

November 30, 2010

International Accounting Standards Board
30 Cannon Street,
London EC4M 6XH
United Kingdom

Dear Sirs

Re: Insurance Contracts

This letter is the response of the Canadian Accounting Standards Board ('AcSB') to the International Accounting Standards Board's Exposure Draft *Insurance Contracts* dated July 2010.

The staff of the AcSB discussed some aspects of the proposals with the AcSB's User Advisory Council and Academic Advisory Council, and the full proposals in-depth with the AcSB's Insurance Accounting Task Force. Given the specialized nature of the Exposure Draft, the AcSB sought the Task Force's advice on the applicability of the proposals to Canadian entities. The Task Force comprises a diverse group of professionals with in-depth knowledge of insurance issues and includes auditors, preparers, actuaries and users:

- Phil Arthur, retired partner of Ernst & Young LLP (Chair)
- Mark Causevic, Director, Accounting Policy Division, Office of the Superintendent of Financial Institutions Canada (observer)
- John Craven, Principal, Craven Consulting Group
- Helmut Engels, Director, Actuarial Division, Office of the Superintendent of Financial Institutions Canada (observer)

- Richard Gauthier, Partner, PwC LLP
- Alex Guertin, Senior Vice President & Chief Financial Officer, Europe, The Canada Life Assurance Company
- Neil Harrison, Partner, National IFRS Insurance Leader, Deloitte & Touche LLP
- Doug Hogan, Senior Vice President & Chief Financial Officer, The Dominion of Canada General Insurance Company
- Tom MacKinnon, Analyst, BMO Nesbitt Burns Inc.
- Doug McPhie, Partner, Ernst & Young LLP
- Patricia O'Malley, Senior Advisor to the AcSB
- Neil Parkinson, Partner, National Insurance Sector Leader, KPMG LLP
- Dave Pelletier, Chair, Actuarial Standards Board
- Noeline Simon, Vice President, International Financial Reporting Standards, Sun Life Financial Inc.
- Lynda Sullivan, Executive Vice President & Controller, Manulife Financial Corporation
- Philippe Thieren, Partner, PwC LLP.

In developing the views expressed in this letter, the AcSB considered the comments and perspectives raised by these stakeholders. However, the views do not necessarily reflect those of the stakeholders we consulted or represent a common view of the AcSB, its Committees or staff. Views of the AcSB are only developed through due process.

We commend and strongly support the IASB in its effort to develop a comprehensive standard on the accounting for insurance contracts.

One high quality standard applied globally

Given the global nature of the insurance industry and the number of years and amount of effort that has been invested to develop a comprehensive standard, we think the result must be an accounting standard for insurance contracts that is of high quality and applied around the world.

Within the 120 day comment period provided, stakeholders have worked hard to understand and develop thoughtful comments on the proposed accounting model for insurance contracts. We think it is imperative that the IASB respond to requests for clarification and additional guidance.

In developing a new model, it is essential that the concepts are fully thought through and that sufficient guidance is provided on all aspects of the model. Testing the thoroughness of the guidance, including conducting field tests, is critical to ensuring that the standard is of high quality and can be consistently applied across jurisdictions. Taking the time needed to develop such a standard would avoid having to make multiple improvements or provide interpretations in the future.

We think the IASB and the FASB must issue identical standards on insurance contracts. Major financial institutions that sell insurance products compete and raise capital globally.

Comparisons are not possible if their financial statements are prepared using different accounting standards. We recognize that the FASB has yet to issue an exposure draft of a new insurance contracts standard and, as a result, further changes may need to be considered by the FASB and the IASB. We think the IASB should take the time to consider all the comments received thoroughly. Such actions would increase the acceptance of the final standard.

We note that the G20 has called on the Boards to produce common high quality standards in several areas to respond to the global financial crisis. In our view, achievement of this critical primary objective should not be jeopardized by attempting to meet unrealistic deadlines. We see no risk that the project would not be completed on a timely basis simply because the Boards are responding to important issues identified by constituents. Reconsidering issues in the light of the comments received is fundamental to established due process.

Therefore, we strongly recommend that the IASB and the FASB give the highest priority to taking the time to deliberate constituents' comments fully, resolving the differences between their approaches, and developing a common and high quality standard.

Proposed building block approach

We fundamentally agree with the building block approach proposed in the Exposure Draft for determining a current measurement of insurance contracts, except for one aspect of the “time value of money” building block. Therefore, in assessing the advantages of the measurement model compared to its disadvantages, we continue to support and encourage the IASB to complete this accounting standard based on the proposed building block approach.

We strongly agree with using a current measurement because of the high degree of uncertainty in estimating the amount and timing of the cash flows to fulfill insurance obligations. Requiring an insurer to update its cash flow estimates and adjustments for risk at each reporting date will provide a faithful representation of its liabilities and timely recognition of changes in its expectations. Canadian insurers have been accounting for insurance contracts successfully for almost twenty years using a measurement model that is similar to the proposed building block approach. Based on that experience, we know that the model can be applied practically and can provide decision useful information to financial statement users.

Discount rate proposal

Though we support including the “time value of money” building block, we most strongly disagree with the rate proposed to convert the future cash flows into a current amount. We think that using a risk-free interest rate adjusted for illiquidity to discount insurance liabilities is inappropriate for several reasons, both theoretical and practical. Our most important reason is that the resulting volatility in earnings would make financial statements ‘irrelevant’ to users because that volatility arise from accounting measurements not the economic phenomena of insurance activities. Instead, the financial statement users we consulted said they would be forced to rely on non-GAAP financial information.

From talking with stakeholders in Japan, the United States and Europe, we understand that the discount rate proposal has become the most important and most contentious element of the proposals world-wide. Therefore, we urge the IASB to reconsider the discount rate proposal in order to provide decision useful information to financial statements users. If a credible solution is not developed, we are very concerned that the resulting standard would not be of high quality.

