

Measurement of reinsurance contracts held

Accounting of reinsurance contracts held has changed significantly compared to the 2010 Exposure Draft. The changes comprise both changes of the measurement model for reinsurance assets (e.g. at initial recognition now deferral of all gains and losses, apart from losses of retroactive contracts) and the newly introduced requirements for adjusting the contractual service margin. Since the measurement of reinsurance contracts held is affected by the requirement to adjust the contractual service margin, we provide our comments as part of our response to Question 1.

We fully agree with ED.51 that states “When an entity buys reinsurance, it shall derecognise the underlying insurance contract(s) if, and only if, the underlying insurance contract(s) are extinguished.” as well as ED.63 that states “An entity shall not offset income or expense from reinsurance contracts against the expense or income from insurance contracts.”

However, we would like to draw your attention to the following issues and we will explain our concerns in more detail below:

ED.41, first sentence: Interrelationship of business assumed and ceded.

ED.41 (c): Determination of the contractual service margin of reinsurance contracts held at inception.

ED.41 (d) (ii): Subsequent release of the contractual service margin of reinsurance contracts held.

ED.41 (d) (iii): Subsequent adjustment of the contractual service margin of reinsurance contracts held.

We also agree with the conclusion in BCA 143 of the ED that the contractual service margin for business assumed (i.e. for insurance liabilities) is different to that for business ceded (i.e. for reinsurance assets). While the contractual service margin on the liability side defers uncertain future expected profits not yet earned, the reflection of uncertain future results is not the purpose of the contractual service margin on the asset side. Rather the contractual service margin of reinsurance contracts held needs to be determined in such a manner that the reinsurance asset reflects the effects generated by the release from risk provided under a reinsurance contract. Hence, the measurement of the contractual service margin of reinsurance contracts held is still a major concern.

From our perspective reinsurance transactions on an aggregate loss basis can be measured as outlined in the ED, because those reinsurance contracts transfer a risk defined on a portfolio of underlying insurance contracts from the cedant to the reinsurer. However, we do believe that in other cases reinsurance transactions (where the risk transfer is based on individual underlying insurance contracts) should not be measured as costs of purchasing reinsurance cover. As a consequence, the assumption in ED.41 (c) (i) that "the entity shall recognise any net cost or net gain on purchasing the reinsurance contract as a contractual service margin" is not appropriate under certain circumstances.

As outlined in BCA 128 and mentioned in ED.41 (b) the cash flows of a reinsurance contract held depend on the cash flows of the contracts they cover. In particular, from an economic perspective, a reinsurance contract on individual loss basis is fully dependent on the underlying direct insurance contracts. We believe that this fact should be taken into consideration when measuring the corresponding reinsurance asset, both at inception and for subsequent measurement. When ceding risks to a reinsurer, the cedant replaces uncertain future results with certain future results. Consequently, the cedant is not on risk for the risks covered under the reinsurance contract. This should be reflected in a strong link between the evolvement of the contractual service margin of the reinsurance contract held and the contractual service margin of the underlying business. The current wording can lead to significant divergence between those margins and provides room for accounting arbitrage.

In contrast to the economic effects outlined above the current proposals in ED.41 (c) and 41 (d) for determining the contractual service margin of reinsurance contracts held lead to

inconsistencies to the contractual service margin of the underlying direct insurance contracts both at inception of a contract and subsequently. This has two consequences which we consider not being in line with appropriate measurement and presentation:

Since the contractual service margin of reinsurance contracts held is neither at inception nor subsequently linked to the contractual service margin of the underlying insurance business, this would facilitate accounting arbitrage (this comment refers to ED.41 (c) and 41 (d) (ii)). Moreover, the calibration of the contractual service margin as proposed in the ED would not allow for proper measurement and presentation of non-performance risk.

The core function of reinsurance as measure to mitigate losses from insurance risk is not reflected appropriately by the concept of ED.41 (d) (iii) dealing with the subsequent adjustment of the contractual service margin. In a situation of unfavourable changes in future cash flows of the underlying insurance contracts exceeding the contractual service margin on the liability side, the cedant would suffer a loss from the incoming business. Although covered by a reinsurance contract held, according to the current proposals in the ED this loss cannot be compensated by a respective change of the value of the reinsurance asset. This is caused by ED.41 (d) (iii) requiring in such a situation to reduce the contractual service margin for a reinsurance contract held and even allowing for a negative contractual service margin.

