

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
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Email: commentletters@iasb.org

30 November 2010

Dear Sir David,

Re: Exposure Draft ED/2010/8 Insurance Contracts

Deloitte Touche Tohmatsu Limited is pleased to respond to the Exposure Draft, ED/2010/8 *Insurance Contracts* (the 'ED').

The development of an International Financial Reporting Standard ('IFRS') that deals comprehensively with the accounting for, and presentation of, insurance contracts is long overdue and we welcome the publication of the ED as an important step towards improving the accounting for insurance contracts and completing the body of IFRSs. We support the Board in its efforts to complete this project and to work with the Financial Accounting Standard Board to achieve convergence with US GAAP.

We welcome the model proposed in the ED because it offers improvements to the accounting for insurance contracts under existing IFRS practices. In particular, we support the ED's proposals regarding the following core principles:

- a) the introduction of a consistent measurement basis for insurance contracts as defined (this basis presents insurance contracts as a bundle of rights and obligations);
- b) the use of a current measurement model focused on the insurer's fulfilment of its obligations under a portfolio of insurance contracts (a portfolio current fulfilment value); and
- c) the transparency of the measurement model using explicit "building blocks" which is also reflected in a set of presentation requirements to display the "building blocks" in the statement of comprehensive income.

However, the ED includes a number of proposals that appear to move away from these core principles and we recommend that the Board considers alternative solutions to address these areas to ensure consistency with the ED's core principles.

Interaction with the accounting for financial assets under IFRS 9

Insurers run their businesses by managing portfolios of assets purchased with the proceeds of issuing insurance contracts to their customers such that these assets are sufficient to fulfil the insurers' obligations under these contracts. It is therefore important to ensure that the interaction of the ED's accounting model with IFRS 9 produces a meaningful reflection of the insurance business model.

Insurers expect to settle their contractual obligations and dispose of their assets over several years due to the long term nature of many insurance liabilities. Matching assets against contractual obligations is a core activity of virtually any insurer. The ED has recognised that when the amount, timing or uncertainty of the cash flows of insurance liabilities contractually depend on the performance of matching assets (i.e., cash flows from participating insurance contracts), the insurance liabilities should be measured taking into account this link. We support this principle.

However, we note that a significant portion of insurance liabilities that are of a very long term nature (e.g., payout annuities) do not have participating features but they do require a significant investment return to satisfy the liability cash flows. As a result, companies seek to invest in assets with cash flow characteristics very similar to those of the liabilities. Ignoring the accounting for the assets backing insurance liabilities will create an accounting mismatch that could make insurers' reported performance less relevant.

Under IFRS 9, financial assets purchased by an insurer to fund its future insurance obligations are measured either at amortised cost or fair value whilst under the ED the related insurance liabilities will always be measured at current fulfilment value. These differing measurement models create inherent accounting mismatches as follows.

- If an insurer's liabilities are funded by assets measured at fair value through profit or loss, changes in the assets' credit risk will be recognised in profit or loss each reporting period. However, no offsetting changes in the credit risk (i.e., non-performance risk) of the insurer will be recognised because credit risk is not a component of current fulfilment value of the insurance liability. Even if credit risk were included as a component of current fulfilment value, it would have limited correlation to the credit risk of the assets.
- If the insurer's liabilities are funded by assets carried at amortised cost, changes in the rate used to discount the liabilities would be recognised in profit or loss whilst no offsetting changes associated with the assets would be recognised.

This situation seems to create a "dead end" for an insurer in terms of its IFRS-reported performance, because the asset or liability volatility will always flow through to its statement of comprehensive income. The volatility associated with short term fluctuations in credit risk, or that of risk free rates and illiquidity premiums, may disguise the underlying economic performance of taking on, pooling and being released from insurance and other risks through an effective asset-liability management.

We encourage the Board to work with the preparer, investor, analyst and actuarial communities to explore alternative methodologies for measuring a current fulfilment value that would more faithfully represent the underlying economics of an insurer's asset-liability management strategies.

We have identified a number of potential solutions to this issue that we have included in our response, which we recommend the Board explores as possible alternatives. These include:

1. requiring the recalibration of the residual margin at the end of each reporting period against the prospective re-measurement of the current fulfilment value; and
2. amending the proposed guidance on the selection of a discount rate to permit the insurer to determine the appropriate discount rates on the basis of a reference asset portfolio adjusted for the insurer's estimate of expected default losses associated with those assets.

In addition, the Board may wish to consider the development of a macro hedge accounting approach capable of reflecting an insurer's asset-liability management under the Board's proposed hedge accounting amendments to IFRS 9. We would be happy to assist the Board and its Staff in developing our suggested solutions noted within this letter.

1. Recalibration of the residual margin

Restricting the calibration of the residual margin to initial recognition makes the ED internally inconsistent because the other components of the building blocks (expected cash flows and risk adjustment) are recalculated at each reporting date. This restriction may also result in more volatility in an insurer's reported performance and it may make it more difficult for financial statement users to assess the insurer's asset and liability management for the period. For example, if the insurer's measurement of future cash flows and their related uncertainty results in the need to recognise an onerous contract / portfolio, under the ED an insurer would continue to recognise income from the residual margin release in all subsequent financial periods, ignoring the fact that the application at that point of the net cash flows test required on initial recognition would produce a negative difference and not a residual margin.

We therefore recommend that if an insurer measures the related financial assets at amortised cost, it should recalibrate the residual margin at each reporting date and use the prospective changes in the building blocks to determine the subsequent measurement of the residual margin component of the insurance liability, after deducting the systematic release.

The final IFRS should also require that when a portfolio becomes onerous, the insurer must release to profit or loss any remaining aggregate residual margin in full or in part (to the extent needed).

We also recommend that if an insurer measures the related financial assets at fair value through profit or loss, it should remove from the recalibration of the residual margin financial variables like interest rate risk, thus allowing the change in discount rates caused by movements in market interest rates to flow directly to profit or loss.

Our recommendation to recalibrate the residual margin would reduce, to some extent, the earnings volatility that would otherwise be experienced by insurers that use the amortised cost measurement basis under IFRS 9 for a significant portion of their assets, because the market driven volatility of the insurance liability discount rate would be offset, in part or in total, by the recalibration of the residual margin.

The ED's transitional provisions would be inconsistent with our recommended accounting model to recalibrate the residual margin as under the proposed transitional provisions no residual margin would be accounted for. We agree with the Board that a full retrospective application under IAS 8 could result in significant costs. However, we believe that establishing the residual margin of in-force contracts at zero at the date of transition does not represent faithfully the underlying economics (i.e., the profitability) of the in-force portfolio.

We would be happy to meet with the Board to discuss in more detail our recommended recalibration model, and its effect on the residual margin on transition relative to the model proposed in the ED. If the Board were to adopt our model, we strongly recommend that the Board carries out field testing to establish whether insurers could apply this model to a wide and diverse range of insurance contracts.

2. A reference asset portfolio approach to selecting discount rates for non-participating cash flows

The ED requires an insurer to measure its insurance contract liabilities using a discount rate that reflects the characteristics of the liabilities' cash flows, including their degree of illiquidity. The Board has acknowledged the absence of consensus on how best to measure illiquidity of insurance cash flows. Our discussions with insurers and investors have highlighted this area as of particular concern.

As a possible way to mitigate the difficulty in applying this principle, we recommend the Board introduces additional application guidance that extends from the guidance on using a replicating portfolio described in paragraph B45 of the ED.

We believe that this additional guidance should address the selection of the discount rate and should offer insurers the option to determine the discount rate for cash flows that do not vary with the value of the assets backing them using a "top down" approach starting with the rate of return on a reference asset portfolio. If an insurer chooses to use this top down approach, the amended guidance should require the insurer to determine the discount rate by removing the risk of default (based on its estimate of expected credit losses) from the rate of return on a reference asset portfolio that matches the duration and currency of the insurance contract cash

flows (as the risk of default is not relevant to the insurance contract cash flows). The adjustment for expected credit losses on the assets should be consistent with the approach the Board is developing for IFRS 9.