To help, we have developed an alternative discount rate proposal that we think meets the IASB’s project criteria. It is set out in Appendix A. Key aspects of the proposal are summarized below.

First, we recommend that the discount rate proposal be revised to require an insurer to discount its insurance liabilities by reference to market rates on high quality corporate bonds and, in countries where there is no deep market for such bonds, the market yields on government bonds (a risk-free rate). Using an ‘asset independent’ or market benchmark discount rate would result

in including compensation for bearing the risk of sector credit spread (a risk specific to the liability for that class of borrower in the market) and would avoid the practical challenges of determining an adjustment for illiquidity that faithfully represents that risk.

Second, we recommend a two-step approach for reporting the interest cost on insurance liabilities, as follows:

- (a) In profit or loss, an insurer would report the effect of discounting insurance liabilities using the long-term rate the insurer expects to earn on its investments (i.e., a rate determined based on a probability-weighted estimate of the net cash inflows that it expects to earn on its investments, net of expected defaults/losses, and including a risk adjustment).
- (b) In other comprehensive income, an insurer would report the change in the difference between discounting the liability using the current market observable rate (i.e., a high quality corporate rate) and the long-term expected rate of return on investments.

Although this approach would be more complex than using one discount rate as proposed in the Exposure Draft, insurers would not have to change the basic valuation model but rerun it with a different discount rate. This added complexity is offset by the advantages of this approach because it would:

- (a) result in measuring assets and liabilities at consistent current measurements on the statement of financial position;
- (b) reflect the insurer's business model in profit or loss, as well as providing a measure comparing the insurer to current market expectations in other comprehensive income;
- (c) not create an accounting mismatch in profit or loss;
- (d) improve the transparency of financial reporting by insurers by providing information about asset management performance separately from information about underwriting performance; and
- (e) not require any amendment to IFRS 9 *Financial Instruments*.

We think the proposal would provide more relevant information to financial statements users by reporting the key risk exposures arising from insurance activities.

We are willing to provide the IASB with any additional assistance we can in conducting further needed research and analysis to develop a revised discount rate requirement.

Our responses to the questions set out in the Exposure Draft are included in Appendix B.

We would be pleased to elaborate on any of our comments in more detail if you require. If so, please contact Peter Martin, Director, Accounting Standards at +1 416 204-3276 (e-mail peter.martin@cica.ca) or Rebecca Villmann, Principal, Accounting Standards at +1 416 204-3464 (e-mail rebecca.villmann@cica.ca).

Yours truly,

A handwritten signature in cursive script that reads "G. C. Fowler".

Gordon Fowler, FCA

Chair,

Canadian Accounting Standards Board

APPENDIX A

Alternative discount rate proposal:

Two views that drive the selection of a discount rate

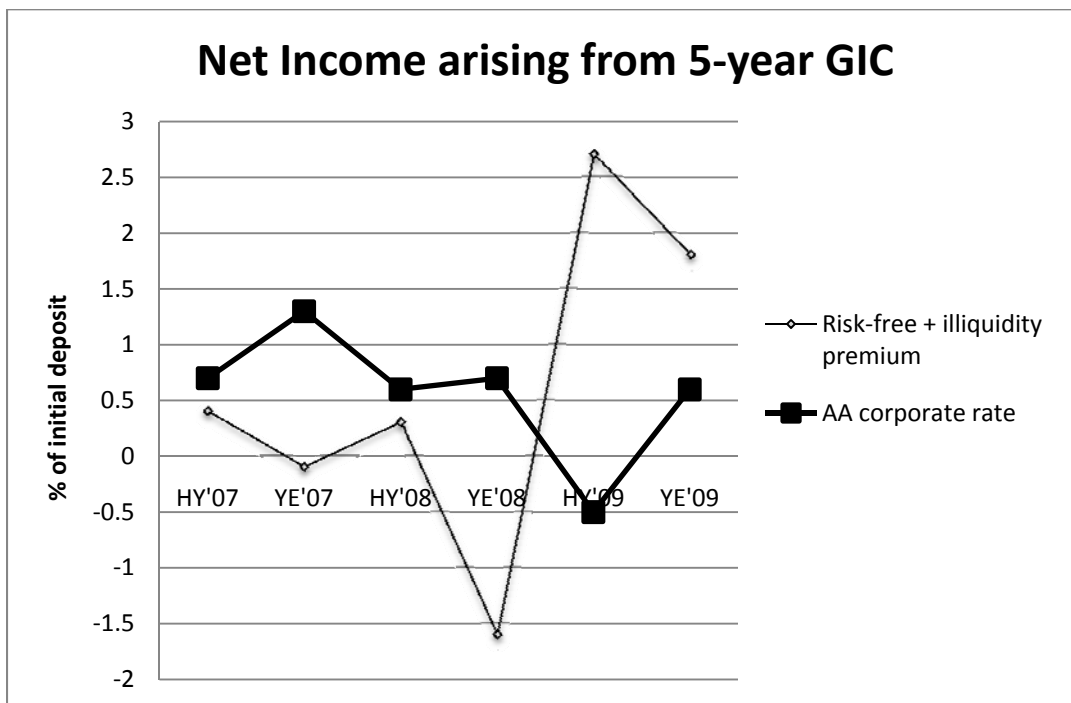
Reporting insurers' exposure to risks

- A1. Users of insurers' financial statements want to evaluate two key exposures.
- A2. One exposure relates to the asset investment risk, that is, whether the income earned on assets held exceeds or is less than the rate the insurer expects to earn or the rate the market would demand. An insurer's business model is based on using investment cash flows from assets to reduce the price (premium) it charges its customers and to pay its liabilities when they fall due. Any shortfall in or excess returns will affect the profitability of an insurer and its ability to satisfy those liabilities.
- A3. The other exposure relates to the risk of underwriting insurance liabilities, that is, the risks an insurer assumes when providing insurance coverage for a premium. Though insurers have developed sophisticated methods for estimating the amounts and timing of claims and payments, and the risks associated with those estimates, uncertainty remains as to the timing and, in some cases, the amount that will ultimately be paid.
- A4. Given the long-term nature of many insurance liabilities, assessing an insurer's ability to manage both these exposures is important. Thus, we evaluated the Exposure Draft proposals on the discount rate for insurance liabilities and financial statement presentation based on the ability of users to assess these exposures.
- A5. In selecting the measurement model, the Basis for Conclusions states that the IASB thinks that the proposals would produce more relevant information for users of an insurer's financial statements because they provide:
- (a) "clear reporting of economic mismatches that occur when insurance liabilities and related assets respond differently to the same changes in economic circumstances"; and

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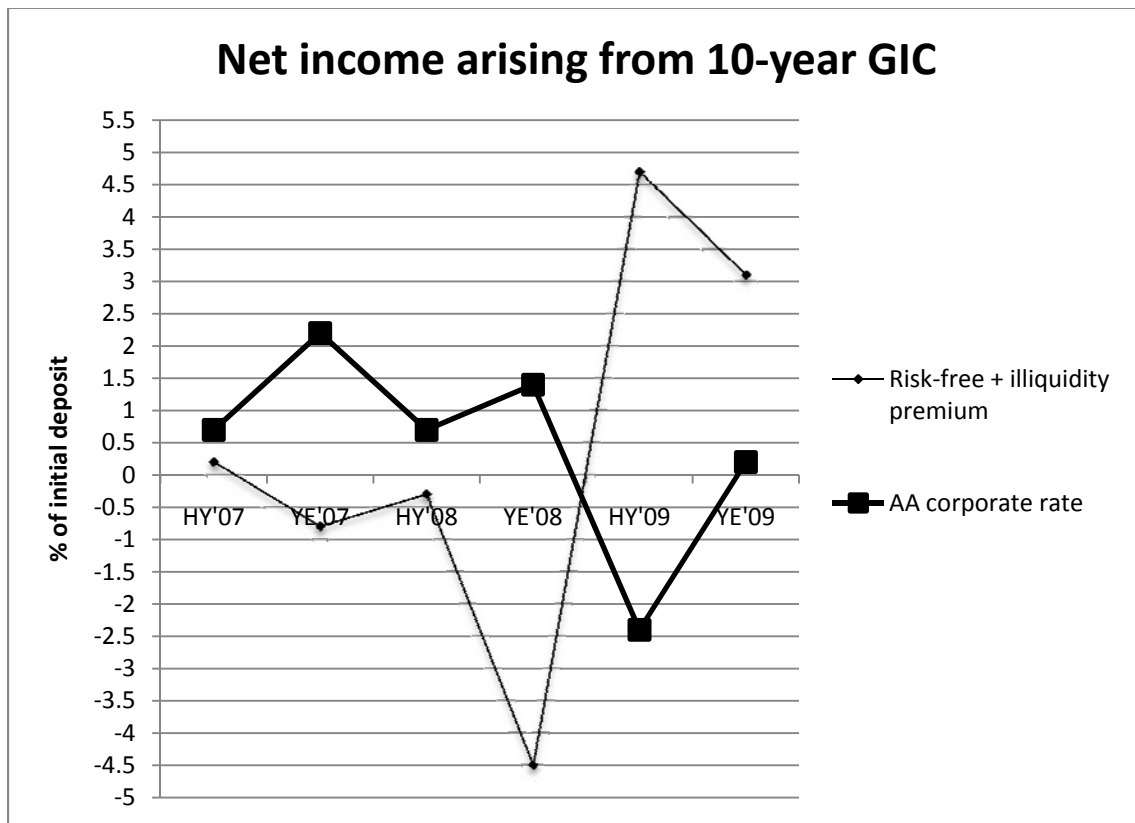
- (b) “a reduction in accounting mismatches that arises [sic] if changes in economic conditions affect assets and liabilities equally, but the accounting requirements do not adjust the carrying amounts of those assets and liabilities equally in response to those economic changes” (paragraph BC44).

- A6. To evaluate whether the proposals eliminate accounting mismatches that arise today because assets reflect current market rates, the Insurance Accounting Task Force developed the following simple example. The example illustrates the net income that would be reported by an entity holding an AA corporate bond asset and a guaranteed investment certificate liability. The cash flows on the investment perfectly match the cash flows on the liability. The example uses a simple GIC as the “insurance liability” rather than an actual insurance contract to eliminate all the complicating factors and focus attention on the accounting mismatch created by the differing measurement requirements for the asset and the liability.
- A7. In both cases, the bond asset is measured at fair value. The GIC liability in one case is measured at the risk-free rate adjusted for illiquidity in accordance with the Exposure Draft proposal. In the other case, it is measured at an AA corporate rate. The actual rates and spreads for the periods indicated were used.



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- A8. The simple example above demonstrates that, although the cash flows are perfectly matched (and the characteristics of the asset and the liability are the same), net income using a risk-free rate adjusted for illiquidity, as proposed in the Exposure Draft, would vary from a negative 1.6 to a positive 2.7 over a three year period. The volatility is reduced when a high quality corporate bond rate is used for the liability because it includes default risk for that class of issuer in the market (i.e., sector credit spread) and that risk matches that of the asset.
- A9. When a ten-year GIC is used in the example, the Task Force noted that these differences became more pronounced (ranging from negative 4.5 to positive 4.7 over the same three year period).