We support the Board's approach in ED.41 (a) for recognition of reinsurance contracts held and would like to follow this approach for the measurement. For recognition, a differentiation is made between

reinsurance contracts providing coverage for the aggregate losses of a portfolio of underlying contracts (here referred to as 'reinsurance contracts on aggregate loss basis') and

all other reinsurance contracts (i.e. reinsurance contracts providing coverage for the loss of individual underlying insurance contracts, here referred to as 'reinsurance contracts on individual loss basis').

For reinsurance contracts on aggregate loss basis, we support the Board's approach outlined in ED.41 (c) (i). The contractual service margin of the reinsurance asset should be solely based on the reinsurance contract. This implies a calibration of the contractual service margin to the reinsurance premium at inception.

This approach refers to the reinsurance contract, which is consistent with the requirements for recognition of the reinsurance asset.

Appendix I

DAV comments on the Revised Exposure Draft, *Insurance Contracts (ED/2013/7)*

For reinsurance contracts on individual loss basis the principle of following the fortunes is decisive and consequently should be reflected in accounting. Based on this, the contractual service margin of the reinsurance asset should reflect the reinsurer's share in the risk of the underlying business. This is best reflected by the proportion of the risk adjustment of the reinsurance asset to the risk adjustment of the liability of underlying contracts.

This approach refers to the underlying primary insurance contracts, which is consistent with the requirements for recognition of the reinsurance asset.

For the sake of clarity, we further propose the following two amendments:

The word "only" should be inserted in the first sentence of ED.41 in order to make clear that there is always a link between business assumed and business ceded.

As a general rule a favourable (or unfavourable) change in the future cash flows of reinsurance contracts held is generated by an unfavourable (or favourable) change in the future cash flows of the underlying insurance contracts. Hence, in order to reflect the logic on how this should be calculated, "minus" and "plus" should be exchanged at the beginning of ED.41 (d) (iii).

As requested in the invitation to comment please find below a proposed wording for the future standard for insurance contracts.

Standard for insurance contracts: Proposed wording

Reinsurance contracts held

41 An entity that holds a reinsurance contract pays a premium and receives reimbursement if it pays valid claims arising from underlying contracts, instead of only receiving premiums and paying valid claims to the policyholder. Consequently, some of the requirements in this [draft] Standard are modified to reflect that fact, as follows:

(a) the recognition requirements of paragraph 12 are modified so that an entity shall recognise a reinsurance contract held:

(i) from the beginning of the coverage period of the reinsurance contract, if the reinsurance contract provides coverage for the aggregate losses of a portfolio of underlying contracts; and

(ii) when the underlying contracts are recognised, in all other cases.

(b) in applying the measurement requirements of paragraphs 19–27 to estimate the fulfilment cash flows for a reinsurance contract held, the entity shall use assumptions that are consistent with those that are used to measure the corresponding part of the fulfilment cash flows for the underlying insurance contract(s). In addition, the entity shall, on an expected present value basis:

(i) treat cash flows, including ceding commissions, that are contingent on the occurrence of claims of the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract;

(ii) treat ceding commissions that it expects to receive that are not contingent on the occurrence of claims of the underlying contracts as a reduction of the premiums to be paid to the reinsurer;

(iii) apply the requirements of paragraph 21 so that the fulfilment cash flows reflect the risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes; and

(iv) determine the risk adjustment required by paragraph 27 so that it represents the risk being transferred by the holder of the reinsurance contract.

(c) the requirements of paragraph 28 that relate to determining the contractual service margin on initial recognition are modified so that, at initial recognition the entity shall recognise a contractual service margin measured at an amount that:

(i) ~~the entity shall recognise any net cost or net gain on purchasing the reinsurance contract as a contractual service margin measured at an amount that~~ is equal and opposite to the sum of the amount of the fulfilment cash flows ~~and pre-coverage cash flows~~ for ~~the~~ reinsurance contracts providing coverage for the aggregate losses of a portfolio of underlying contracts; ~~unless~~

(ii) is equal to the proportion of the risk adjustment of the reinsurance asset to the risk adjustment of the liability of underlying contracts applied to the contractual service margin of the liability of underlying contracts, in all other cases ~~net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the reinsurance contract, in which case the entity shall recognise such a cost immediately in profit or loss as an expense~~.

