Accounting Standards Board

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30 November 2010

Dear Françoise

EFRAG DCL on IASB ED *Insurance Contracts*

This letter sets out the views of the UK Accounting Standards Board (ASB) on the EFRAG Draft Comment Letter (DCL) on the IASB Exposure Draft (ED) *Insurance Contracts*.

We attach a copy of our response to the IASB which sets out our views on the proposals in the IASB ED. On the concerns raised in the covering letter of the DCL:

- We agree with the concerns raised in the EFRAG DCL on the transition requirements in the IASB ED.

- However, we do not support the recalibration of the residual margin on subsequent measurement. Instead, we believe that the remeasurement of the risk adjustment in subsequent periods will offset the changes from the remeasurement of the present value of fulfilment cash flows that affect future periods leading to changes in the expected profitability of the insurance portfolio. As such, we cannot see the rationale for adjusting the residual margin as well as the risk adjustment to offset these changes. We also believe that in practice it may be difficult to recalibrate the residual margin and that it would be even more difficult to explain the changes therein to users.

- As you will note from our response to the IASB, we are concerned about the presentation requirements in the ED in relation to volume information.

However, given the changes in the measurement requirements proposed in the ED, we believe that further work is required to ensure the requirements in the final standard allay users' concerns in this area. We believe that the best way in which this information can be presented in the financial statements, without making them cluttered, should be considered during the field testing of this standard.

We have responded to the questions for constituents in the DCL in the appendix to this letter.

If you would like to discuss these comments, please contact Seema Jamil-O'Neill on 020 7492 2422 or myself on 020 7492 2422.

Yours sincerely

David Loweth

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Appendix: Comments on Requests for information in the DCL

Question on Page 10 of EFRAG DCL after paragraph 39 of Appendix 1

> The majority of members of EFRAG's Insurance Accounting Working Group (IAWG) supported the ED's proposal to consider the effects of liquidity in determining the discount rate when measuring an insurance contract. In their view, the risk-free rate does not faithfully represent the characteristics of the insurance contract.
>
> EFRAG would be particularly interested in understanding constituents' views on whether and why the effects of liquidity should or should not be considered when determining the discount rate to be used in measuring an insurance contract.

1. The ASB agrees with the IASB proposals that the discount rate should include the effects of liquidity. We believe that this would ensure that the resulting measurement reflects the fulfilment value of cash flows, which represents a current measurement but not necessarily the settlement value.

2. We believe that the requirement in the ED to include the expected present values of cash flows when measuring the insurance contract renders the measure as a current value. The inclusion of a measure for illiquidity in the discount rate then serves as an acknowledgement that for insurance contracts the insurer often has significant control over the terms for early extinguishment.

Question on Page 15 of EFRAG DCL after paragraph 62 of Appendix 1

> Do constituents think that confidence level information provides useful information or do constituents think that other disclosures could provide equal information?

3. The ASB does not agree with the requirement in the ED that the confidence level information be disclosed even if an entity has used one of the other two methods for calculating the risk adjustment. We believe that if an insurer chooses to use CTE or the cost of capital method in their risk adjustment calculation then it is more apt to require an explanation for why the chosen method was used together with the most relevant quantitative disclosures to those techniques.

Question on Page 19 of EFRAG DCL after paragraph 80 of Appendix 1

> With respect to accounting for changes in estimates we refer to Appendix 2, which provides a summary of possible accounting mismatches caused by the interaction between IFRS 9 and the proposals in the ED. EFRAG asks constituents' input on this issue.

4. The ASB's answers to the questions asked in Appendix 2 of the DCL are set out on page 7 of this letter.

5. The ASB disagrees with the EFRAG view that the residual margin should be adjusted to offset changes from the remeasurement of the present value of the fulfilment cashflows. This appears to be a solution devised to deal with the accounting mismatches that would arise in the financial statements of insurers that measure financial assets at amortised cost. We believe that the remeasurement of the risk adjustment in subsequent periods will offset the changes from the remeasurement of the present value of fulfilment cash flows that affect future periods leading to changes in the expected profitability of the insurance portfolio. As such, we cannot see the rationale for adjusting the residual margin as well as the risk adjustment to offset these changes.