The discount rate resulting from our proposed approach would allow for the measurement of insurance contracts to be more aligned with assets that are measured at fair value through profit or loss if the insurer has selected assets that are similar to the reference asset portfolio, excluding their credit risk. If the assets are measured at amortised cost, the prospective changes arising from this discount rate would be part of our proposed recalibration of the residual margin.

Other significant recommendations

In addition to the recommendations set out above there are other areas of the ED where we believe that alternative solutions would allow the final IFRS to be closer to the stated objectives of the Board's project.

Reflecting insurance contract sales in the statement of comprehensive income

Insurers and investors frequently comment to us on the limited information the ED presents on the volume of contracts that an insurer sells in a reporting period. We believe that the presentation of an insurer's performance would be more relevant if it also included information related to contracts sold in the reporting period.

One possible way to achieve this objective under the current fulfilment value model would be to present the elements of the initial calibration of the residual margin as separate lines at the top of the statement of comprehensive income. This approach would have the following benefits: (a) it would capture consistent information for contracts issued in the reporting period; (b) it would be consistent with the underlying measurement model; and (c) it would allow the calculation of common ratios that investors have developed for insurers' new business (e.g., new business margin for life insurance businesses).

Unbundling of certain components of insurance contracts

We believe that the Board should modify the proposed unbundling principle to require separation of components from an insurance contract only when those components (i) are not interdependent with the insurance coverage and (ii) have been combined with the insurance coverage for reasons that do not have commercial substance.

Like the Board, we view an insurance contract as a bundle of rights and obligations that generates a package of cash inflows and outflows, and we generally believe that the bundle should be the unit of account. We also recognise that insurance contracts may be written alongside, or bundled with, other forms of obligations, and that such components may not be interdependent with the provision of insurance coverage.

For example, a car dealer might sell cars complete with insurance coverage for the first year's use. Clearly the different elements of such transactions should be accounted for separately in accordance with the relevant Standards. However, a unit-linked policy which incorporates a death benefit equal to the higher of a fixed amount or the value of the units clearly has two features that could be unbundled but which in fact are "interdependent". As such, we believe that these unit-linked contracts should be accounted for as a single unit, but we are not certain as to whether that would be the accounting outcome under the unbundling principle in the ED.

Introducing an unbundling principle that requires separation when components (i) are not interdependent with the insurance coverage and (ii) have been combined with the insurance coverage for reasons that do not have commercial substance would achieve the Board's objective with a better cost-benefit balance.

Valuation of the risk adjustment liability

We support the ED's proposal to measure the underlying estimation uncertainty explicitly because it enables users to assess management's most current view of the different degree of volatility of outcomes from the future cash flows of insurance portfolios in force at the reporting date. We believe this approach is preferable

to the composite margin because it updates the assessment of the residual uncertainty based on information obtained subsequent to initial recognition of insurance contract amounts.

The explicit measurement of the risk adjustment will be a key element of the ED's overall model; however, its application could be improved if the final IFRS clarifies the following areas.

1. We have found the principle surrounding the measurement of the risk adjustment set out in paragraph 35 of the ED confusing and thus potentially leading to diversity in practice. We believe that the ED should define the risk adjustment as "the amount the insurer would rationally pay to eliminate the uncertainty in the amount and timing of the ultimate fulfilment cash flows".
2. The definition of a portfolio is not supported by any application guidance. This may lead to diversity in practice. We recommend that guidance should be included in the final IFRS to explain how portfolios are defined vis-à-vis different legal structures. We believe that it would be more relevant for users if the definition of portfolio is independent of the insurer's legal structure. Guidance would need to be developed in the final IFRS to explain that the degree of diversification in a portfolio is established at the highest level at which a reporting entity is consolidated if enforceable intercompany agreements exist that would allow access to the portfolio diversification benefits. In addition we believe that our recommendation to designate the recalibration approach at a portfolio level would also contribute to the application of the definition and it should be included in the application guidance.
3. We believe the Board should specify in the final IFRS that when the insurer determines the risk adjustment the portfolio it considers would include the group of contracts as defined and the benefits from the purchased reinsurance contracts that reinsure those insurance contracts. The calculation of the risk adjustment before and after the benefit of the purchased reinsurance contracts will be used to measure the reinsurance asset.

Need for field testing the new IFRS

We are in support of the Board's plan to field test the new IFRS prior to its issuance. However, we believe that the Board should enlist the help of the Insurance Working Group in the period up to the mandatory effective date of the final IFRS in order to address emerging issues that insurers may discover as they prepare for the adoption of the new IFRS. Issues should be elevated to the IFRS Interpretation Committee or the Board for additional standard setting as appropriate.

Our detailed responses to the questions in the ED are included in the appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 207 007 0884 or Francesco Nagari in London at +44 (0) 207 303 8375.

Sincerely,



Veronica Poole
Global Managing Director
IFRS Technical

Appendix: Invitation to Comment

Question 1 – Relevant information for users (paragraphs BC13–BC50)

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer’s financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

Our cover letter addresses our major concerns on the relevance of the ED.

In addition, we would like to clarify that the term “users” in our response refers to investors (and lenders), and not to regulators. This is in line with the IASB’s Framework although we acknowledge that the perspective of other users should not be ignored.

In particular, we draw your attention to the fact that currently there are many important insurance regulatory reforms taking place around the world, for example Solvency II within the European Union, which have taken the Board’s work on its insurance project as a reference point for the development of their own valuation rules for insurance liabilities.

Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)

- (a) *Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?*
- (b) *Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?*
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- (a) We agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract, as this is consistent with the Board's objectives. As the cash flows that are being discounted are received / paid out at different points in time, the wording of the ED could be improved to clarify whether a full yield curve should be used for discounting, or a single discount rate.
- (b) We believe the guidance in the appendix is appropriate for a principle-based standard. We believe the Board should clarify whether it expects entities to use the "mean" value. If this is the case, we suggest including in the phrase in paragraph 22(a) the word 'mean' for clarification:

*(a) an explicit, unbiased and probability-weighted estimate (i.e. expected **mean** value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract (paragraphs 23–25);*

It appears to us that the Board's intention is that 'expected value' is synonymous with a 'mean value', as that term is used in statistical measurements. This distinction is particularly important for property/casualty unpaid claim liabilities, as the most appropriate methods typically involve basic data averaging approaches to estimate expected (mean) values using aggregated claims data. While the goal of these methods can be to estimate an unbiased expected (mean) value, these methods do not estimate an expected (mean) value using explicit probability weights applied to explicit scenarios or explicit possible outcomes.

In Appendix B, paragraph B38 seems to describe that the measurement objective is to estimate an expected (mean) value, and that paragraph B39 indicates that the approach used to estimate an expected (mean) value can vary depending on the circumstances. We believe these paragraphs could be improved to state that B38 is not intended to prescribe specific estimation techniques and does not limit the choice of techniques, whereas B39 provides examples thereof. A suggestion as to how paragraphs B38 and B39 could be amended as follows.

*B38 ~~The starting point for an estimate of cash flows is a range of scenarios that reflects the full range of possible outcomes.~~ **The measurement objective of an explicit, unbiased estimate of the present value of future cash outflows less the future cash inflows is to estimate the expected value of uncertain outcomes. The notion of an expected value is consistent with a statistical mean value which can be explained as a probability-weighted average that is reflective of the range of possible outcomes for outcomes that can have a meaningful effect on the expected value.** Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome in order to derive an expected present value. Thus, the aim is not to develop a single 'best' estimate of future cash flows, but, in principle, to identify all possible scenarios and make unbiased estimates of the probability of each scenario. In some cases, an insurer has access to considerable data and may be able to develop those cash flow scenarios easily. But in other cases, the insurer may not be able to develop more than general statements about the variability of cash flows without incurring considerable cost. In those cases, the insurer shall use those general statements in estimating the future cash flows.*

*B39 **The expected present value of future cash flows should be estimated using approaches that are appropriate for the contracts being measured. This may involve the use of basic methods using averages or average factors applied to aggregated data, or the estimation method may involve complex modelling, simulating many future outcomes at the policy level, or some other approach that meets the measurement objective of an expected value.** When considering all possible scenarios,*

the objective is not necessarily to identify every possible scenario but rather to incorporate all relevant information and not simply ignore data or information that is difficult to obtain. In practice, it is not always necessary to develop explicit scenarios. For example, if an insurer estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will suffice to estimate those parameters. Similarly, in some cases, relatively simple modelling may give an answer within a tolerable range of precision, without the need for a large number of detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and respond in a highly non-linear fashion to changes in economic conditions (e.g. if the cash flows reflect a series of interrelated implicit or explicit options). In such cases, more sophisticated stochastic modelling is likely to be needed, including the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes.

Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)

- (a) *Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?*
- (b) *Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?*
- (c) *Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?*
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- (a) Our cover letter highlights the broader issues arising from the interaction between the proposal to have a discount rate that is independent of the yield of the assets backing insurance liabilities and the options available under the new IFRS 9 accounting for financial assets.

We agree that for insurance liabilities with cash flows that do not vary with the value of the assets backing them, i.e., where no link exists between the cash flows and the assets, the discount rate should not be a function of the assets held to fund those liabilities. However, as discussed in our response to (b) below, we believe the ED should permit an insurer to set a discount rate in line with a reference asset portfolio with cash flow characteristics similar to those of the liabilities. There will undoubtedly be instances where that reference asset portfolio is similar, if not the same, as the actual assets held.

Our recommendation to recalibrate the residual margin set out in our response to Question 6 below, or the composite margin if adopted, would reduce, to some extent, the earnings volatility that would otherwise be experienced by insurers that use the amortised cost measurement basis under IFRS 9 for a significant portion of their assets. In a scenario where assets are held at amortised cost the market driven volatility of the insurance liability discount rate would be offset by the recalibration of the residual margin, thus avoiding the reported performance of the insurer being inappropriately impacted by short term fluctuations in market consistent variables used to estimate the present value of future insurance cash flows.

We also recommend that if an insurer measures the financial assets backing those insurance contracts at fair value through profit or loss, it should remove from the recalibration of the residual margin financial variables like interest rate risk, thus allowing the change in discount rates caused by movements in market interest rates to flow directly to profit or loss.

- (b) We agree that in a current valuation of liabilities the discount rate should take into account market interest rates that reflect a premium for the relative illiquidity of the liabilities. We share the Board's concerns that at this stage there are no clearly emerging techniques to estimate the degree of illiquidity of liabilities and we agree that it would be appropriate to continue the field testing activity in this area. This is particularly relevant for long term liabilities (e.g., fixed annuities) with no form of policyholder participation in the assets backing the insurance contracts.

In responding to this question we observe that the IASB Staff issued a paper on discount rates on 8 November 2010. In the example illustrated in that paper, the Staff highlights the fact that within a single insurance contract there may be three different types of expected cash flows to discount, each with their own appropriate methodology:

1. cash flows that do not vary with the assets backing them (referred to as “fixed cash flows” in the Staff paper) which can be discounted using a single yield curve;
2. cash flows that vary with asset performance, which can be measured as a function of the assets; and
3. options and guarantees, which should be measured using option pricing techniques.

We agree with this analysis and recommend that the final IFRS includes additional guidance on the selection of the discount rate applicable to cash flows that do not vary with the value of the assets

backing them that offers insurers the option to determine the discount rate using a “top down” approach starting with the rate of return on a reference asset portfolio (rather than using a risk free rate plus illiquidity premium).

The portfolio of reference assets should be built to comprise debt instruments of good credit quality denominated in the relevant currency and economic environment in which the insurance contracts are issued. This is a key practical point to ensure the consistent application of the IFRS across jurisdictions where debt markets are in different stages of development. There should be no requirement for an insurer to hold the assets comprising the reference asset portfolio.

The “top-down” approach to determination of the discount rate is consistent with the ED’s three building blocks model. It is quite different from the “replicating portfolio” approach described in paragraph B45 of the ED. Under the “top-down” approach the reference asset portfolio is used to derive a discount rate that an insurer can use to measure the insurance liability; the valuation of the reference asset portfolio is not used as a proxy to measure the current fulfilment value of that liability.

If an insurer chooses to use the “top down” approach, it should be required to determine the discount rate by removing the risk of default based on its estimate of expected credit losses from the rate of return on a reference asset portfolio. The adjustment for expected credit losses should be consistent with the approach the Board is developing for IFRS 9.

The discount rate resulting from the “top down” approach would continue to be aligned with the requirements of the ED because it would be based on observed interest rates and it would implicitly reflect the degree of illiquidity of the cash flows it replicates after the removal of the spread equivalent to an insurer’s estimate of expected credit losses for that reference asset portfolio.

We believe that this approach to estimating the discount rate would be less complex to apply in practice than using a risk free rate plus illiquidity premium. It would allow for the measurement of insurance contracts to be more aligned with assets that are measured at fair value through profit or loss if the insurer has selected assets that are similar to the reference asset portfolio, excluding their credit risk, and thus would be more representative of the insurers’ business model.

We encourage the Board to explore this approach and we would be happy to provide assistance in that regard.

- (c) As discussed in our cover letter, we believe that these concerns are valid and stem from the interaction between the ED and IFRS 9 accounting for financial assets. We have recommended in our covering letter and in our responses to sub-questions (a) and (b) above possible solutions to address the volatility problem arising from the selection of the discount rate used to account for insurance contracts, in particular in terms of their pricing of long term insurance contracts such as fixed annuities, and to align the accounting to the insurers’ business models.

We do not believe that including the premium to reflect the risk of insurer’s non-performance would address this concern because it would not correlate with the assets held against the liabilities and it could potentially amplify the accounting mismatch rather than mitigate it.

Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

As explained in our cover letter, we believe that users would benefit more from a current assessment of the uncertainty of the outcomes of future cash flows than from a reporting basis that does not actively measure this underlying uncertainty. For this reason, we do not support a composite margin model. However, our support for the two margin approach proposed in the ED assumes that a final standard will clarify the definition of risk adjustment margin. Our concerns are discussed further in our response to Question 5 below.

Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)

- (a) *Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?*
- (b) *Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?*
- (c) *Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b) (i))? Why or why not?*
- (d) *Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (i.e. a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?*
- (e) *Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?*

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- (a) Although we broadly agree with the proposed objective, we suggest amending the definition of risk adjustment as follows to limit the diversity in practice that we believe would arise from the application of the current definition included in the ED:

*“The risk adjustment shall be the ~~maximum~~ amount the insurer would rationally pay to ~~be relieved of the risk that~~ **eliminate the uncertainty in the amount and timing of** the ultimate fulfilment cash flows exceed those expected. “*

We believe that our proposed wording addresses the interpretation issues relating to both the words “**maximum**” and “**exceed**”.

The use of the word “maximum” causes much concern amongst practitioners because it has a clear mathematical meaning of the highest value among a particular set of values. The ED does not define how an insurer defines such a set of values which is likely to lead to confusion as to what the maximum amount would represent.

We understand that the Board introduced the word “maximum” to avoid insurers showing a minimum risk adjustment (or a nil risk adjustment amount). We believe that the intentions of the Board could be achieved more effectively if the guidance clarified that it is hard to envisage circumstances under which the risk adjustment would be zero and explained what it should reflect, i.e., the characteristics of what the risk adjustment amount should be, using each of the three recommended techniques. In addition, the application guidance could be expanded to include the characteristics that would indicate a high versus a low percentile for the Confidence Level and CTE techniques; and the characteristics that an insurer would need to consider to determine a higher or lower amount of capital and cost of capital rate for the Costs of Capital technique.

The use of the word “exceed” implies that only one tail of the distribution curve is considered when measuring the risk adjustment, i.e., only events that would increase the liability are considered. We believe that the objective of the risk adjustment should be to determine the amount an insurer would be willing to pay to eliminate all the uncertainty in the cash flows, whether it is positive or negative. For example, this could be achieved by entering into a reinsurance contract.