(d) the requirements of paragraphs 30–31 that relate to the subsequent measurement of the contractual service margin are modified so that the entity shall measure the remaining amount of the contractual service margin at the end of the reporting period at the carrying amount that was determined at the start of the reporting period:

(i) plus the interest accreted on the carrying amount of the contractual service margin to reflect the time value of money (the interest accreted is calculated using the discount rates specified in paragraph 25 that applied when the contract was initially recognised);

(ii) minus the amount recognised relating to services that were received in the period (in particular, for reinsurance contracts not providing coverage for the aggregate losses of a portfolio of underlying contracts the pattern of transfer of services is based on the underlying primary insurance business); and

(iii) ~~plus~~minus (or ~~minus~~plus) a favourable (or unfavourable) change in the future cash flows if that change arises from a difference between the current and previous estimates of the future cash flows that relate to future coverage and other future services. With the exception of reinsurance contracts on aggregate loss basis where the contractual service margin at initial recognition is negative, the contractual service margin should not be negative. In the case of reinsurance contracts on aggregate loss basis where the contractual service

> margin at initial recognition is negative the contractual service margin should not be less than the contractual service margin at initial recognition including interest accreted on the contractual service margin. Changes in the expected present value of cash flows that result from changes in the expected credit losses of the reinsurer do not relate to future coverage or other future services and shall be recognised immediately in profit or loss.

42 Other requirements of this [draft] Standard apply to a reinsurance contract held. For example:

(a) an asset that arises under a reinsurance contract may be regarded as comprising both the expected value of the recovery that relates to the remaining risk coverage and the expected value of the recovery that relates to incurred claims. An entity may simplify the measurement of the expected value of the recovery that relates to the remaining coverage using the approach set out in paragraphs 38–40 if:

(i) doing so would produce measurements that are a reasonable approximation to those that would be produced by applying the requirements in paragraph 41; or

(ii) the coverage period of the reinsurance contract is one year or less.

(b) disclosure requirements apply to reinsurance contracts.

Rationale based on Framework

The differentiation between types of reinsurance contracts is consistent with the differentiation already introduced for recognition.

The approach supersedes any differentiation between prospective and retroactive contracts. Such a distinction does not appear to be appropriate from an economic view, since it would imply a different treatment of the ceded liability for incurred claims depending on the nature of the reinsurance contract (i.e. prospective or retroactive).

For reinsurance contracts including both prospective and retrospective features, which are common in practice, the IASB approach would result in two separate contractual service margins for one reinsurance contract. The contractual service margin for the “prospective portion” of the reinsurance contract would be released over the coverage period, while the contractual service margin for the “retroactive portion” of the reinsurance contract would be released over the settlement period. This would be both confusing for users and impracticable for preparers.

Non-performance risk is appropriately reflected when applying ED.41 (b) (iii). Since the contractual service margin is not calibrated to a premium in the approach proposed above, the impact of non-performance risk on the fulfilment cash flows is not offset by an increase in the contractual service margin.

By contrast, under the ED approach non-performance risk would not result in any impact on the total reinsurance asset (i.e. the sum of the fulfilment cash flows and the contractual service margin).

The proposed approach is easy to apply in practice and easy to understand.

It enables users to identify and understand similarities in, and differences among, reinsurance assets for different types of contracts. In particular, the approach for reinsurance contracts on individual loss basis enables users to identify the reinsurer's share in the underlying business. Beyond that, users can identify more or less favourable reinsurance conditions.

Different knowledgeable and independent observers can easily reach consensus, although not necessarily complete agreement, that a particular depiction of a reinsurance asset is a faithful representation. In particular, the proposed reference to the underlying insurance liability for contracts on individual loss basis allows an easily verifiable measurement of the reinsurance asset.

The approach provides relevant financial information capable of making a difference in the decisions made by users. When applied to reinsurance contracts on individual loss basis the reinsurance asset exactly reflects the reinsured portion of both income (i.e. premiums) and expenses (i.e. claims) of the underlying business. This is the most relevant information enabling users to assess the economics of the reinsurance contract. By contrast, for reinsurance contracts on aggregate loss basis, where such a direct relation between the underlying primary insurance business and the reinsurance coverage does not exist, a calibration to the reinsurance premium provides more relevant information. Hence, the approach fully reflects the economics of the reinsurance transactions. Consequently, it is relevant and faithfully represents what it purports to represent.

