THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

Response from
The Institute of Chartered Accountants of Scotland
to the International Accounting Standards Board

Exposure Draft 2010/8: Insurance Contracts

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INTRODUCTION AND KEY ISSUES

The Institute's Accounting Standards Committee has considered the above exposure draft and I am pleased to forward its comments to the IASB.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires the Accounting Standards Committee to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

We support the IASB's proposals to develop a new standard on insurance contracts. We believe the proposals will result in significant improvements in the consistency and comparability of financial reporting by the insurance industry. We also note that the proposals in the Exposure Draft in relation to measurement represent an improvement on the proposals in the Discussion Paper.

Any enquiries should be addressed to Amy Hutchinson, Assistant Director, Accounting and Auditing and Secretary to the Accounting Standards Committee.

ANNEX: RESPONSES TO SPECIFIC QUESTIONS

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?

Response:

We think that the proposed measurement model is an improvement on both the current accounting model for insurance contracts and the model proposed in the May 2007 discussion paper. The proposed model will enhance consistency and comparability of reporting between insurers and the use of fulfilment cash flows reflects the way that insurance contracts are managed in practice.

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?

Response:

We agree that the measurement of an insurance contract should be on an expected value basis, as this provides an accurate depiction of the way an insurer manages its business. We support the use of fulfilment cash flows in the Exposure Draft, as opposed to the current exit value model proposed in the discussion paper. This reflects the fact that insurers intend to fulfil contracts rather than transfer them, and therefore the accounting model is aligned with the strategy and internal reporting of insurers.

The draft application guidance in Appendix B seems to be at the right level of detail.

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 and34)? 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?

Response:

(a) We agree that the discount rate for non-participating contracts should reflect the characteristics of the liability and not the assets backing the liability. The insurance contract liability is independent of the assets held by the insurer therefore the discount rate used should reflect this. The resulting mismatch between the discount rate used for the insurance liabilities and the yield on the assets held demonstrates the level of unmatched risks in the insurer's activities.

(b) We agree with the requirement to make a liquidity adjustment to the discount rate as liquidity is one of the differences between an insurance contract liability and the assets that it is matched against.
(c) We support the Board's conclusion that the present value of fulfilment cash flows should not reflect the risk of non-performance by the insurer. The inclusion of own credit risk in the measurement of liabilities produces counter-intuitive accounting results, and is not relevant to the measurement of insurance liabilities on a fulfilment basis.

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.

Response:
We support the separate recognition of a risk adjustment and a residual margin rather than a single composite margin. We agree with the Board that a separate risk adjustment provides an explicit measurement of risk which provides useful and relevant information to users of the financial statements. The risk adjustment and residual margin are separate elements and therefore the benefits of presenting these separately will outweigh the costs of calculating this information in terms of the clarity of the information provided.

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?

Response:
(a) We 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. We agree with this approach because it represents the insurer's own assessment of the risk and therefore is consistent with the use of fulfilment cash flows in the measurement model.

(b) We agree that it is appropriate to limit the techniques available to insurers for calculating the risk adjustment in order to promote consistency and comparability between entities. However it would be preferable to articulate a general principle for the objective of the risk adjustment, with the three proposed techniques recommended as means of achieving this objective. This would allow an entity to use a different technique if it was more appropriate in achieving the objective.
(c) We are not convinced that the disclosure of the confidence level if the CTE or cost of capital method is used will provide useful information. The requirement for this disclosure may also influence entities towards using the confidence level method even if this is not the most appropriate technique in the circumstances.
(d) We agree the risk adjustment should be measured at the portfolio level, as all measurements should be made at the same level.
(e) We are happy with the level of detail of the application guidance in Appendix B.

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?

Response:
(a) We agree that an insurer should not recognise any gain at initial recognition of an insurance contract, as this is consistent with the fulfilment value measurement objective which depicts profit being earned over the coverage period.
(b) We agree that a loss at initial recognition should be recognised immediately in profit or loss – it would not be appropriate to spread the loss over the coverage period.
(c) The residual margin should be measured at the portfolio level in line with the other elements being measured.
(d) We agree with the proposed method of releasing the residual margin.

(e) As stated above, we do not support the composite margin approach and therefore do not support the proposed method of releasing this margin.
(f) We agree that interest should be accreted on the residual margin.

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)
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?

Response:
We agree that only incremental acquisition costs should be included in the initial measurement of the insurance contract and that all other acquisition costs should be recognised as expenses when incurred. This is consistent with the treatment of the transactions costs of financial instruments. However, we do not agree that incremental acquisition costs should be measured at the contract level – the level of measurement should be consistent across all elements therefore the portfolio level is appropriate.

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?

Response:
We understand that the insurance industry may favour flexibility in this area i.e. permit but not require. However, we are not convinced that the premium allocation approach represents a significant simplification in practice, and therefore if it is to be retained in the standard, we believe that further guidance is required on applying this approach.

Question 9 – Contract boundary principle
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?

Response:
We agree with the proposed boundary principle but we suspect that it may be difficult to apply in practice and more guidance may be required.

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?

Response:
(a) We agree that the measurement of insurance contracts should include participating benefits on an expected present value basis as these are part of the insurance contract.
(b) We think that financial instruments with discretionary participation features should be within the scope of the IFRS on insurance contracts to ensure consistent treatment with insurance contracts with similar features.
(c) We do not agree with the proposed new condition that investment contracts must participate in the same pool of assets – this restriction appears somewhat arbitrary and could cause problems in practice.
(d) We do not have any comments on paragraphs 64 and 65.

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?

Response:
We have no concerns with the definition and scope section.

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?

Response:
We are concerned that the added complexity necessitated by the requirement to unbundle some components of an insurance contract will not be justified by any improvement in the information that will be provided. We believe that further analysis of the impact of unbundling should be carried out before conclusions are reached.

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 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?

Response:
We agree with the proposed presentation requirements.

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.

Response:
We agree with the proposed presentation principle and requirements.

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?

Response:
We do not have any comments on the proposals on unit-linked contracts.

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?

Response:
We do not have any comments on reinsurance.

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.

Response:
We do not have any specific comments on transition and effective date, but we believe that implementing the new standard will require significant time and effort from insurers. Other demands on insurers such as the major changes to other IFRS and significant changes for European insurers arising from the implementation of the Solvency II Directive should be taken into account in planning the transition to the new standard.

Question 18 – Other comments
Do you have any other comments on the proposals in the exposure draft?

Response:
We have no other comments.

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.

Response:

We believe that this is an important project and that while there will be significant costs in implementing the new standard, these will be outweighed by the benefits in terms of the increased usefulness, consistency and comparability of financial reporting by insurers.