- (b) Although we understand that the Board is concerned about the lack of comparability that may arise from insurers selecting different techniques to calculate the risk adjustment for similar portfolios of insurance contracts, we do not believe that the final IFRS should restrict the risk adjustment measurement to three (or any other specific number of) valuation techniques. In our experience other techniques exist and, almost certainly, new techniques will emerge in the future and it would not be appropriate to prohibit their use if they were better suited to a particular type of risk.

For the above reasons, we recommend that the final IFRS allows the use of methods other than the three techniques set out in the ED, provided an alternative technique represents more faithfully the uncertainty of the expected present value of the future cash flows of the portfolio. The final IFRS should provide an example in the application guidance to illustrate when none of the three methods would be sufficient to measure the additional liability. We also suggest that the Board addresses its concern about the lack of comparability by requiring robust disclosures about the technique used to calculate the risk adjustment.

- (c) We believe clarification of paragraph 90 (b) of the ED is critical because there are two incompatible interpretations of this disclosure requirement: (1) when the Cost of Capital (CoC) or Conditional Tail Expectation (CTE) methods are used to measure the risk adjustment, an insurer must solve for what the confidence level (CL) would be to arrive at the same result; or (2) if the CoC or CTE methods are used, an insurer must disclose the confidence level used in those techniques. We believe that the basis for conclusion BC117 (c) confirms that interpretation (1) is what the IASB intended. On that basis, we do not agree with that disclosure requirement.

The disclosure of how an insurer measures the risk adjustment should be sufficient to provide users with useful and transparent information. We do not agree that the disclosure proposed in paragraph 90 (b) of the ED would enhance comparability because, as the Board acknowledges, there are instances where the CL methodology is not appropriate, and thus if the CoC or CTE were chosen as the most appropriate technique to measure a particular risk, it would be meaningless to then try to reproduce the same amount under a less appropriate technique.

Furthermore, there is currently limited experience in converting CTE and/or CoC results into CL amounts and the resulting disclosures would likely be prepared inconsistently for a number of periods. For example, paragraph B82 of the ED refers to a risk such as an earthquake exposure – in that case the CoC and CL methods would take into account the possibility of low-frequency high-severity losses in all but the extreme tail of the probability distribution curve and it is likely that insurers would not deem them appropriate. It would be meaningless to compare the resulting risk adjustment calculated using CTE (or another more relevant technique) to an “equivalent” risk adjustment using the CL technique.

- (d) We agree that the risk adjustment should be measured at a portfolio level, provided that “portfolio” is better defined in the final IFRS (see also our answer to (e) below). We believe that this is the most practical solution and the most likely to produce relevant information for users at a reasonable cost.

The ED defines a portfolio of insurance contracts as a group of insurance contracts that are subject to broadly similar risks and managed together as a single pool. It does not specify whether an insurer’s legal structure affects how it defines its portfolios when measuring its insurance liabilities.

We believe that when a reporting entity determines the risk adjustment margin for a portfolio of contracts, that amount should not reflect the benefits of diversification from contracts held by a parent or sister entity within the group, unless enforceable intercompany agreements exist that would allow access to the diversification benefits. This limitation exists even if contracts held at the reporting entity level are similar to contracts held at the parent or sister entity level, and such contracts are managed together as a single pool by a parent of the reporting entity. For example, if the reporting entity is Subsidiary A, it would consider contracts issued by Subsidiary B, or those held by the parent of Subsidiary A and B, if and only if an enforceable agreement exists that allows Subsidiary A to access these diversification benefits.

We believe it would not be a faithful representation of the insurance contract portfolio liability to include in that liability the extent of the diversification benefits that the insurer may have from other portfolios it has assembled.

- (e) **Application guidance on determining the risk adjustment to open portfolios** – As drafted, the ED fails to address the fact that portfolios are often open portfolios. Addressing this characteristic is fundamental for a consistent application of the new standard. The definition of portfolio becomes very relevant when future cash flows associated with new contracts need to be allocated to a cohort in order to calculate the risk adjustment (for the portfolio) and the residual margin (for the cohort). In practice,

an insurer would first need to allocate the risk adjustment to the cohort and in turn determine the residual margin; that concept relating to new contracts is missing from the ED. A possible approach to determine the margins could be to perform the calculation at a portfolio level, with and without the new cohort and take the difference as the residual margin on the new cohort.

Application guidance on the application of the risk adjustment techniques – The ED does not clarify what time frame should be used when calculating the risk adjustment under the CoC technique. Usually, companies would use a one year period with, for example, a 99.5% confidence level. If a longer run-off were to be used, a lower confidence level would generally be used. We believe that the guidance should clarify this aspect of the risk adjustment calculation.

We understand that the techniques proposed in the ED are already being used in several countries (e.g. VAR in Australia, CTE in Canada) primarily for solvency purposes. However, the application of these concepts for financial reporting purposes is less common and we recommend that the Board includes illustrative examples for each of the three techniques to ensure consistent application of the three techniques.

Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

- (a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?**
- (b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?**
- (c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?**
- (d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?**
- (e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?**
- (f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?**

-
- (a) We agree that the insurance accounting model should not permit recognition of Day 1 gains for the reasons cited in BC 121, namely that (1) permitting such recognition would be inconsistent with the proposed revenue recognition model (i.e., because no performance obligation has been satisfied at inception); and (2) doing so may result in recognising gains arising from an improper estimation of the initial insurance liability.
 - (b) We agree that the residual margin should not be less than zero because permitting recognition of a negative residual margin would inappropriately result in deferral of estimated contract losses and would be inconsistent with the notion that the residual margin is an allocation of premium receivable in excess of expected outflows to policyholders.
 - (c) We agree that it is appropriate to estimate the residual or composite margin for a group of contracts; however, as noted in our response to Question 5 above, we believe the Board needs to clarify further, or provide additional application guidance on, the definition of “portfolio” to avoid diversity in practice. We also understand, and agree in principle, with the rationale behind requiring portfolios of contracts to be disaggregated further into cohorts for the purposes of determining the residual margin. However, for entities that write a large volume of contracts it is possible that this requirement could become burdensome in practice. We believe, it would be helpful if the final IFRS further clarified what is meant by “similar” and provided examples of how this principle might be applied in practice (e.g., grouping all contracts written in the month of September 201X having a coverage period of 2 years) or by setting some minimum level of aggregation. The final IFRS should also clarify that such cohorts could still be combined and reported at the portfolio level in the statement of financial position.
 - (d) We do not agree with the proposed method of releasing the residual margin. As explained in our cover letter, we believe that the residual margin should be recalibrated in subsequent reporting periods to reflect changes in assumptions affecting the expected present value of fulfilment cash flows. In essence, this means that all prospective changes in building blocks 1 and 2 are first offset against any remaining residual margin. Actual experience, i.e. the difference between cash flows anticipated at inception and actual cash flows, would be recognised directly in profit or loss for the period. For example, an insurer that pays in the current period an insurance contract cash flow that it had expected to pay at a later date would recognise the resulting change in the time value of money through profit or loss in the period. In contrast, no experience variance would be reported from the amounts of the cash flow if their quantum is as previously expected. At the end of each reporting period, the remaining amount of residual margin to be amortised would equal the original residual margin

established at inception, less the accumulated amortisation, plus or minus the change in the present value of expected future fulfilment cash flows arising from changes in assumptions updated during the reporting period.

The recalibration is performed using the same elements that the ED would require insurers to present on their statement of comprehensive income. At each reporting date, the insurer will always recognise through profit or loss (i) the release of the risk adjustment expected in the period, and the gains and losses on initial recognition described in paragraph 72(b), (ii) non-incremental acquisition costs and non-direct issuance costs, (iii) experience adjustments and (iv) interest expense from the unwinding of the discount. The other elements would be taken against the residual margin, net of its systematic release, to the extent there is residual margin remaining and any excess over the remaining residual margin would be recognised in profit or loss (i.e., the residual margin would never be less than zero).