Appendix I

DAV comments on the Revised Exposure Draft, *Insurance Contracts (ED/2013/7)*

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

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

(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?

(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfilment cash flows as follows:

  (i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

  (ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underly ing 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?

Summary:

We agree with the idea of mirroring in the sense that possible accounting mismatches for participating contracts have to be eliminated taking into account the accounting of linked assets. But we disagree with the proposed decomposition of cash flows and reject the guidance given in example ED.B85 and ED.B86. We believe that the idea of mirroring would be achieved if the discount rate applied for presentation of the liabilities in the P&L is consistent with the presentation of investment income from actual assets.

We support the concept not to separate embedded derivatives for measurement. But we oppose the requirement to present changes in the value of embedded derivatives in the P&L.

We further believe that the scope of the approach is too narrow.

Detailed response:

We agree with the idea of mirroring in the sense that it is an appropriate concept to eliminate accounting mismatches. As stated in our cover letter, the "mirroring-principle" has to be embedded into an coherent and feasible measurement of participating contracts. This includes unlocking of the contractual service margin and risk margin (see our answer to question 1) and the OCI-solution (see our answer to question 4). The Revised Exposure Draft (ED) with these 3 components is a significant step ahead.

We appreciate the Board's recognition that insurance contracts requiring the insurer to hold underlying items should be treated differently; however we are very concerned about the Board's definition of participating contracts and the rejection (7 in favor; 8 opposed) of a full floating contractual service margin. We recommend - as described in our cover letter - a solution for participating contracts consisting of an optional OCI solution plus a fully prospective contractual service margin. The global industry's alternative approach to accounting for participating insurance contracts is a solution meeting these requirements. In our view it is an appropriate solution for treating participation contracts. ***A description of this proposal is attached to this document (see appendix II).*** This proposal is consistent with the mirroring principle (ED.33 & ED.34) in a sense that the yield curve for the valuation of liabilities reflects consistently the yield curve for the valuation of assets. This holds true for the Balance Sheet as well as for the P&L-Statement. This interpretation of the mirroring concept is by far more in line with the business economics and provides a simpler and more operationally achievable approach without the need for decomposition of cash flows.

Decomposition of cash flows is overly complex and flawed

We are very concerned about the IASB's formulation of the measurement approach described in the application guidance (ED.B83 to B87). This could be seen as a requirement to decompose the cash flows of contracts between those that are reflective of investment performance and those that are not.

If this was the intention of the IASB, the approach would lead to a measurement of the insurance contract liability that is not controllable, especially for contracts with complex profit participation systems as they are widespread in countries like Germany, France, Austria, Switzerland etc. We discussed the proposed criteria for the decomposition of contractual cash flows in a number of meetings and organized a task force that did intensive modeling work for typical German life insurance contracts and analyzed the suggestions/requirements in ED.33 and ED.34 of the exposure draft and ED.B83 to B87 of the application guidance:

Appendix I

DAV comments on the Revised Exposure Draft, *Insurance Contracts (ED/2013/7)*

1. Starting from the very simple setting described in the ED the task force extended successively the complexity of the modeled contracts to capture the most important aspects of the German life insurance contracts. The model developed turned out to be very complex and operationally not feasible. The results of the model are difficult to interpret and don't fit the way how life insurance business is managed in Germany.
2. The main reason for the complexity of the model results from a number of characteristics of the participation system in Germany (regulatory requirements, typical features embedded in insurance contracts etc.) being conceptually difficult to handle by using the proposed measurement approach. One of the main difficulties is caused by the fact that current bonuses are declared to individual policyholders each year and are guaranteed after allocation (lock-in of bonuses based on statutory P&L figures and regulatory requirements; especially not possible to be negative). Increases in guarantee either from profit allocation but also from additional premium payments would force a new decomposition of the cash flows during subsequent measurement and a "regrouping" of assets from those backing the variable part of the decomposition to those backing the fixed part.