- A10. The rates used in the examples are based on observed market rates from 2008 and 2009 and reflect the volatility experienced during a time of economic crisis. Although some may assert that the resulting volatility is unrepresentative, such volatility occurs with distressing regularity. Insurers experienced such challenges in the 1980s and 1990s, for

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example, and they will likely occur again. Thus, the effect of such volatilities must be considered in developing an insurance standard.

A11. Such differences would be difficult to explain to financial statements users, especially when the cash flows are perfectly matched. The Task Force thinks these examples illustrate clearly that reported financial statement volatility of matched cash flows increases in direct proportion to the duration of the contracts. Highlighting this effect of the proposals is important because the Canadian industry believes that longer duration non-participating life insurance contracts are more common in North America than in other parts of the world.

A12. To reflect economic mismatches when they occur and not create an accounting mismatch, the rest of the appendix proposes using two discount rates to:

- (a) measure assets and liabilities at consistent current measurements that reflect all risks specific to the liability on the statement of financial position; and
- (b) reflect the insurer's business model by using an expected rate of return in profit or loss, as well as providing a measure comparing the insurer to current market expectations in other comprehensive income;

(1) Current market rate - Reflect risks specific to liability

A13. In Canada, insurers have included provisions for expected and unexpected defaults and losses on invested assets, the asset-liability mismatch and re-investment risks, as well as risk adjustments on those provisions, in the measurement of insurance liabilities. For liabilities that are not contractually linked to specific assets, i.e., the specific assets are not legally being held to satisfy the liability, an insurer can choose which assets to invest in and how they will be used to fulfill its liabilities. The investment loss, asset-liability mismatch and re-investments risks associated with these assets and insurance liabilities are business risks of an insurer. Although these risks can be significant, they are not characteristics of the liability. Thus, we have sympathy with the Exposure Draft proposal to prohibit including those risks in the measurement of insurance liabilities.

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- A14. However, we think that using the discount rate specified in the Exposure Draft (a risk-free rate plus an illiquidity adjustment) is inappropriate because it does not reflect the risk specific to the liability. Most importantly, the risk of sector credit spread is excluded.
- A15. Several members of the AcSB's User Advisory Council strongly agree with including credit risk in liability measurements and stated clearly that they would not support a present value measurement that did not include non-performance risk. Reflecting the sector credit risk in the measurement of insurance liabilities would be consistent with measuring an insurer's assets at a current market value that includes non-performance risk and would provide a more consistent basis for evaluating the performance of an insurer. Omitting the sector credit risk creates an accounting mismatch.
- A16. The IASB issued the Discussion Paper *Credit Risk in Liability Measurement* (the Credit Risk DP) to solicit views on including credit risk when measuring liabilities. Almost all respondents to the Credit Risk DP objected to including the effects of changes in credit risk in profit or loss. In soliciting those views, we note that the Credit Risk DP did not specifically seek views on whether sector credit spread or all components of credit risk should be excluded from liability measurements. In considering the views of respondents who do not support the inclusion of credit risk, we do not know whether they would object to including a sector credit spread and changes in that spread. We note that some of the controversy surrounding the effects of including credit risk factors in remeasuring financial liabilities periodically has focused on the counter-intuitive results of entities reporting gains as their own creditworthiness declined. On this basis, we think the IASB should reconsider the issue of credit risk in liability measurements and not base the choice of a discount rate for insurance contracts solely on the responses to the Credit Risk DP.
- A17. In explaining why credit risk should not be included in some liability measurements, many note that there are important differences between financial liabilities and non-financial liabilities. Paragraphs 23 and 24 of the Credit Risk DP outline the major differences between the two including, for non-financial liabilities:

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- (a) the absence of an exchange transaction that establishes the liability on initial recognition, and
- (b) the possible absence of an individual counterparty.

A18. We note that an insurance contract is established by an exchange transaction between an insurer and the policyholder, the counterparty. Although there may be no observable market price for an insurance obligation, an insurer will fulfill the obligation by providing risk protection and paying claims, if any, to the policyholder or the beneficiary. Thus, an insurance obligation is a financial liability and does not have the attributes identified in the preceding paragraph.

A19. Including credit risk or compensation for the risk of sector spread in the discount rate for insurance contracts would be consistent with other IFRS. For instance, under the existing and proposed lease standards, a lessee is to determine the discount rate for measuring a capitalized lease obligation as either the interest rate implicit in the lease, if available, or its incremental borrowing rate. Both rates, by definition, include the lessee's credit risk.

A20. The analysis of the responses received on the Credit Risk DP noted that respondents commented on the difficulties of separating out the credit risk, especially in the case of non-financial liabilities when there was no observable market price. Although there is no market price for employee benefit obligations, IAS 19 *Post-employment Benefits* requires an entity to determine the present value of its employee benefit obligations, discounted using a rate "determined by reference to market yields...on high quality corporate bonds. ...*The discount rate reflects the time value of money but not the actuarial risk or investment risk.* Furthermore, the discount rate does not reflect *the entity-specific credit risk borne by the entity's creditors*" (paragraphs 78 and 79, with emphasis added).