The recalibration adjustment would be reported as a separate component in the statement of comprehensive income defined as the "release/increase of residual margin". This line item will be distinct from the systematic release of the residual margin. All other components would be recognised in profit or loss.

The systematic release of the residual margin is governed by paragraph 50 of the ED which requires that the residual margin be amortised based on the "passage of time" or the "expected timing of incurred claims and benefits" if it differs significantly from the passage of time. For many life insurance products, the pattern of claims and benefits will, in fact, be substantially different from the passage of time because the probability of having to pay benefits tends to increase in the later policy years. For example, whilst the death benefit under a whole life policy is often level throughout the life of the policy, the value of that benefit typically increases with duration as the probability of death increases with age. As another example, most of the benefits under a short-term endowment policy are paid at policy maturity. As compared to the "passage of time", an amortisation pattern based on the "expected timing of incurred claims and benefits" will result in a substantial back-loading of residual margin amortisation. For these reasons, we recommend that the Board modifies paragraph 50 to require that the systematic residual margin release be computed on the basis of passage of time, or another rational basis.

In addition, we believe that the proposal in the ED to release the residual margin over the period of coverage under the insurance contract establishes an arbitrary bright line. Instead, we recommend that the period for the release of the residual margin be the combined coverage and claims handling period.

As explained in our response to Question 3 above, the recalibration of a portfolio's residual margin would exclude financial variables like interest rate risk when an insurer has measured the financial assets backing that portfolio at fair value through profit or loss.

Whilst our recommended approach is more complex than the approach proposed in the ED, we believe it is preferable because recalibrating the residual margin against the other building blocks results in a more faithful representation of the economics of the insurer's business model compared to continued recognition of the residual margin on the basis of assumptions made at inception of the cohort.

Finally, our proposed recalibration repeats the same exercise that the insurer is required to carry out under the ED at initial recognition when all cash flows are prospective. However, at the recalibration date the insurer would recognise the actual experience in profit or loss and it would adjust the residual margin only for updated assumptions applied to future estimated cash flows. If the Board adopts our proposed recalibration approach, the final IFRS should also require that, the recalibration must release in full (or to the extent needed to cover the onerous nature of contract) to profit or loss any aggregate remaining residual margin, i.e. at the portfolio level, when a portfolio becomes onerous.

- (e) As noted in our response to Question 4 above, we do not support the use of the composite margin approach. However, if the Board were to adopt that approach, we would recommend the same recalibration and systematic release methods as described in our response to (d) above.

- (f) Under our recommended approach of releasing the residual margin over the combined coverage and claims handling period, we do not agree that interest should be accreted on the residual margin. Such accretion would not add any substantial benefit to the relevance of an insurer's financial statements.

Question 7 – Acquisition costs:

Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

We agree with the concept of including in the expected present value of an insurance contract those incremental costs identified in the ED. However, we believe that the cash flows to be included in the building blocks should also include directly attributable costs related to the issuance of an insurance contract. Including these directly attributable costs would be consistent with the economics of the insurance contract.

We believe that the following language from FASB Accounting Standards Update (ASU) No. 2010-26 *Financial Services – Insurance* (Topic 944) would be an appropriate guideline for identifying those costs that should be included in the expected cash flows. As stated in the ASU:

“The portion of the employee’s total compensation [...] and payroll-related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:

- 1. Underwriting*
- 2. Policy issuance and processing*
- 3. Medical and inspection*
- 4. Sales force contract selling.*

Other costs related directly to those insurers acquisition activities described above that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred”.

Question 8 – Premium allocation approach

- (a) **Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?**
- (b) **Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?**

-
- (a) We believe that there should be a modified accounting approach for short duration contracts' pre-claims liabilities as a practical approximation of the building blocks measurement that would allow the presentation of these contracts along the lines of the statement of comprehensive income presentation widely accepted by investors in insurers that sell these types of contracts, often referred to as general insurers or property and casualty insurers. We believe that any modified accounting approach should be permitted, but not required.

However, using a bright line of 12 months to determine whether insurance contracts would qualify for this modified accounting approach appears to be arbitrary. We recommend that the Board considers alternatives such as that currently applied in US GAAP where there is no specific limit on the duration of the contract to determine the classification of insurance contracts. Insurers would disclose in their accounting policies the parameters selected to define short duration, similar to the approach adopted for the IFRS 4 definition of significant insurance risk.

- (b) We do not agree with the proposed modified accounting approach. Instead, we recommend that the Board adopts an accounting approach for short duration contracts similar to the unearned premium approach currently used under US GAAP. Under this approach, premiums from short duration contracts are recognised as revenue over the period of the contract in proportion to the amount of insurance protection provided. If the period during which the insurer must stand ready to pay claims differs significantly from the contract period, premiums would be recognised as revenue over the period of risk in proportion to the amount of insurance protection provided. This methodology generally results in premiums being recognised as revenue evenly over the contract period (or the period of risk, if different). Premiums subject to adjustment (e.g., retrospectively rated or other experience-rated insurance contracts) would be recognised as revenue over the period of the contract. Acquisition costs incurred would be netted against the unearned premium and amortised in proportion to the premiums earned. Please see our response to Question 7 above for the types of acquisition costs that we believe should be included. A provision for onerous contracts based on the building blocks model would be recognised if the measure of the portfolio using the building blocks approach exceeds the unearned premium liability at each reporting date.

Our proposed short duration contract accounting model would also include the following elements.

- As premiums are earned over the period of coverage, a liability would be recognised for losses incurred in the period of coverage including reported losses, incurred but not reported losses and claims handling and settlement costs. The liability would be recognised using the principles of the building blocks approach including the present value of the probability weighted cash flows and a specific risk adjustment to address the uncertainties in the ultimate amount and timing of the cash flows.
- A residual margin liability would be determined and established as the premiums are earned and as the claims liability is recognised for the losses and claims expenses incurred.
- A portion of the residual margin would be attributed to the period of coverage and such portion would be part of the premiums earned. The remaining portion of the residual margin would be accounted for consistent with the recalibration model we described in our response to Question 6 above. As discussed in that response, we believe the residual margin release should include the claim settlement period. To recognise the entire residual margin only over the period of coverage seems inconsistent with the continuation of the exposure for the uncertainty in the cash flows after the period of coverage ends.
- We believe that a revenue (earned premium) and expense (incurred loss and expenses) presentation in the statement of comprehensive income arising from this proposed model would provide the most useful information. Disclosures of the earned premium would

include the earned premium for the current reporting period and adjustments for earned premium reported in prior periods. Disclosure of the incurred losses and expenses would include separate disclosure of paid losses and expenses and changes in the individual components of the building blocks used to establish the liability, separately presented for insured events of the current period and for insured events of prior periods. We have commented more extensively on our recommendation to the presentation in the statement of comprehensive income in our response to Question 13 below.

Question 9 – Contract boundary principle

(a) **Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not?**

(b) **If not, what would you recommend and why?**

We agree with the concept of contract boundary as set out in the ED. However, we recommend that the Board amends the definition of contract boundary in paragraph 27(b) to replace the reference to “the particular policyholder” with “the particular class of insurance contracts”. This change would allow underwriting actions carried out for a specified group of policyholders for a single risk known as “community ratings” to be included in the contractual clauses that create a contract boundary. We believe that in these circumstances it is appropriate that the future premiums and associated benefits are excluded from the expected value if they arise subsequent to the date on which the insurer has the practical ability to introduce a new risk rating for the specified group of policyholders.

In addition, we believe that further guidance is necessary to assist preparers in applying a concept that does not have a precedent in IFRS literature. We have set out below a few areas for which we recommend guidance in the final IFRS.