We believe that the decomposition of cash flows is artificial or arbitrary and is not practical for insurance contracts (e.g., in some cases policyholder participation is not based on investment income but on the entire earnings of the entity or the net result of a portfolio of assets and liabilities). Furthermore, the ED's requirement to decompose cash flow described in ED.B85 and ED.B86 does not reflect the economics of participating business with annual lock-in of additional guarantees resulting from profit participation. As described above accounting of this feature (according to the decomposition according to B85 and B86) is highly complex and leads to results not reflecting the economics of the business.

We fully support the IASB that options embedded in the insurance contract that are not separated and guarantees of minimum payments embedded in the contract and not being separated ("options and guarantees", O&G), should be measured using the expected value of the distribution of possible outcomes and taking into account risk and time value of money. We agree that both the intrinsic and time value of options and guarantees should be presented in the statement of financial position.

But with regard to O&G the decomposition according to ED.B86 is overly complex and does not reflect the economical exposure to financial risk: Assume a company seeking release from financial risk in ED.B86 by hedging the guarantee. The company buys/sells derivative instruments of ED.B86 (b), i.e. the company successfully replicates the cash flows of the insurance contract. The insurer will receive cash equal to the contractual service margin for

selling 10% of the option on the expected shareholder participation in investment returns and buying the put option to secure the guarantee. The economically correct measurement of the insurance contract liability is then equal to 100% of the book value of A plus/minus the market values of the derivatives. In this case the hedge cancels out in P&L.

The decompositions described in ED.B86 (a), (b) and (c) always have the same fair value. But the book value of the three alternatives differs when A is not measured at fair value or there is a change in the discount rate for the guarantee. Therefore the accounting treatment prescribed by ED.B86 (c) will not necessarily present a profit/loss pattern similar to the replicating portfolio. In fact, ED.B86 (c) establishes a "mirror-derivative" that does not reflect the economic risk exposure of the company. For MCEV and Solvency II purposes the time value of O&G is determined under the (economically correct) assumption that the entity actually holds 100% of A and has to bear the risk of an asymmetrical profit participation according to the decomposition described in ED.B86 (b).

Technically the decomposition requested by ED.B86 (c) is not feasible. In general, the time value of O&G embedded in German life insurance contracts cannot be calculated using a closed formula and it is not possible to take reference to market values of derivatives. Today the only way to obtain an accurate time value is to perform a Monte Carlo simulation of cash-flows using market consistent scenarios simulating the possible development of capital markets. The time value of O&G is defined as the difference between the present value of the deterministic best estimate path and the mean (or expected value) of the present value of the stochastic simulations. This simulation has to be performed on a company level because of the German participation rules. As profit participation changes the guaranteed benefits, the decomposition of cash flows has to be recomputed at each point of time. A so called minimum guarantee projection for the fixed cash flows of the company taking into account the lock-in guarantees is required. Technically this requires a nested stochastic simulation: To determine the IFRS Balance Sheet and P&L at each point of time in each scenario one has to perform a minimum guarantee projection over a time period of up to 70 years. This is not feasible for a German Life company so far.

We think that this technical interpretation does not meet the intention of the IASB and are aware of the auditors' general acceptance of any reasonable technical approach reflecting the principles of the standard. But from an actuarial point of view we would not see any feasible approach to determine the required time value of the "mirror-derivative" at all.

We therefore strongly recommend eliminating ED.B85, the example in ED.B86 and their discussion in the basis of conclusion. In particular, approaches which are not based on decomposed cash flows but measure the contract in aggregate by applying the building block approach should be permitted without any restriction.

All participating contracts should be treated consistently

It can be ultimately noted, that as well for all other dependent liabilities than those covered by ED.34(a) conceptually the mirroring approach applies and should apply, i.e. the permission to refer in measurement to the measurement of the underlying items. As well ED.26 (a) in combination with ED.B73 determines that in determining the discount the measurement of the underlying item, here assets, is considered. That results in an elimination of any accounting mismatch between discounting and development of asset as far as the dependence eliminates any economic mismatch. We propose to put all guidance for measuring in application of the mirroring principle together.

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

ED.26(a) should be modified to refer to participating contracts and to apply assumptions for the contract which are consistent with the measurement of the underlying items. This implies the discount rate and would lead to a consistent presentation of interest expense and interest income in the P&L.

Presentation of embedded derivatives

Regarding the treatment of changes in the embedded derivatives / O&G for participating contracts (ED.34 (a) or ED.86) in P&L we refer to our response to question 1.