6. We also believe that in practice it may be difficult to recalibrate the residual margin and that it would be even more difficult to explain the changes therein to users.

7. Furthermore, we understand that the requirements in Solvency II for measuring the financial liabilities are very similar to those in the ED with the exception that there is no concept of a residual margin, profit on inception is taken directly to retained earnings for regulatory purposes. An additional complication for preparers would be to develop a reconciliation item between the recalibrated residual margin subsequent to inception with the valuation of the insurance liabilities/equity under Solvency II.

Question on Page 28/29 of EFRAG DCL after paragraph 134 of Appendix 1

The ED proposes to exclude fixed fee service contracts from the scope of the standard if the primary purpose of the contract is the provision of services. EFRAG supports the Board's reasoning, however EFRAG does not find the criteria to assess whether or not a contract is in the scope of the standard to be clear enough.

Do you agree with the Board's intent that contracts whose primary purpose is the provision of services should be out of the scope of the standard, even if they meet the definition of the insurance contract?

Do you share EFRAG's concerns about the wording of the scope exclusion?

8. The ASB believes that this confusion arises from the proposed changes to the scope of the insurance contracts ED from that currently included in IFRS 4. The ASB believes that the current scope of IFRS 4 works well in practice and would recommend that the IASB retain it. For more details on our views on this issue we would refer you to the answer to question 11 in the appendix to our response to the IASB.

Question on Page 29 of EFRAG DCL paragraph 134 of Appendix 1

> The proposals in the ED will bring financial guarantee contracts that meet the definition of an insurance contract within the scope of the new insurance standard.
>
> Do you think there could be a reason to exclude financial guarantees from the scope of the insurance standard? Financial guarantees are currently in the scope of IAS 39, except for those contracts that are explicitly 'selected' and treated as insurance contracts. IAS 39 requires such contracts to be measured at the higher of the amount determined in accordance with IAS 37 and the initially recognised amount less cumulative amortisation.
>
> The proposed amendments to IAS 39 mean that a financial guarantee contract that does not meet the definition of an insurance contract should be measured as a derivative in accordance with IAS 39. Do you agree with these classification and measurement requirements?

9. The ASB acknowledges that a wide range of contracts are labelled financial guarantee contracts and that a number of such contracts take on insurance risk. However, we believe that credit risk is a financial risk and should be accounted for in accordance with the financial instruments standard. The ED does not make this distinction, although this is dealt with in paragraph B22 of Application guidance B which makes a distinction between certain types of credit guarantees without giving an overall principle for making such a distinction. We would recommend that the IASB base its principle on looking at the substance of the insurance contract: if the only risk in the contract is credit risk then it should be accounted for as a financial contract; however, if it consists of a bundle of different risks, one of which is credit risk, then it should be accounted for in accordance with the insurance contracts standard.

10. Aside from that, we would recommend that, regardless of the standard that deals with accounting for financial guarantees, a consistent approach is adopted for contracts offering risk protection of a similar nature.

Question on Page 31 of EFRAG DCL paragraph 140 of Appendix 1

> Do you agree that unbundling can enhance the usefulness of information by increasing transparency and comparability?
>
> Do you agree the underlying principle should be further clarified especially how the terms closely related and interdependent should be interpreted in the context of unbundling?
>
> Do you believe the guidance and examples in the ED change the current practice of unbundling?
>
> Do you think the way a product is structured and monitored may present an appropriate basis for deciding if components of the insurance contracts should be unbundled?

11. Please see the answer to question 11 in the appendix to our response to the IASB.

Question on Page 43 of EFRAG DCL paragraph 208 of Appendix 1

> We do not refer to a specific transition date as requested in question 17d.
>
> Can you provide an indication of the time needed for changing insurance processes and policies and implementing the new requirements?
>
> What is in your opinion a feasible transition date?