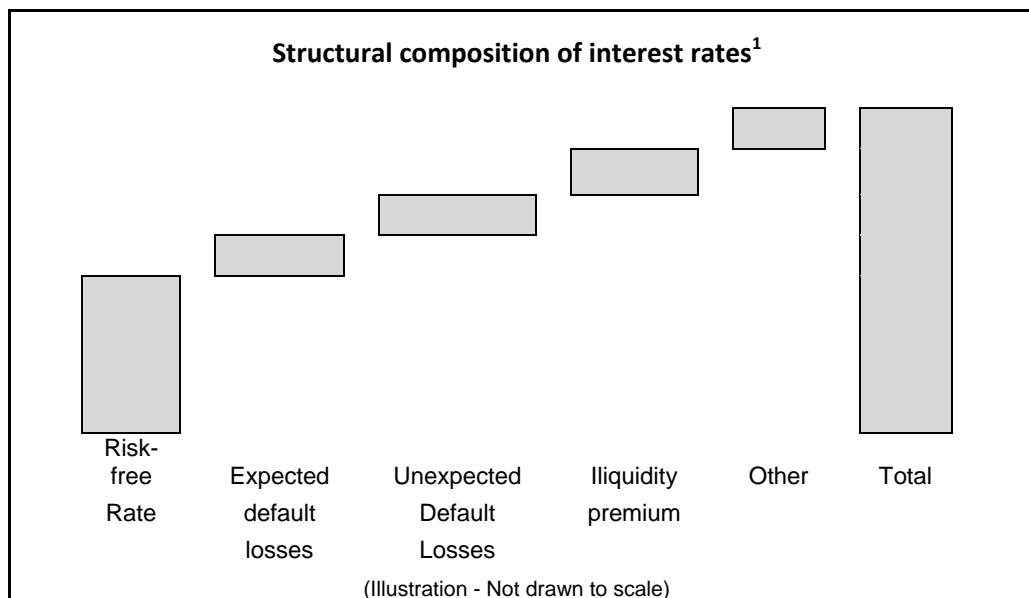
A21. Thus, although there is no market price for insurance liabilities, the sector credit spread could be estimated by the using the yields on high quality corporate bonds, consistent with IAS 19. As a life annuity issued by a pension plan is fundamentally the same as a

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corresponding life annuity issued by an insurer, IAS 19 is the most relevant standard for comparison. We see no reason for the measurement of these two types of life annuities to be based on different discount rates.

A22. We note that FAS 87 *Employers' Accounting for Pensions* also requires the accumulated benefit obligation to be discounted at a high quality corporate bond rate. Paragraph 198 explains that “The Board concluded that selection of the discount rates should be based on current rates for settling the pension obligation.” The FASB decided on using high quality corporate bond rates by assuming settlement of annuity contracts would presumably be invested in high grade (relatively low risk) investments.

A23. Using a corporate bond rate would result in including elements similar to the risk-free rate adjusted for illiquidity and credit risk. The diagram below identifies the different elements included in a corporate bond rate that market participants demand a premium for. Expected and unexpected default losses represent the compensation charged for credit risk. The “Other” factor includes the compensation market participants charge for taxes, conversion costs, and other market imperfections, and would result in a difference compared to the proposed discount rate.



¹ The chart is from the report “Discount Rate” prepared by Oliver Wyman for Manulife Financial.

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- A24. We are concerned about the practical ability of insurers across jurisdictions to determine the adjustment for illiquidity that faithfully represents the risk. We understand that current practice in Europe has resulted in adjustments for illiquidity ranging from 10 up to 350 basis points for embedded values in the same timeframe. Using a market benchmark rate would result in implicitly including an adjustment for illiquidity in the measurement and would avoid insurers having to determine an explicit adjustment.
- A25. Consequently, we recommend that the discount rate proposal be revised to require an insurer to use an ‘asset independent’ or ‘market observable’ discount rate. To use the same words as those in IAS 19, the rate used to discount an insurance liability should be determined by reference to market rates on high quality corporate bonds and, in countries where there is no deep market for such bonds, the market yields on government bonds (a risk-free rate) should be used.

(2) An expected rate of return - Reflect an insurer’s business model

- A26. Using a discount rate that includes compensation for the risk of sector credit spread would still result in volatility in reported income that is difficult for entities to explain and users to understand. We think the volatility results from differences between insurers’ long-term expectations and the market’s current expectations. For example, insurers tend to settle for or accept a lower rate of return on long-term investments than many other market participants would demand for the same investment. We think these differences might arise because, in the discount rate they use, insurers do not seek compensation for:
- (a) illiquidity, as they do not need immediate access to all cash flows;
 - (b) some risks, as insurers can diversify their asset portfolios more than many market participants can;
 - (c) longer duration investments, as insurers require these investments to match their liabilities; and

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- (d) other non-diversifiable risks for which other market participants would demand compensation.

A27. As these risks are hard to identify and quantify, we are uncertain how a market rate (i.e., a risk-free rate) could be adjusted to include these factors faithfully, along with the illiquidity factor the Board proposes, and also reduce the volatility.

A28. Many respondents to the Credit Risk DP generally agreed that using market rates makes sense for liabilities that are traded, but not for those that are not. Thus, we question the use of market rates when insurance liabilities are not traded and, in most cases, cannot be transferred without a regulator's approval.

Approaches used in IFRSs to address volatility concerns

A29. To address the concerns about volatility in income that is difficult to explain or not decision-useful, we considered alternative solutions that have been used or proposed in IFRSs. We agree with the Board's objectives that the accounting treatment should report economic mismatches that occur when insurance liabilities and related assets respond differently to the same changes in economic circumstances, and not create accounting mismatches.