Statutory requirements – The public interest associated with insurance contracts creates situations where insurers are not always able to reflect fully the price of the specific risk transferred by a policyholder. For example, some jurisdictions have a statutory (or regulatory) requirement for an insurer to renew an insurance policy at the same rate (which may not fully reflect the risk of the policyholder) unless the insurer provides the policyholder with written notice, within a specified period before the contract expiry, of its intent to re-price the contract (or not to renew the policy under conditions specified by statute or regulation). In such circumstances, we believe that the insurer has the ability to re-price fully prior to the expiry of the notice period to reflect fully the risk of the policyholder and therefore, the ‘contract boundary’ should not include the notice period imposed by this statutory/regulatory requirement. .

Similarly, some jurisdictions may have enacted laws or regulations that restrict an insurer to re-pricing a contract at a rate that only substantially but not “fully” reflects the risk of the policyholder. As currently worded in the ED, such a restriction could result in an insurer using a different contract boundary in two jurisdictions for the same contract on the basis of the statutory/regulatory requirements applicable in each jurisdiction. We believe that such statutory/regulatory limitations should be disregarded in the assessments of contract boundaries.

Another example of statutory/regulatory limitations to re-price individual contracts fully relates to certain health insurers that may be compelled by law or regulation to write or renew individual insurance contracts at a price that does not fully reflect the risk of the specified policyholder, but the insurer can aggregate such contracts into “community-rated pools” such that the pricing for the pool as a whole fully reflects the aggregate risks of all of the contracts in that pool. The final IFRS should clarify whether a contract boundary has been established for the entire pool in such circumstances.

Contract boundary for purchased reinsurance – Certain reinsurance contracts cover risk from contracts in force and also risks that will arise from contracts that are yet to be issued either within a specified future period of time or until such time as the re-insurance treaty is closed to new business by agreement of the two parties. The ED does not address how the contract boundary should be determined for purchased reinsurance contracts that protect the cedant for insurance contracts it has yet to issue.

Paragraph 27 of the ED indicates that “the boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance contract from those that relate to future contracts”. However, the ED is unclear if this principle also applies to an existing purchased reinsurance contract that also reinsures future contracts issued by the insurer.

We believe that the guidance should specify that, when a reinsurance agreement is purchased by the cedant for contracts yet to be issued (e.g., agreement covers contracts issued in next 12 months), the initial reinsurance asset is to be represented entirely by the reinsurance residual margin asset until a contract that falls under the

reinsurance agreement is sold and the basis to measure the reinsurance contract using the principles in paragraph 43 of the ED can be used.

If the Board adopts our recommended recalibration approach, the final IFRS would also need to elaborate on the subsequent measurement of the reinsurance residual margin asset. The recalibration would need to be consistent with the amortisation described above as new reinsured contracts are issued.

Question 10 – Participating features

- (a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?**
 - (b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB’s financial instruments standards? Why?**
 - (c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?**
 - (d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?**
-

- a) We agree that the estimated future cash flows should include all the cash flows that are expected to be paid to policyholders, including those that are subject to insurer’s discretionary decisions within the terms of the contract’s participating clauses. This would provide users of the financial statements information on the insurance contract liability that matches the cash outflows that the insurer expects to pay to fulfil its contractual obligations.

In particular, we support the approach taken in paragraph B61 (j) of the ED to include in the estimate the payments to current and future policyholders. This requirement implies that the participating fund is the unit of account for the cash flows that vary with asset performance rather than the portfolio of participating contracts that are in force at the reporting date. We recommend that the Board includes an explicit statement to that effect to help the application of this key principle for participating business.

The application of this principle to the measurement of participating contracts on transition would require specific guidance if the Board adopts our recommendation to allow for a restatement that recognises an opening residual margin balance. Under the current provisions of IFRS 4, insurers have classified the discretionary participating feature either as a liability or as a split between equity and liability. The Board will have to decide if the surplus of participating funds that is represented by these amounts should form part of the residual margin of a participating liability or whether it should be part of equity.

This issue is particularly relevant for those funds where the application of the contribution principle (i.e., that policyholders must receive benefits based on their contribution to the surplus) has resulted in a significant amount of assets within the participating fund that have been contributed by policyholders under contracts that are no longer in force. This issue is known in some jurisdictions as the “orphan estate” or the “inherited estate” and its attribution to policyholders or the insurer is often a complex legal and regulatory matter. In these cases, one approach would be for the Board to conclude that the application of B61(j) results in the orphan estate on transition to be an element of the residual margin of the participating fund liabilities until an approved attribution scheme is in place.

Finally, we note that the application of these accounting principles to mutual insurers that operate their entire business on a participating basis would mean that the present and future policyholders are also the business owners. In many of these cases, the application of B61 (j) could produce a participating liability that incorporates the entire amount of equity of the reporting entity because it will result in payments to parties in their capacity as holders of a participating contract. We recommend that the application guidance in the final IFRS should address this particular case.

- b) We believe it is appropriate that contracts with participating features are within the scope of the final standard, even if no insurance component exists in such contracts, for two main reasons:

- those contracts share many common aspects with insurance contracts, in particular they build on the principle of mutualisation of risks; and
 - the accounting under the ED's proposals (subject to our recommendations and comments) would be better aligned with the economics of the transaction between the policyholders and the participating funds from where their contracts are issued.
- c) We understand the Board's intention to restrict the measurement of participating contracts to those issued within the insurance industry through the requirement that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity. However, we are concerned that this would create different accounting results for similar transactions depending on how the participating funds are structured. We do not believe that this approach would make the IFRS more relevant and thus we do not support the proposed amendment of the definition of a discretionary participating feature from its current text within IFRS 4.
- d) We agree with the proposals in paragraphs 64 and 65 of the ED.

Question 11 – Definition and scope

- (a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?**
 - (b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?**
 - (c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?**
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- (a) We agree with the definition of an insurance contract and the related guidance, because we consider the changes to be of an explanatory nature, clarifying further the classification principles that already exist in IFRS 4.

To our knowledge, the application of IFRS 4 has been consistent with these two additional clarifications and therefore we do not expect a change in the way contracts are currently classified in jurisdictions where IFRS 4 is applied.

- (b) We do not agree with the proposed amendment to the scope exclusions in paragraph 4 that proposes to scope out fixed fee service contracts. This scope exclusion is not well defined and it could result in less relevant information than if these contracts were in the scope of the final IFRS. Our proposed approach to unbundling would require the separation of service obligations that are not interdependent with an insurance coverage.

For example, assume an entity issues a fixed fee service contract with an employer under which it offers to administer, for a fixed fee, all the claims arising from the employees' health related issues, and also offers stop loss coverage to limit the employer's cumulative costs if they exceed a specified amount. The current definition of fixed fee services would suggest that this contract is scoped out and the provider would not be required to recognise the liability under the stop loss coverage other than by allocating an amount of the fixed fee to it unless the whole contract became onerous. This accounting result would be less relevant to the investors in that entity because they would be informed of potential losses less timely than if these contracts were measured using the building blocks approach proposed in the ED.

- (c) We agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts. However, we also recommend providing an entity with the accounting policy choice to account for financial guarantee contracts in accordance with IFRS 9 if the entity's business model treats these contracts as financial instruments, rather than as insurance. This approach would retain the existing scoping requirements, which have worked well in practice.

Question 12 – Unbundling

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

We believe that the Board should modify the proposed unbundling principle to require separation of components from an insurance contract only when those components (i) are not interdependent with the insurance coverage and (ii) have been combined with the insurance coverage for reasons that do not have commercial substance. Like the Board, we view an insurance contract as a bundle of rights and obligations that generates a package of cash inflows and outflows, and we generally believe that the bundle should be the unit of account. We also recognise that insurance contracts may be written alongside, or bundled with, other forms of business, and that such components may not be interdependent with the provision of insurance coverage.

For example, a car dealer might sell cars complete with insurance coverage during the first year's use. Clearly, the different elements of such transactions should be accounted for separately in accordance with the relevant Standards. However, a unit-linked policy which incorporates a death benefit equal to the higher of a fixed amount or the value of the units clearly has two features that could be unbundled but which in fact are "interdependent" because the death benefit cannot be determined without knowing the value of the units. As such we believe that these unit-linked contracts should be accounted for as a single unit under the ED.