We do not support the requirement of ED.66(b) to include changes in the value of O&G in the P&L. We recommend that all embedded derivatives are measured and presented consistently with the other cash flows in the contract.

Appendix I

DAV comments on the Revised Exposure Draft, *Insurance Contracts (ED/2013/7)*

The scope of the approach ED.33 and ED.34 is too narrow

The definition of participating contracts is too narrow to capture all contract types that provide policyholders with rights to additional benefits. Among contracts with cash flows depending on asset returns there are some having a contractual link others don't. Not all of these contracts require the insurer to hold the underlying items (e. g. products in Belgium). Thus the definition given in the Revised ED will result in inconsistent accounting across comparable participating contracts. We think the accounting should not be driven by whether the entity is "required to hold" the underlying items.

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?

Summary

We are not convinced that the IASB's presentation proposal meets the objective to provide relevant information that faithfully represents the entity's financial performance.

Detailed response:

Generally we agree with the proposed "earned premium approach" and see conceptual preference compared with the "summarized margin approach" as in ED/2010/8. Since the summarized margin approach results effectively from off-setting parts of movements of the liability with items resulting from bookkeeping, we do not see that there is any complexity of the earned premium approach which is not as well contained in the summarized margin approach.

Investment component

However, the requirement to exclude any investment component from revenue and claims presented in P&L adds complexity. Since such movements are simply off-set under the summarized approach and consequently need not to be identified, the summarized margin approach is consequently easier to realize than the earned premium approach. We believe the additional complexity to be so grave, that it outperforms the conceptual advantages of the earned premium approach compared with the summarized margin approach.

Furthermore, the definition of the investment component is conceptually and technically flawed. The reference to surrender values in some publications of the IASB may be interpreted such that any contract in P/C business that has a surrender value has an investment component. (The surrender value is a repayment of the premium for the coverage not used). This does not reflect the economics of P/C business. It is not clear how the definition of the investment component in the ED/2013/7 can be formalized such that it is generally applicable, e.g. for profit commissions or no-claims commissions in reinsurance

contracts, for annuities with death benefit equal to zero that have a positive surrender value or for contracts with partial payments or annuity conversion options.

Acquisition cost

Another issue arises similarly only in the earned premium approach: The deferred presentation of acquisition cost and covering premiums in P&L. The ED requires that the premium covering acquisition cost is similarly as the CSM recognized over time (but without floating) as revenue in the P&L and, we assume, although that is not explicitly stated in the ED, as well the acquisition cost are equally recognized as expenses. We do not agree with such an approach. In the balance sheet, acquisition costs are covered by premiums immediately at outset, very timely to the occurrence of those cost.

The presentation of expenses, including employee cost like post-employee benefits, is not presented as required by the respective standards but – in difference to all other industries – artificially distributed over the life time of the insurance contracts. In consolidated groups, it would cause intransparency regarding the entire cost situation. This obscures the cost reporting and does not allow users identifying whether the insurer is currently able to limit acquisition cost appropriately, since they are mixed up within historical acquisition cost of the entire portfolio.

To explain the amounts in P&L it would be necessary to introduce a fictive Deferred Acquisition Cost, which is not included in the actual liability. This adds unnecessary complexity. The total approach to monitor the development of the amounts over time is an additional retrospective element – and each retrospective element causes additional complexity in a generally prospective environment.

We understand and support the wish of the IASB to recognize revenue as services are provided. But acquisition cost in insurance are something special: Collective risk mitigation is the actual product of insurers under macro economic theory. Aggregating the pool is part of the production process. New business does not only enhance economy of scales, it is needed for upholding the ability to provide services at all. Further, the acquisition process often includes important parts of the overall service, e.g. risk examination to make the pool work well, advise to the customer-to-be about needs of coverage, old-age protection etc. In many countries such advice is legally prescribed and consequently part of the insurance contract. It becomes retroactively obligatory when the contract is signed.

Therefore, we believe, there are good reasons to recognize revenue in an amount of acquisition incurred allocated to the contract. Acquisition cost should be presented as

expenses when required by the respective IFRS and capitalized expected to be covered until the related contract is issued. The difference between the expected amount and the actual amount released from the liability is reported as revenue or expense (experience adjustment) at initial recognition of the contract.