A30. In other projects, the IASB has selected measurement bases to avoid reporting volatility and/or presentation approaches to manage how volatility is reported, as follows:

IFRS 9	<p>As the normal measure of an entity's liability is amortized cost, the IASB had to develop an approach for valuing assets on a basis other than fair value to avoid reporting the resulting volatility from the accounting measurement mismatch. As a result, IFRS 9 permits an entity to measure financial assets at amortized cost if the business model objective is to hold the assets in order to collect the contractual cash flows and that those cash flows are principal and interest (paragraph 4.1.2).</p> <p>To avoid creating or enlarging an accounting mismatch in profit or loss, IFRS 9 requires an entity to report the change in the fair</p>
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	value of financial liabilities that are attributable to changes in the credit risk of those liabilities to be reported in other comprehensive income (paragraph 5.7.7).
IAS 19 proposals	In order to report the net financing cost of an employee benefit plan in profit or loss, the IASB is proposing to apply the rate used to discount the pension obligation (i.e., high quality corporate bond) to the net surplus or deficit of the plan. This implicitly assumes a rate of return on the assets equal to that rate. The difference between the actual and the implicit expected rate of return on plan assets is reported in other comprehensive income.
Lease proposals	The IASB has proposed two models for lessors in accounting for leases depending on whether the lessor's business model is to sell a good or provide financing. Without commenting on the merits of the lease proposals, we nonetheless note that they are based on consideration of the entity's business model.

A31. We agree with the Exposure Draft proposals that liabilities of uncertain timing and amount, such as insurance contracts, must be measured using current estimates. These liabilities would not qualify for amortized cost measurement in any event. Measuring related assets at amortized cost would create or exacerbate an accounting mismatch because the liabilities would be measured at current estimates. Consequently, in most cases assets held to satisfy insurance liabilities are or would be reported at fair value by applying other existing IFRSs. When necessary, an entity can elect to use the fair value option to do so. In the case of accounting for insurance contracts, we do not think that developing a separate alternative approach to measuring the financial assets of an insurance business would be supportable.

A32. That leaves considering alternative presentation approaches as a basis for reporting volatility in insurance liabilities separately.

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A33. The Exposure Draft's proposed measurement model is based on a fulfillment notion. Accordingly, we think the discount rate should reflect the insurer's perspective rather than that of a market participant. We note that the discount rate is the only component of the proposed measurement model that is not entity-specific. It is also the only assumption that is not a probability-weighted expected value with a risk adjustment. Consequently, it is inconsistent with the rest of the proposed liability measurement.

Proposal

A34. We propose reporting in profit or loss the effect of discounting insurance liabilities using the long-term rate the insurer expects to earn on its investments. We propose reporting the change in the difference between the two liability measures in other comprehensive income, that is, the change in the difference between discounting the liability using the current market observable rate (i.e., a high quality corporate rate) and the expected rate of return on investments.

A35. We recommend this approach because it would provide more useful information about expected long-term profitability.

Expected long-term rate of return on investments

A36. Using the expected rate of return on investments would reflect an insurer's business model. That is, if an insurer's business model establishes and maintains investment portfolios to fulfill its insurance liabilities, an insurer should be able to use the expected rate of return on investments as the discount rate on those liabilities. As a result, the performance statement would reflect changes in insurance liabilities financed at the rate the insurer expects to achieve. Users would then be able to evaluate an insurer's ability to manage its underwriting risk separately from changes in market prices on its investments. Users would also be able to evaluate an insurer's ability to achieve a return on assets that equals the rate it assumed in setting the premiums it charged to provide insurance protection, providing information about an insurer's ability to manage its asset investment risk.

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A37. We propose that the expected rate of return on investments be determined in the same manner as the other assumptions included in the measurement of an insurance liability and that the rate be reassessed at each reporting date. An insurer would be required to determine the rate based on a probability-weighted estimate of the net cash inflows that it expects to earn on its investments and include a risk adjustment. We think that an insurer's long-term expected rate of return on investments would be its expected nominal rate of return on its planned asset mix, net of expected defaults/losses. The planned asset mix could include interest-bearing investments, equities and other asset classes, but may not necessarily be based on what the insurer currently holds.

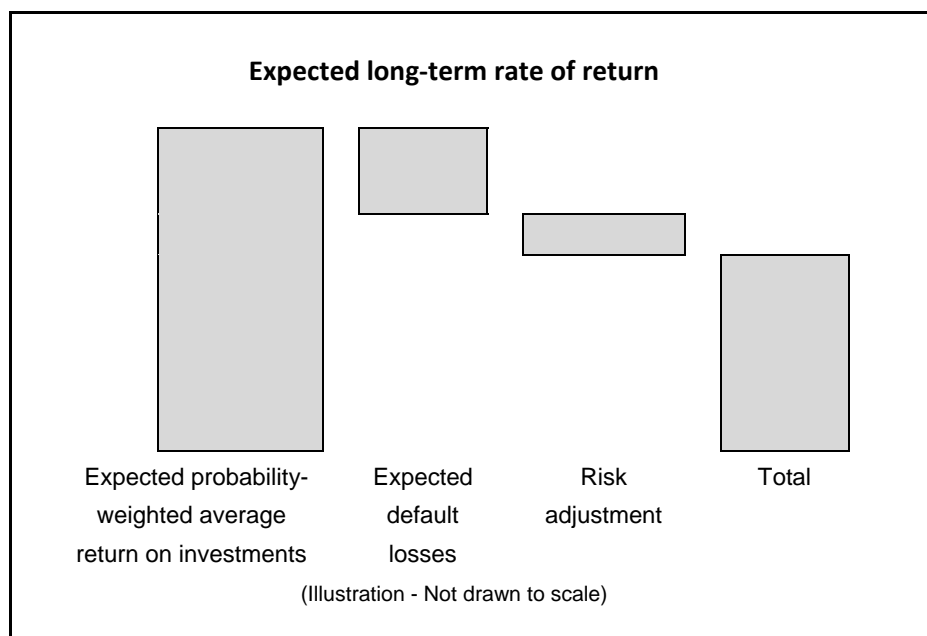
A38. The expected long-term investment rate should include a risk adjustment for the possibility that the future asset returns may differ from those expected, so it would include provision for both reinvestment risk and unexpected losses. To parallel the existing description of the risk adjustment for the liability cash flows, we propose that the risk adjustment on the expected long-term rate of return on investments be described as follows:

“The risk adjustment [related to the long-term expected investment rate] shall be the maximum discount the insurer would rationally accept to be relieved of the risk that the ultimate return on the investments is less than that expected.”