Regardless of the unbundling threshold chosen by the Board (interdependent versus closely related), we believe that the Board should provide additional application guidance and/or illustrate the application of the unbundling guidance to common contracts. This will ensure that similar contracts are accounted for consistently by different entities. The Board should also amend or delete its existing bifurcation guidance (e.g. paragraph B4.3.5(d) of IFRS 9) to be consistent with the new standard.

We recommend modifying the requirements to unbundle components of insurance contracts to components that ***are not interdependent with the insurance coverage and which have been combined with the insurance coverage for reasons that do not have commercial substance***. The result of this alternative approach would be to limit the number of components accounted for without using the "building blocks" measurement.

We are concerned that the unbundling requirements in the ED are too onerous and do not pass the cost-benefit analysis test: two of the three mandatory examples for unbundling would result in reporting that is substantially equivalent to the core model proposed for the host insurance contract. We do not believe that the proposed requirements would enhance the relevance and reliability of insurers' financial statements.

One example where an insurer would be required to unbundle relates to account balances. Account balances are cash flows that insurers have an obligation to pay to the policyholder irrespective of the occurrence of the insured event. When an account balance exists in an insurance contract, it is usually closely related to the insurance component and it is funding all of the charges that the insurer is entitled to receive from the policyholder to meet its obligation to stand ready to pay claims (i.e., an additional amount that is due only if the insured event occurs, sometimes calculated as a proportion or a multiple of the account balance and in other instances a guaranteed minimum amount) and to render services (i.e., to remunerate the account balance based on the management of the relevant funds that the policyholder has paid into it).

Unbundling would require the account balance to be treated as a financial liability and accounted for under IFRS 9 at amortised cost or at fair value through profit or loss. However, the treatment of the account balance within the insurance liability would achieve a substantially equivalent measurement and preserve the integrity of the principle the ED is developing, i.e., accounting for insurance contracts and not for their separate rights and obligations. Unbundling in this example effectively separates the obligation to pay cash under a particular scenario from those obligations that could arise from the contract.

The proposed model in the ED requires the insurers to consider all relevant scenarios and the associated cash flows to determine the probability weighted present value of the contract. Whenever the contract has an inherent component that is payable irrespective of the occurrence of the insured event, the resulting expected value will always consider this cash flow under each scenario. In addition the insurer is required to develop scenarios for different events and also for events occurring at a different time - this is equivalent to calculating

the expected life of a financial instrument under IFRS 9. However, unlike IFRS 9, under the ED the insurer would always discount the cash flows using a discount rate that is consistent with the market interest rates observable at the reporting date. This would be different from the effective interest rate used if the account balance was measured at amortised cost under IFRS 9.

Finally, we observe that with the unbundling of the account balance and its accounting under IFRS 9, the insurer would be able to apply the IFRS 9 fair value option for a financial liability. This choice would allow the recognition of the amount relating to an insurer's own credit risk in contrast with the measurement attribute in the ED where credit risk would be explicitly excluded from the measurement of the cash flows of the host insurance contract.

Embedded derivative cash flows under the ED would be measured using substantially equivalent inputs to those used under IFRS 9, except that IFRS 9 would require the measurement of bifurcated embedded derivatives to be based on market participants' assumptions and include the own credit risk of the insurer.

Overall, we see very little benefit in requiring the efforts necessary to assess whether there is a close relationship of embedded derivatives with the host insurance contract and the resulting bifurcation compared to leaving the embedded derivative as an integral component of the insurance contract to be accounted for under the ED as there is a sufficiently clear requirement to use market prices to ensure the embedded derivatives cash flows are substantially aligned with their stand alone market value.

If the Board does not agree with our proposals above, we recommend that the examples given in paragraph 8 (a) are moved out of the final IFRS into the Implementation Guidance. We also recommend that additional examples relating to unbundling of account balances are included together with the existing examples on embedded derivatives contained in the current text of the IFRS 4 Implementation Guidance.

Question 13 – Presentation

(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?

(b) Do you agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

- (a) We observed that the investors' reaction to the proposed summarised margin presentation has been mixed. The link to the measurement model and the identification of the sources of profit under the model is welcomed. However, the lack of information on an insurer's volume of activity, the difficulty to reproduce some of the more common key performance indicators and the less than prominent display of cash based information (proposed to be given only in the footnotes) result in the criticism that the summarised margin would remove and/or de-emphasise financial information that investors find useful under current presentation practices.

We believe that the above factors make the proposed summarised margin presentation less useful to users of financial statements because the information about volume of activity typically represented by the revenue an entity recognises from contracts with its customers is not part of the current fulfilment value model which instead considers the insurance contract as a bundle of inflows and outflows. As noted above, we support the measurement of an insurance contract on this basis, but we are also of the view that volume information must be included in the statement of comprehensive income to satisfy the needs of financial statement users.

One possible way to achieve this objective is to present the information used to determine the initial residual margin at the top of the underwriting margin section of the statement of comprehensive income. The elements included would be the present value of future inflows, the present value of future outflows, the initial measurement of the risk adjustment and the resulting residual margin liability (see paragraph 17 of the ED). In addition, the underwriting margin would also include the losses arising at issue of new insurance contracts which are currently proposed to be disclosed as a separate line below the underwriting margin (see paragraph 72(b) of the ED). In line with the general presentation principles of the ED, the items arising from the initial recognition of purchased reinsurance contracts would be presented after each of the corresponding lines for the insurance contracts they reinsure, with the gains at initial recognition of these contracts also included in the underwriting margin. In addition, the change of the risk adjustment liability would be split between the expected release for the period (due to the insurer being released from risk) and its re-measurement at the reporting date which would be presented together with the other prospective assumptions changes.

The advantages of the presentation described above would be as follows:

- the amounts presented would be extracted directly from the underlying measurement model and would be presented in the statement of comprehensive income;
- the amounts presented would offer a better indication of the insurer's volume of insurance contract sales during the period because their calculation would be based on the same contract boundary concept that underpins the current fulfilment value approach; and
- investors would be able to calculate immediately the most common key performance indicators such as new business margins.

Finally, to address the concern about the limited emphasis on amounts linked to cash, the Board could require that the experience adjustments component of the required statement line set out in paragraph 72 (d) of the ED is disclosed showing the gross amount of actual cash flows paid and received together with the release of the equivalent estimated amount from the insurance contracts liability.

The following table illustrates the presentation described above, assuming an insurer elects all lines to be presented on the face of the statement of comprehensive income:

Ref, to ED paragraph	Description (all amounts would have an adjacent potential corresponding reinsurance amount, usually with opposite sign)	
17	New contracts expected present value of the future cash inflows	XX
75(a)(i)	Earned premium from short duration contracts	XX
17	New contracts expected present value of the future cash outflows	(XX)
17	New contracts risk adjustment	(XX)
17	New contracts residual margin	(XX)
75(a)(ii)-(iv)	Claims incurred and expenses from short duration contracts	(XX)
72(c)	Acquisition costs that are not incremental at the level of an individual contract	(XX)
72(a)(i)	Release of risk adjustment	XX
72(a)(ii)	Release of residual margin	XX
72(d)(i)	Actual cash flows paid and received	XX / (XX)
72(d)(i)	Estimated cash flows paid and received	(XX) / XX
72(d)(ii)	Changes in assumptions (including cash flows, discount rates and risk adjustment)	(XX) / XX
New proposal	Recalibration of the residual margin from changes in assumptions	XX / (XX)
72(e)	Interest on insurance contract liabilities	(XX)

Some users believe that an alternative approach to presentations such as a written premium approach is more relevant to their investment decisions. For the avoidance of doubt, our comments above should not be understood as our indifference to such investor needs. If the Board is able to establish that investors are better served by an alternative presentation format, such format should not be precluded.