12. The ASB acknowledges that the European insurance industry is facing huge changes to its regulatory and accounting frameworks. Additionally, we acknowledge that the implementation of IFRS 9 will have a direct impact on insurer's financial statements. We believe that IASB must take these factors into account and permit a period of adjustment after the implementation of Solvency II before requiring implementation of Phase II of IFRS 4.

Question on Page 44 of EFRAG DCL paragraph 211 of Appendix 1

> In our response to question 17 we have stated that we believe IAS 8 should be required. IAS 8 requires retrospective application (unless impracticable). Could you provide an assessment of the benefits and costs of applying IAS 8?

13. We do not have a view on the costs of applying IAS 8. Please refer to our answer to question 17 in the appendix to our response to the IASB for our views on the benefits of retrospective application.

Question on Page 47 of EFRAG DCL paragraph 230 of Appendix 2

Do you consider that the IASB should address the interaction of IFRS 9 and the proposals in the ED? In particular:

(a) Do you agree with the view held by some insurers that they are unable to reflect their business model in the measurement of their financial assets and/or insurance liabilities?

(b) Do you think the IASB should address the accounting mismatch for insurers that measure financial assets at amortised cost? If so, how?

(c) Do you believe that the effect of changes in assumptions of financial and/or non-financial variables should be accounted for in the residual margin? How do you believe the IASB should address the resulting mismatch for insurers that account for financial assets at fair value?

(d) Do you think that the IASB should allow or require shadow accounting in the cases described in paragraph 18? Do you support the arguments presented by the IASB to reject shadow accounting? Please explain why or why not.

14. In principle, on (a) the ASB agrees with EFRAG that the interaction between the requirements in IFRS 9 and those in IFRS 4 will have a significant impact on some insurance companies. As such, we would support a pragmatic solution that enables entities to retain their business models to the extent possible without creating additional complexity in the model.

15. However, on (b) and (c) we also agree with the IASB that insurance accounting is currently regarded by users as a "black box" which creates great barriers in their understanding of the insurance financial statements. In particular, this leads to the cost of credit for insurance companies being higher than that for other comparable companies. We believe that the ED's proposals go some way to addressing the complexity inherent in insurance accounting and in so doing, remove some of the imbalances between information held by preparers and that provided to the users. As a result, we would not support any proposals that could lead to an increase in complexity or opacity of information provided in insurer's financial statements. Therefore, we would not support the recalibration of residual margin or the shadow accounting approaches proposed in the DCL which we view as highly complex and difficult to understand.

16. We do not believe that shadow accounting should be required in the ED. Although, we can see the arguments for its inclusion for some of the insurers with particular business models, we are concerned that its inclusion in the ED would lead to complexity that would not be easy for users to understand and preparer's to apply. Additionally, we believe that permitting shadow accounting would have a direct impact on the IASB's aim to enhance the comparability of financial statements prepared by insurance entities.

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30 November 2010

Dear Peter

IASB ED *Insurance Contracts*

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the IASB Exposure Draft (ED) *Insurance Contracts*.

The ASB agrees with the IASB that insurance accounting is currently viewed by many users as a 'black box' that does not provide relevant information about the insurer's financial position. As such, the ASB supports the IASB in its aim to provide a comprehensive framework that will enable insurance companies to provide relevant information to users of financial statements for economic decision making. We believe that the IASB's measurement model proposed in the ED goes a long way to providing just such a comprehensive and coherent framework. However, we recognise that there are some areas of detail that require further consideration by the IASB before a final standard is issued, although we do not believe that amendments to address those areas of detail would lead to significant changes in the model proposed in the ED.

Answers to the questions in the invitation to comment section of the ED are included in the appendix to this letter. The following are some concerns with aspects of the measurement model proposed in the ED which we believe would need to be addressed prior it being finalised.