Volume information

The term “volume information” was to some extent misunderstood. It simply refers to the presentation of the “premium due” in P&L, which is seen as significant sales indicator. Since the emergence of profit was not really transparent in most accounting systems, analysts often limited their perspective to pure sales success. We do not believe that the time has come, where users of financial reports will be satisfied with information purely profit related, specifically if the sales effort is obscured by artificial deferral of revenue and expenses. We believe that the theoretical sound concept of revenue that is based on an evaluation of expected claims minus a technically defined investment component obscures the P&L to users. We believe that the information in the interim period until the new style of reporting intended by the IASB is understood could be enhanced by including the traditional sales information as well in P&L, e.g. by permitting to include the reconciliation information of ED.79 in the P&L, for example: 100 premium received minus 105 premium expected plus 4 liability reduction plus 65 earned premiums released from the liability = 64 insurance contract revenue (here, the reduction of CSM by non-paid premium is off-set with insurance contract revenue rather than shown as expense).

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?

Summary:

We support the introduction of an OCI presentation in IFRS 4 and the related Fair Value through OCI (FVOCI) category in IFRS 9. However, the use of OCI must not be mandatory.

Detailed response:

OCI enables a current fulfillment measurement model, while preserving a decision-useful income statement that reflects the long term nature of the insurer's business (i.e., interest expense determined using the discount rates that applied at the date that the contract was initially recognized).

The use of OCI for insurance contract liabilities is aligned with the Board's decision to reintroduce FVOCI in IFRS 9, which we view as a vital element to adequately reflect the performance of an insurer in a current measurement environment.

Even if the impact of interest rate changes on assets and liabilities counterbalance to a certain extent, there will usually a net OCI left. This is because not all assets backing insurance liabilities (but also shareholders equity) and the fair value movements of assets do not only react to interest rate changes but to other factors as well (credit risk spreads, illiquidity etc.). The resulting net position in current value movements of assets and insurance liabilities is not representative for the long term performance and should not hit P&L directly, but be reflected in OCI.

However, while OCI mitigates accounting volatility for non-participating insurance contracts, it is insufficient for participating contracts, which also require a fully prospective or unlocked contractual service margin (refer to our response to question 1 and question 2 above): For determining net income for participating contracts the cash flows must not be decomposed but rather a single discount rate needs to be applied to all cash flows. In order to avoid accounting mismatches the discount rate (used for determining net income) has to be asset-based for the matched part of cash flows and current for the non-matched part, i.e. it has to be a rate reflecting the degree of impact the change in interest rates has on cash flows. For this reason the rate depends on the accounting of assets for determining net income. It is current market rate in case of fair value through P&L asset accounting and a rate consistent with an amortized cost calculation in case of fair value through OCI asset accounting.

OCI must not be mandatory

OCI must not be mandatory as some products require fair value through P&L accounting (e.g., unit linked products, variable annuities and products that are backed by assets not eligible for the IFRS 9 Fair Value through OCI category). Requiring OCI presentation for all insurance liabilities would result in an accounting mismatch in these cases. In addition some portfolios are managed on a current value basis and therefore all changes should be directly presented in P&L.

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?

Summary

The effective date of the new standard for insurance contracts must be aligned with the mandatory first application of the revised IFRS 9. We support the decision to require retrospective application of the new standard to enable a comparable and decision useful reporting of insurers.

Detailed response:

Effective date of IFRS 9 and IFRS 4 need to be aligned for insurers.

We strongly believe that insurers should not be required to adopt IFRS 9 before the effective date of the new IFRS 4. Insurers would have to implement two significant accounting changes in short succession, which would be operationally burdensome and distort the informative value of insurers' financial statements for users over several periods. Effective dates of IFRS 9 and IFRS 4 should be aligned so that for entities conducting insurance business the mandatory application of both standards coincides.

Should application dates of IFRS 9 and IFRS 4 differ, it is requested that IFRS 4 provide a fully unconstrained re-designation option for all assets under IFRS 9 at the date of first application of the new IFRS 4.

We generally agree with the proposed approach for transition.

We do appreciate the efforts undertaken for establishing a new way of transition compared to the Exposure Draft 2010/10/8 and are overall very pleased that our proposals have been incorporated.

The possibility of measuring a contractual service margin for the business in force at transition is a huge progress and fits/matches the suggested measurement model introduced in ED 2013/7 for all insurance contracts.