It is the maximum discount in this case because it relates to assets. However, because the rate would be used to measure liabilities, the definition could also be reworded from a liability perspective to state “the minimum discount the insurer would rationally pay to be relieved of the risk . . .”.

A39. Diagrammatically, the expected long-term rate of return on investments is described as follows:

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A40. To report interest expense in profit or loss at the expected long-term rate of return on investments, changes in the risk adjustment relating to the investment return assumption should be included with the interest on the liability.

Current market rate

A41. We propose that the insurance liabilities would be measured on the statement of financial position using the observable current market rate, such as the high quality corporate bond rate recommended above. The difference between the two liability measures, both on initial measurement and subsequently, would be reflected in accumulated other comprehensive income, permitting users to compare an insurer's liabilities measured at its expected long-term rate of return on investments to a measurement at the current market expectations.

A42. Over time, the current market measure and the actual fulfillment amount would converge and the amount in accumulated other comprehensive income would automatically reverse. This would occur when the expected cash flows are reduced as contracts lapse or are fulfilled, and the risk adjustments and residual margins are released as the liability being discounted reduces. Thus, the difference between discounting the liability using the two rates would become smaller too.

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- A43. The changes from receiving and paying the expected cash flows are not recognized in the statement of comprehensive income in the Exposure Draft's presentation model. Any difference between the two discount rate measurements related to the expected cash flows that is included in accumulated other comprehensive income will simply be eliminated when the actual cash flows take place and the liability is derecognized.
- A44. When a debit or a credit is reported in other comprehensive income on initial measurement, we would describe it as a measurement difference and not day one gain or loss. We think the amount recognized in accumulated other comprehensive income both on inception of the contract and thereafter is the result of using an alternative measurement.
- A45. We recognize that, in previous comment letters on other topics, we have not supported the use of other comprehensive income without establishing a conceptual rationale for its use and criteria for when items should, or should not, be reclassified subsequently to profit or loss (recycled). We observe that currently the Board uses other comprehensive income to report the volatility that arises from market measurements that are not consistent with an entity's business model. Thus, this proposal is consistent with that rationale. We would also expect that over the life of a contract accumulated other comprehensive income would reverse or be eliminated. In this proposal, no special treatment would have to be specified for recycling accumulated other comprehensive income as it would automatically reverse over time as described above.

Residual margin

- A46. To report changes in insurance liabilities in profit or loss on a true fulfillment basis, we recommend that the residual margin be determined using the insurer's long-term expected investment rate instead of determining it based on the current market rate. Using the entity's expectations to determine the residual margin is consistent with how customer consideration is determined in the Exposure Draft *Revenue from Contracts with Customers*, that is, without reference to whether the entity is earning a current market rate of return on the contract. In the revenue proposals, market prices are used

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only when allocating the total customer consideration to different performance obligations, not to measure the performance obligations directly.

A47. Thus, we propose that the initial measurement requirement in paragraph 17(b) be revised as follows:

"a residual margin that eliminates any gain at inception of the contract. A residual margin arises when the expected future cash outflows less future cash inflows that will arise as the insurer fulfills the insurance contract discounted using the long-term expected investment rate and adjusted for the effects of uncertainty about the amount and timing of those future cash flows ~~amount in (a)~~ is less than zero (i.e., 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)."

A48. Any loss on initial recognition using the long term investment rate would be recognized immediately in profit or loss, consistent with the requirement in paragraph 18 of the Exposure Draft.

Advantages

A49. Although this approach would be more complex than using one discount rate as proposed in the Exposure Draft, insurers would not have to change their basic valuation model but rerun it with a different discount rate. This added complexity is offset by the advantages of this approach because it would:

- (a) result in measuring assets and liabilities at consistent current measurements on the statement of financial position;
- (b) reflect the insurer's business model in profit or loss, as well as providing a measure comparing the insurer to current market expectations in other comprehensive income;
- (c) not create an accounting mismatch in profit or loss;

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- (d) improve the transparency of financial reporting by insurers by providing information about asset management performance separately from information about underwriting performance; and
- (e) not require any amendment to IFRS 9 *Financial Instruments*, such as adding an available for sale classification.

A50. If some kind of alternative to the Exposure Draft approach is not developed, we are extremely concerned that non-GAAP measures will evolve as the primary focus for users and the usefulness of financial statements will diminish substantially.

Presentation

A51. Under our proposal, the statement of financial position would include the following:

Insurance Contract Liabilities	XXX
(e.g. by Portfolio or Par, Non-Par)	
<i>Measured using market discount rate</i>	

Equity

Accumulated other comprehensive income	
Related to cash flow hedges	
Related to translation of foreign operations	
Related to remeasurement of insurance contract liabilities	
at current market rates	XXX

A52. To report the two components of interest on the liability under our proposal, the statement of comprehensive income would include the following:

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Income Statement (for insurance business)

Change in risk adjustment (opening/closing)	a
Release of residual margin (amortization of initial gain)	b
Underwriting Margin	a + b
Experience adjustments (difference between expected and actual cash flows)	c
Change in future cash flow estimates (opening/closing)	d
Net underwriting performance	a+b+c+d
Return on assets backing insurance contracts (investment income at fair value)	e
Interest on insurance contract liabilities (at expected rate and including release of risk adjustment)	f
Total net insurance income before tax	a+b+c+d+e-f

Other Comprehensive Income (excerpt)

Expected interest on insurance liabilities	f
Current (observable) market interest on insurance liabilities	g
Change in difference between expected and market interest	f-g

Disclosures

A53. To enhance further the disclosures provided, we propose that an insurer also explain the components of its expected long-term rate of return on investments and differences between that expected rate and the actual rate achieved.