1. We believe that the change proposed to the scope has led to confusion as to the types of contracts that should be within the scope of the ED (including financial guarantee contracts). We note that the existing scope of IFRS 4 has worked well in practice and would recommend that IASB make no changes to it. However, if the IASB decides to retain the scope exemptions in the ED we believe a clear explanation for the rationale behind these is required in order to avoid implementation problems on initial application (see more detail in the answer to question 11 in the appendix).

2. We suggest that the use of the modified measurement approach for short-duration contracts is permitted but not required. We believe that the modification itself is a concession for entities with short-duration contracts and that it should be up to the entities to decide whether it is appropriate for them to take up the concession. As such, to assist users in their understanding of the information included in the financial statements the disclosure requirements in the final standard should set out a requirement for entities to provide information on their rationale for adopting that model.

3. The ED prohibits insurers from presenting volume information on the face of the financial statements. The ASB understands that users are particularly concerned about the loss of volume information from the face of the insurer's income statement. They are concerned that the presentation approach in the standard would deprive them of vital information about the business undertaken by the insurer during the period. The ASB believes that more work is required to ensure that the requirements in the final standard allay users' concerns in this area. We believe that the best way in which this information can be presented in the financial statements, without making them cluttered, should be considered during the field testing of this standard. (see point 5 below).

4. We also draw you attention to the issues in relation to transition adjustments and the effective date for the final standard. Given the many regulatory and accounting changes faced by the insurance industry we would recommend that the IASB work closely with the insurance industry and users to ensure that a cost effective and smooth transition to the measurement model is achieved. In this respect, we would draw your attention in particular to the treatment of the residual margin in the insurer's extant portfolio on transition to the new standard, which will lead to the entire deferred profits in those portfolios being transferred to retained earnings. We believe this approach to transition disregards the long term nature of certain insurance contracts and will lead to future profits on those not being recognised. We would recommend that the IASB consider permitting other approaches to transition

5. We understand that the IASB is currently conducting some field testing in relation to the application of the requirements in the ED. We would recommend that the IASB considers the scope and sufficiency of such field testing to ensures that it deals with a wide range of business types and sizes.

We would also recommend that the IASB ensure that the results of the field testing are sufficiently transparent and made available to constituents. We believe that such an approach will ensure a smooth transition for the insurance industry as well as the users of financial statements as well as reducing any implementation problems (see more details in answers to question 17 in the appendix).

If you would like to discuss these comments, please contact Seema Jamil-O'Neill on 020 7492 2422.

Yours sincerely

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Appendix: Responses to questions in the IASB ED *Insurance Contracts*

Measurement

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?

ASB response:

1. The ASB agrees that the proposals in the ED represent an improvement in financial reporting of insurance contracts. In particular, we believe that the accounting and measurement proposals in the ED which provide similar treatment for life and non-life contracts will enhance the understandability and consistency of insurer's financial statements. We believe the ED's proposals make it easier for users to understand the insurer's financial position in the context of its business model and to compare it to those of other insurers.

2. We also believe that the inclusion of the explicit margins from the insurance contracts on the face of the statement of financial position will ensure that users have access to full information about the insurance entity's profitability. Although, we note there are concerns in relation to the appropriate disclosure of volume information that would need to be addressed before the IASB can finalise the standard. For more detail see our answer to question 13.

3. We also note that there are areas of detail where further consideration is required before the proposals can be issued as the final standard. We discuss some of these areas of detail together with some proposed solutions in the answers to the following questions.

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?*

ASB response:

4. The ASB agrees with the IASB that measurement of an insurance contract should include the expected present value of the future cash flows that will arise as the insurer fulfils the insurance contract. We also agree that the portfolio is the appropriate level of measurement for insurance contracts.

5. We note that the application guidance in Appendix B of the ED prescribes the use of several different levels of portfolios within the same measurements i.e. portfolios with "broadly similar risks" are prescribed for future cash flows, portfolios "at cohort level" are prescribed for the calculation of the residual margin whilst "the level of an individual insurance contract" is prescribed when considering the incremental acquisition costs to be included in the present value of cash flows. Conceptually, we believe that such inconsistency in the unit of account used for different aspects of the same measurement has the potential to confuse users. However, in view of the practical application of the requirements in this ED we agree with the IASB's proposed approach in this area. We would, however, recommend that the Board explain its rationale for moving away from the concept and prescribing these different units of account in the guidance to the final standard.