Using the same measurement for business in force and new business leads to an adequate presentation of the insurance business. The most important change is not requiring the

insurance industry to establish a full retrospective measurement for business in force. The exploration of the needed data would have been not only a challenging but sometimes not solvable task especially for long term insurance contracts with beginnings forty or even fifty years ago.

C6 provides useful suggestions for measuring the insurance contracts in force that can lead to comparable and verifiable results. As we understand C6 c) and d) it is possible to deduct discount rates of the assets using the last three years before the transition date and use these to measure the business in force. Still in our opinion these paragraphs need clarification since the intention is not quite obvious.

Overall we strongly favor a fully prospective measurement following our answers to questions 1, 2 and 4. As a consequence, at the point of transition the measurement of in-force and new business would blend together smoothly without any inconsistencies and complexity would be reduced significantly.

Question 6 - The likely effects of a Standard for insurance contracts

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

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

(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and

(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

After several months of intensive study of the ED/2013/7 we find it difficult to determine the cost of implementation of the standard, but they deem high. For example, we do not see any life insurance company in the European market that was or is ready to apply the ED/2013/7 on main parts of his stock of with-profits business. In our view, this is largely based on the wording in ED.B85 and ED.B86, for which an appropriate methodological extension to the real product landscape is currently questionable.

At that point methodological progress must be made or the ED/2013/7 has to be formulated more principle-based. It is obvious that if a standard raises methodologically unsolved questions costs are difficult to determine. Nevertheless, one can see in both the ‘building block approach’ and the alternative approach for contracts under ED.33 that accounting figures need to be created using stochastic models in many cases. The industry has learned in projects like MCEV and Solvency II that depending on the required granularity the computation of accounting figures is costly, since new software combined with faster hardware needs to be used or existing system must be greatly expanded.

Another potential source of very high complexity is the requirement to exclude the investment component from the insurance contract revenue. The additional efforts to cope with the required complexity is not justified by —in our view— very limited additional benefits for users of financial statements who might have difficulties to understand and use this calculated number and who might prefer the simpler “premium due” information anyhow.

A third example of high one-off implementation and ongoing effort is the requirement to disclose the equivalent confidence interval for the risk adjustment. Although we understand the intention of the IASB to provide users with relevant information, from our point of view for this case the additional costs are not justified, as the relevance of this disclosed information would be very limited: If in a given example the confidence approach is not chosen to

calculate the risk adjustment because other methods are regarded as more adequate, the current ED would force the preparer to disclose information which he himself regards as non-adequate and non-relevant.

Next we consider costs for prepares much higher than for the users of the information of the ED/2013/7. For example the preparer will have to explain accounting effects to the user resp. the preparer needs to bridge accounting figures of the old world to the new account world of ED/2013/7. For example: the figure 'earned premiums' is very technical and needs to be mapped resp. translated towards 'due premiums' for any user.

On-going costs will also be higher in our opinion, since the standard will force the preparer to store a lot of information of the initial recognition for the use in subsequent measurements.

The ED/2013/7 is in many parts very technical and complex. This complexity and the data management at the individual points appear to be manageable. However, for the sum of all these technical requirements and complex calculations and data handling will be a masterpiece to control. Whether then the quality of this information is justifying this expense is unclear and remains to be seen.

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?

Definition of portfolios

The term “portfolio” is used in different contexts with different meanings and consequences. It should be made clear that “portfolio” as defined in App. A relates to the initial recognition of the CSM only. For that purpose, the definition has to be broad enough in order to avoid the case that highly interdependent contract features would have to be split up in order to determine the CSM. Participating contracts are an issue here, too.

For the measurement of the other building blocks, different groupings apply (e.g. groupings adequate to the statistical measurement methods which are based on pricing-parameters for building block 1). This should be made clear in order to avoid confusion about the portfolio definition.

General Comment on Question 7

The proposals of ED/2013/7 still lack conceptual clarity with regard to central aspects (we refer to our response to answers 1-5).

We believe that it is essential to establish a measurement principle for participating contracts that is

- applicable to (central European) participating contracts and
- supported by the insurance industry.

Clarity of drafting should be reviewed afterwards.

Cologne, 24 October 2013

Deutsche Aktuarvereinigung e.V. (DAV)