- (b) We considered the possibility of reflecting certain changes of the insurance contracts within other comprehensive income (“OCI”) similar to what is currently permitted under the IFRS 4 “shadow accounting” approach. However, we believe that the Board’s decision not to retain the available-for-sale classification category for financial instruments in IFRS 9 makes it particularly difficult to address the asset-liability volatility through recognition of components in OCI using the approach from IFRS 4. However, as stated in our cover letter, we strongly encourage the Board to explore all possible ways to address the accounting mismatch and present insurers’ business in a manner relevant to users.

Question 14 – Disclosures

- (a) ***Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?***
- (b) ***Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?***
- (c) ***Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.***
-

- (a) We agree with the principles as described in paragraphs 86 and 91 of the ED.
- (b) In line with our comments on the presentation of new insurance contracts issued as set out in our response to Question 13 above, we suggest that paragraph 86 requires the disclosure of cash flows relating to policies in force and those related to contracts issued in the year.

To that extent, we propose to change the wording of sub items (a) to (g) of paragraph 86 to specify that those items are for policies that were in force at the start of the year and then add the following lines for new contracts sold during the year:

- h. Insurance contract liabilities for policies sold in the year
- i. Risk adjustments included in h
- j. Residual margins included in h
- k. Reinsurance assets arising from reinsurance contracts acquired in the year by the insurer as cedant
- l. Risk adjustments included in k
- m. Residual margin included in k
- n. Impairment losses on reinsurance acquired in the year

In line with our comments on the presentation of experience adjustments covered by paragraph 72 (d) with a clearer link to cash flows, we suggest that an analysis is presented in the notes showing these experience adjustments for premiums received and benefits paid. This latter amount should be analysed in its broad components (for example, disclosure of benefits paid for deaths, surrenders, maturities, annuities, claimants' indemnifications and expenses). We believe this information would be useful to users of financial statements.

As set out in our response to question 5 (c) above, we do not believe that the second part of paragraph 90 (b) (i) produces useful disclosure, namely to require the disclosure of "... the confidence level to which the risk adjustment estimated under those methods corresponds (e.g. that the risk adjustment was estimated at conditional expectation (Y) and corresponds to a confidence level of Z percent)".

Question 15 – Unit-linked contracts

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

We agree with the ED's proposals on unit-linked contracts, and we believe that they will help to address existing accounting mismatches.

We also believe that the presentation requirements proposed in the ED will provide financial statement users with greater transparency into the nature of the insurer's unit-linked contracts and their performance, and enable users to differentiate more clearly investment returns that affect the insurer directly from those that are contractually passed through to policyholders.

Question 16 – Reinsurance

- (a) ***Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?***
- (b) ***Do you have any other comments on the reinsurance proposals?***
-

- (a) Generally, we support the expected loss model for reinsurance assets. However, as set out below, we believe that further clarification is required.
- (b) The final Standard should clarify that a reinsurance asset should be measured by reference to the underlying portfolio of insurance contracts.

This is accomplished by first measuring the expected present value of the cash flows of the portfolio of reinsured contracts and the related risk adjustment margin on a gross basis (i.e., excluding the effects of any reinsurance) and comparing those amounts to the net cash flows and risk adjustment (i.e., including the effects of reinsurance). The difference between the gross and net risk adjustment margin would be the risk margin ascribed to the reinsurance asset.

This risk adjustment margin would then be incorporated into the expected present value of the reinsurance fulfilment cash flows for the purposes of determining the amount of the reinsurance asset that will be subject to the final adjustment reflecting the estimated expected losses from default and disputes.

In our response to Question 9 above we have recommended further improvements on the accounting for reinsurance assets for inclusion in the final IFRS.

Finally, we recommend that the final IFRS requires the cedant to disclose the economic reasons that management believe have resulted in the recognition of an accounting gain on the purchase of reinsurance contracts.

The ability to recognise an accounting gain from these transactions is aligned to the economics of risk diversification differential between cedant and reinsurer that the ED has now embedded through the application of the current fulfilment value approach. However, we believe that a requirement to disclose management's rationale for the accounting gain would be particularly useful to users and therefore we would recommend its explicit inclusions in the final IFRS.

Question 17 – Transition and effective date

- (a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?**
 - (b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?**
 - (c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?**
 - (d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.**
-

- (a) We agree with the Board that full retrospective application under IAS 8 could result in significant costs. However, our recommended approach to recalibrate the residual margin deals more effectively with the risk of using hindsight than the current proposals under the ED because it requires recalibrating the residual margins of all portfolios of contracts in force at the transition date based on a prospective assessment.

We recommend that the Board includes in the final IFRS a requirement to restate a number of prior periods that would materially allow the recognition of a sufficiently large opening residual margin to allow the operation of recalibration on the in force portfolios without imposing a full retrospective restatement. However, the Board should carry out field testing to determine the appropriate number of years insurers would need to consider in the restatement. Our view is that this would likely be in a range between five to ten years prior to the mandatory adoption date.

As an alternative to this approach, the final IFRS could allow the option of full retrospective application under IAS 8 with the requirement to disclose in the statement of comprehensive income the impact on results arising from the restated residual margin to enable users to compare companies that did or did not restate.

Another option would be to require insurers to perform a valuation of the fair value of their existing contracts and to use this fair value as the reference to determine the initial residual margin at the date of transition. The fair value of insurance portfolios would take into account all expected sources of profits a hypothetical buyer would be acquiring and it would be a representative basis of the value that the residual margin should represent. We believe that the fair value of the contracts in force to be used for the transition provisions of the new IFRS would need to be adjusted only to remove the insurer's own credit risk to ensure consistency with the subsequent measurement proposed under the ED.

- (b) We believe that the same alternative transition approaches set out under (a) above would need to be used in an IFRS that uses a composite margin accounting model.
- (c) We believe the effective date of the new IFRS should be aligned with the effective date of IFRS 9.
- (d) On the basis of our discussion with clients and other affected stakeholders, we believe that the final IFRS should become effective no earlier than for reporting periods beginning on or after 1 January 2014.

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

Ongoing improvements to the standard

The ED does not provide non-mandatory implementation guidance to illustrate how the proposed principles or accounting models would be applied to various types of insurance contracts or specific contract provisions. Without such guidance, and given the breadth of the standard, we believe it is likely that practice issues will arise as a result of (1) constituents interpreting the underlying principles in the final standard differently, and (2) entities performing more detailed modelling and identifying additional implementation questions about how the principles in the standard should be applied to specific contract features or provisions, or identifying possible unintended consequences of applying the models in the final standard.

Therefore, we encourage the Board to perform more field testing with preparers and users and enlist the help of the Insurance Working Group in the period up to the mandatory effective date of the final IFRS in order to address emerging issues that insurers may discover as they prepare for the adoption of the new IFRS. Issues should be elevated to the IFRS Interpretation Committee or the Board for additional standard setting as appropriate.

IFRS 4 Implementation Guidance

A non-mandatory Implementation Guidance Appendix to the final IFRS should be developed as soon as practicable to assist the adoption of the new requirements.

The implementation guidance that accompanies IFRS 4 should be preserved in the new IFRS for the areas dealing with contract classification and, if the proposed approach to unbundling of embedded derivatives is retained, the guidance on identification and accounting treatment of embedded derivatives.

This guidance has been particularly useful in the adoption of IFRS 4 and should continue to be available particularly for those jurisdictions that will be moving to IFRS in the near future.

The development of the additional guidance recommended above would add further chapters to these two useful products of the Board's Insurance Contracts Phase I project work.

Question 19 – Benefits and costs

Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

As noted in our cover letter, we support the ED as an important step to achieve the benefit of a common IFRS basis for insurance contracts.

It is premature to attempt to quantify the costs and benefits of the adoption of this new IFRS and we would expect that the Board has sight of this dimension as it carries out its field testing activity. The choice of the transition date would contribute to making the implementation efforts more or less marked across an industry that already has substantial challenges in the near future.

Our current assessment leads us to the view that the benefits that a common IFRS basis for insurance reporting delivers to investors should outweigh the costs of implementing the new reporting regime provided the new standard addresses appropriately the concerns expressed in this letter and by other commentators..