6. We believe further clarity is required here to ensure that preparers and users fully understand the concept of risk adjustment as meant by the IASB. One aspect of this is whether the ED is clear on whether there is an overlap between the risk adjustment and the uncertainty built into the probability-weighted fulfilment cash flows. We note that per paragraph 35 of the ED

> "The risk adjustment shall be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected."

7. However, per Appendix B paragraph B68

> "The risk adjustment *conveys information to users of financial statements about the effects of uncertainty about the amount and timing of the cash flows arising from an insurance contract*. [emphasis added] To achieve this, paragraph 35 requires that the risk adjustment shall be the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected."

8. However, we wonder whether probability-weighted fulfilment cash flows by definition build in the effects of uncertainty about the amount and timing of the cash flows arising from the insurance contracts. It certainly appears that the list of relevant cash flows included in paragraph B61 is extensive and includes many items e.g. cash flows from options and guarantees embedded in the contract that would incorporate such uncertainty.

9. If this is the case, then the additional building block in the liability measurement, the risk adjustment, will as a minimum overlap with the uncertainty built into the probability-weighted cash flows. At various junctures in Appendix B it is apparent that the IASB is aware of this potential confusion e.g paragraph B71 states that "care is needed to avoid duplicating adjustments for risk". However, this has not been fully addressed in the application guidance or the basis for conclusions to the ED.

10. We infer from the above that, in purely numerical terms the risk adjustment gives a measure of the range that exists around the probability-weighted fulfilment cash flows amount to be included in the financial statements. We believe this concept of the range should be clarified in the application guidance as it will ensure non-insurers are able to fully gauge the rationale for the risk adjustment.

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?

ASB response:

11. The ASB is aware of concerns raised by preparers and users about what the IASB means when it stipulates that the discount rate used should be "consistent with observable current market prices" whilst reflecting the characteristics of the insurance contract liability. Some users are concerned that this can incorporate a wide range of discount rates freely available in the market e.g. observable market prices for corporate or government bonds, spot or swap rates could all be considered consistent with the insurance liability by different entities. Such users would like to see further guidance on what may be considered appropriate discount rates in different circumstances without requiring one or the other. We would also add that, in accordance with paragraph 90 of the ED, clear disclosures by the preparer about the discount rate it chooses to use, its rationale for using it for the particular insurance liability and the impact on the measurement of any changes in it would ensure that the information provided to the users conveys the impact of the discount rate used.

12. The ASB agrees with the IASB proposals that the discount rate should include the effects of liquidity. We believe that this would ensure that the resulting measurement reflects the fulfilment value of cash flows, which represents a current measurement but not necessarily the settlement value.

13. We believe that the requirement in the ED to include the expected present values of cash flows when measuring the insurance contract renders the measure as a current value. The inclusion of a measure for illiquidity in the

discount rate then serves as an acknowledgement that for insurance contracts the insurer often has significant control over the terms for early extinguishment.

14. The ASB does not believe that the fulfilment cash flows should reflect the risk of non-performance by the insurer. In research conducted by the IASB on the inclusion of own credit risk in the fair value measurement of financial liabilities, users were clear that the impact changes in own credit risk should not be reflected in the income statement as it is not relevant to the users' understanding of whether the entity is able to fulfil its liabilities. We suggest that the IASB maintain a consistent approach on accounting for the risk of non-performance on an entity's own liabilities regardless of whether they are insurance and financial in nature.

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.

ASB response:

15. The ASB favours the separate recognition of a risk adjustment and a residual margin as outlined in the ED. We believe that such a separation provides a clearer insight into the core activity of an insurer as well as being conceptually consistent with the market valuation of financial instruments and their pricing. We also believe that a separation of the risk adjustment and the residual margin would ensure that users of financial statements are provided with relevant and useful disaggregation of the financial information about the performance of an entity's insurance portfolios.

16. We would not favour a composite margin as it would require the entire composite to be a fixed allocation at the inception of the contract which would then be released over time in accordance with the release pattern. We believe that this approach would not permit any changes in the risk profile of an insurer's portfolio to be reflected through its income statement. Given the nature of the insurance business and the, at time significant, risks taken it does not seem appropriate that changes in these risks should not be reflected in the ongoing valuation.

17. Having said that we would refer you to our answer to question 2 in relation to the IASB's definition of risk adjustment.

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 (ie 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?*

ASB response:

18. The ASB agrees with the definition of risk adjustment in (a) above.

19. The ASB would recommend that rather than mandating the choice of techniques for estimating risk adjustment the IASB should just state the principle (as in paragraph 35) and leave the preparers to decide on the most appropriate technique. We understand that currently there are only three techniques available for this purpose as set out in the ED. However, mandating those three in the standard would mean that future development in this area would lead to the need for changes to the standard. We also note, from our outreach to users that they want the choices of such techniques to be clearly spelt out to ensure consistency and comparability of financial information in this area. We believe that as long as the preparer is required to clearly disclose the method it uses and justify its adequacy in the context of its business model the user's concerns about consistency and comparability will be allayed.

20. The ASB does not agree with the requirement in the ED that the confidence level information be disclosed even if an entity has used one of the other two methods for calculating the risk adjustment. We believe that if an insurer chooses to use CTE or the cost of capital method in their risk adjustment calculation then it is more apt to require an explanation for why the chosen method was used together with the most relevant quantitative disclosures to those techniques.

21. The ASB agrees that the portfolio level is a meaningful level of aggregation when calculating the risk adjustment. The ASB does not see merit in taking the diversification between portfolios into account in the calculation as such an approach would impact the comparability of the financial statements of the insurer. However, if management view such an effect to be significant to the financial position or income statement of the insurer then it should be permitted to make disclosures that set out the over all impact and how it may affect the insurer's future profitability or financial position.

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?

ASB response:

22. The ASB agrees with the proposals in the ED that any gain at initial recognition should be deferred as residual margin and released on the basis of contract fulfilment or coverage period. The ASB believes that realisation of the profit element is uncertain and will only be determined by the fulfilment of the contract over the coverage provided. As such, it seems an appropriate period over which the profit on inception should be released.

23. The ASB believes that a loss on inception of an insurance contract has informational value for the investor on the ability of an insurance company to generate positive cash flows on an ongoing basis. As a result, we agree with the IASB that such a loss on inception should be recognised immediately in the income statement.

24. The ASB believes that the unit of account for the residual margin should be at the portfolio level. We note that the ED requires residual margin to be released at a cohort level and that makes it inconsistent with the requirements for the other building blocks e.g. risk adjustment. We would refer you to our answer in question 2 on this particular issue.

25. However, the ASB would like to understand the IASB's view on the impact on the residual margin in the event that an insurance contract becomes materially less profitable or even loss making subsequent to inception. We are aware that some constituents would like to see a recalibration of the residual margin on subsequent remeasurement with any changes in the assumption to be taken through OCI. We are unclear whether per the ED's requirements it would be appropriate to release the residual margin to the extent that it covers a subsequent expected loss on the insurance contract. We believe this issue is linked to that about IASB's view of function of the risk adjustment (see answer to question 5 above) and requires further clarification.

26. The residual margin represents the difference between the premium and the expected present value of the claims plus risk adjustments. The ASB understands that the accretion of interest has an impact on profit recognition patterns for long duration contracts. However, given that the nature of the residual margin is that of deferred profit, we do not believe that accreting interest on it is conceptually valid and, since it merely grosses up two items in the income statement, does not provide meaningful information to the user.

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

(a) *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?*

ASB response:

27. The ASB agrees with the proposed approach on incorporating incremental acquisition costs in the initial measurement of the insurance liabilities.

Short-Duration Contracts
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?

ASB response:

28. Although the ASB agrees that the modified measurement approach is a reasonable proxy for the measurement of pre-claims liability arising from short-duration contracts we do not recommend that the IASB require its use. Instead, we would suggest that the measurement model is permitted as an option for those entities that would like to take advantage of it and fulfil the required criteria, i.e. contracts with a coverage period of one-year or less. So permitting would also ensure that entities that want to use the main measurement model in the ED for all their contracts, including the short-duration ones, are also permitted to do so. If the IASB were to permit the modified measurement approach then we would advise that it requires that entities clearly and prominently disclose the methodology used in their financial statements.

Cash Flows that Arise from Future Premiums
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? If not, what would you recommend and why?

ASB response:

29. The ASB agrees with the principle of contract boundary included in the ED and has seen no evidence to lead it to believe that insurers would not be able to apply it consistently in practice.

Participating Features
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?*

ASB response:

30. The ASB believes that liabilities with discretionary participation features (DPF) need to be considered in the context of the equity and liability project. However, as that project is not currently on the IASB's active agenda we believe that the proposals in the ED represent a pragmatic interim solution. In that context, the ASB agrees that the liability for DPF should be measured on an expected present value basis. We believe this measurement approach is adequate to reflects some of the key features of such contracts e.g. cash flows arising from DPF being subject to uncertainty attached to the inherent risks.

31. The ASB also believes that all financial instruments with DPF should be treated consistently across IFRS regardless of whether they are within the scope of the financial instruments or the insurance contracts standards.

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?*

ASB response:

32. The ASB believes that confusion arises from the proposed changes to the scope of the insurance contracts ED from that currently included in IFRS 4. We believe that the current scope of IFRS 4 works well in practice and would recommend that the IASB retain it. However, if the IASB decides to retain the scope exemptions in the ED we believe a clear explanation for the rationale behind these is required in order to avoid implementation problems on initial application. We include some examples of problematic scope exemptions in the paragraphs below.

33. A number of ASB's constituents are concerned that the proposed scope of insurance contracts in the ED is inconsistently applied. In particular, these constituents are concerned that certain service contracts that appear to meet the definition of an insurance contract have been specifically excluded from the scope of the ED (e.g. fixed fee contracts) whilst financial instruments with discretionary participation features which do not at first sight meet that definition have been included in the scope. We believe that this lack of clarity in why certain items are excluded from the scope will lead to implementation problems on initial application of the standard.

34. The ASB acknowledges that a wide range of contracts are labelled financial guarantee contracts and that a number of such contracts take on insurance risk. However, we believe that credit risk is a financial risk and should be accounted for in accordance with the financial instruments standard. The ED does not make this distinction, although this is dealt with in paragraph B22 of Application guidance B which makes a distinction between certain types of credit guarantees without giving an overall principle for making such a distinction. We would recommend that the IASB base its principle on looking at the substance of the insurance contract: if the only risk in the contract is credit risk then it should be accounted for as a financial contract; however, if it consists of a bundle of different risks, one of which is credit risk, then it should be accounted for in accordance with the insurance contracts standard.

35. Aside from that, we would recommend that, regardless of the standard that deals with accounting for financial guarantees, a consistent approach is adopted for contracts offering risk protection of a similar nature.

36. We are also concerned about the exclusion of unallocated inherited estate arising from mutual and with-profits business from the scope of the draft standard. We believe that the nature and size of such estates is significant and arises from previous insurance business. We understand that this is not an isolated UK issue but that insurance companies in other countries such as Germany and Sweden have similar businesses with large inherited estates. We would suggest that consideration needs to be given as to how to account for such estates on transition if the IASB is to ensure that the final standard is applied consistently.

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?

ASB response:

37. The ASB agrees with the concept of unbundling on the basis that components are not "closely related" to the insurance contract and the provision of

insurance are separated accounted for in accordance with other, more relevant IFRS. This concept is applicable in other IFRSs such as IAS 39 where it is applied to embedded derivatives.

38. We are however, aware that a number of preparers are concerned with the applicability of the concept in the context of insurance contracts and raise questions in relation to the level of guidance in this area. We also understand that such a separation of components is not required under Solvency II. We would therefore recommend that IASB provide more clarity around the concept of what it considers to be “closely related” in the context of insurance liabilities.

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?*

ASB response:

39. We note that the proposed presentation for both the statement of financial position and income statement are based on the measurement model in the ED’s. The summarised margin information represents the financial position and income/expense for the current period based on the measurement model and represents the most relevant information for users on the profitability of the insurance contracts accounted for under this model.

40. The ED prohibits insurers from presenting volume information on the face of the financial statements. The ASB understands that users are particularly concerned about the loss of volume information from the face of the insurer’s income statement. They are concerned that the presentation approach in the standard would deprive them of vital information about the business undertaken by the insurer during the period. The ASB believes that more work is required to ensure the requirements in the final standard allay users’ concerns in this area. A good place to consider the different ways in which this information can be presented in the financial statements may be in the field testing of the standard.

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.

ASB response:

41. The ASB agrees with the disclosure principle and the disclosure requirements in the ED. Although we would reiterate our concerns raised in the answer to question 5 with the disclosure requirements in the ED in relation to the risk adjustment.

42. We also note that given the nature of the measurement model it is important that both quantitative and qualitative information about the inputs and assumptions used in the model is provided to make the information useful and understandable for the users. Similar information about inputs and assumptions is currently required in other areas such as accounting for pensions. As such, the practicability clause in paragraph 90(a) in relation to quantitative information about the inputs used appears redundant.

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?

ASB response:

43. The ASB agrees that assets and liabilities of unit-linked contracts as well as the income or expense from such contracts should be presented as separate line items on the face of the financial statements and not commingled with other insurance assets and liabilities. We believe that the nature of the asset risk in such contracts is different from the majority of insurance contracts and so merits separate presentation on the face of the financial statements.

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?*

ASB response:

44. The ASB agrees that an expected loss model should be used when accounting for reinsurance assets. In accordance with the discussion in the basis for conclusions for the ED, paragraphs BC230-BC241, we do not believe that de-risking through reinsurance means derecognition of the position by the insurer or the realisation of profits on that contract as the insurer itself continues to be responsible for fulfilling the liabilities. We, therefore, agree with the IASB that accounting for reinsurance assets should be fully aligned with that for insurance contracts to ensure any structuring possibilities are avoided i.e. no netting off against the reinsurance contract to generate net profits 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.*

ASB response:

45. The ASB disagrees with the treatment of residual margin on transition that is proposed in paragraph 100 of the ED. We understand that on transition this approach will lead to the entire deferred profits in the portfolios held at that date to be booked into retained earnings. We believe this approach to transition disregards the long term nature of certain insurance contracts and will lead to future profits on those not being recognised. We would recommend that the IASB considers and or permits other approaches to transition e.g. permitting retrospective application of the measurement model to the transition portfolio.

46. We would also refer you to the transitional issues in relation to inherited estate noted in the answer to question 11.

47. Given that insurance companies hold large numbers of financial assets which are currently accounted for in accordance with IAS 39, replacement of that standard has a significant impact on insurance companies' financial statements. In view of this, we would recommend that the IASB consider the effective date for IFRS 9, the replacement standard for IAS 39, and that for IFRS 4 Phase II in context of the IASB's October 2010 consultation on effective dates. We also note that the European insurance industry is facing a significant level of change in the coming years (i.e. the introduction of Solvency II) and would advise the IASB to be mindful of the additional operational burden on both preparers and users when setting the effective date for the final standard.

Question 18 – Other comments

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

ASB response:

48. No.

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.

ASB response:

49. The ASB agrees with the IASB's assessment of the benefits and costs of the proposed accounting for insurance contracts. In particular, we note that there are a number of benefits to users of insurance companies' financial statements in that the new standard will enhance the consistency, comparability and understandability of the information included in those statements.