APPENDIX B

Our responses to the Exposure Draft questions

Question 1 – Relevant information for users

B1. We think that the proposed measurement model will provide users with relevant information about current estimates of future cash flows, the assessment of uncertainty about the amount of future cash flows, and the contract profit that will be reported over the life of the contracts. However, we think that the discount rate proposals in the Exposure Draft would make the financial statements irrelevant for users of the financial statements because using a risk-free rate adjusted for illiquidity would result in earnings volatility that does not appropriately reflect the underwriting or investment management performance of an insurer. We think that this would cause users to demand non-GAAP measures that strip out the volatility caused by market movements. See Appendix A and our response to question 3 for further details.

Question 2(a) – Fulfilment cash flows – *Using the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract*

- B2. Yes. We strongly agree that the measurement of an insurance contract should be based on the expected present value of future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract. We agree with using a probability-weighted approach to estimate future cash flows.
- B3. We agree with the requirement that the present value of fulfillment cash flows should be revised each period for changes in estimates if evidence indicates that previous estimates are no longer valid. We also agree that an insurer should consider whether the updated estimates represent faithfully the conditions at the end of the reporting period, and whether changes in estimates represent faithfully the changes in conditions during the period, as outlined in paragraph 48 of the Exposure Draft.
- B4. However, in some situations estimates could be revised without conditions having changed during the period. For example, an insurer might use enhanced modeling

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techniques to determine better estimates than those that were used at the previous reporting date. Better modeling techniques can enable an insurer to develop estimates that would enhance the faithful representation of the conditions at the reporting date. The equal weighting of the criteria in the standard may preclude an insurer from revising its estimates in such a situation because there have been no changes in economic conditions during the period. As a result, we recommend that the guidance in paragraph 48 be clarified to require an insurer to update its estimates of the present value of fulfillment cash flows if a more faithful representation of the conditions at the reporting date can be determined, even though there have been no changes in conditions during the period. We also recommend that a change in estimates due to a revision in measurement technique or the use of better data be disclosed separately from a change in estimates due to a change in conditions during the period.

- B5. We support the requirement in paragraph 23 of the Exposure Draft that estimates of future cash flows should reflect current market prices for market variables only if prices are based on active markets for instruments with similar characteristics. For example, in determining the cash flow volatility assumptions for investment return guarantees in variable annuity products, it may be difficult to obtain market inputs that faithfully reflect the volatility characteristics of the long-duration contracts. Market prices may be inflated because the supply of instruments in the marketplace that replicate the long-term liabilities is limited. Therefore, we recommend that the requirement be revised to require the use of observed market prices from active markets and that guidance be provided on how to identify an inactive market and how to adjust a market price when necessary. Such guidance could be based on the fair value measurement guidance that the IASB has developed.

Question 2(b) – Fulfilment cash flows – *Appendix B guidance provides right level of detail*

- B6. Yes. We think the draft application guidance in Appendix B on estimates of future cash flows provides the right level of detail for a principles-based standard.

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- B7. Some have raised concern that the guidance in paragraphs B38 and B39 of the Exposure Draft would require most insurance contracts to be valued using complex models, such as stochastic models, even though simpler methods would determine measurements that are not significantly different (i.e., a tolerable range of precision). In order to clarify the requirements, we recommend that the objectives and characteristics of determining estimates of future cash flows be outlined in the final standard, similar to the guidance provided for determining risk adjustments. The guidance should clearly state that the estimation of the expected present value of future cash flows using basic models is appropriate in circumstances when the model considers the characteristics of cash flows and economic conditions being measured.
- B8. We agree with the concept of including incremental future cash inflows and outflows at the portfolio level. We note, however, that the proposed standard requires incremental acquisition costs to be determined at the level of an individual insurance contract (paragraph B61(f)). We suggest that a consistent unit of account be used throughout the measurement model and, accordingly, that acquisition costs should be determined at the portfolio level (see our response to question 7 for reasons for determining acquisition costs at the portfolio level).
- B9. With respect to the list of relevant cash flows to include within the boundary of a contract (paragraph B61(h)), we think that additional guidance or examples of the treatment of different types of tax payments and receipts is needed in order to promote consistent application across jurisdictions. It is not clear what is meant by transaction-based taxes. We recommend that the final standard include a detailed description of transaction-based taxes that specifies how transaction-based taxes differ from taxes that the entity pays on the income it earns. It would also be helpful if the IASB explained why future income tax payments are not included in the contract cash flows. For example, acknowledging in the Basis for Conclusions that the fulfillment approach for measuring insurance contracts conflicts with the current settlement approach for measuring future income tax liabilities under IAS 12 *Income Taxes* would help constituents understand the distinction.

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Question 3(a) – Discount rate - Reflects the characteristics of the insurance contract liability and not those of the assets backing that liability

B10. We have sympathy for the view 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, unless the assets are contractually linked to the liability. However, we question why a fulfillment measurement approach fails to consider the implicit link between insurance contract liabilities and the assets that will be used to satisfy those liabilities. See Appendix A to our letter for further discussion regarding the discount rate proposals.

Question 3(b) – Discount rate - *Including the effect of illiquidity*

B11. We agree that the effect of illiquidity should be included in the discount rate in order to faithfully represent the economic substance of insurance liabilities. From a practical perspective, we are concerned about the ability of insurers across jurisdictions to determine an adjustment for illiquidity that faithfully represents the risk. Compared to determining a risk adjustment, there are no generally accepted methods for measuring the effect of illiquidity. As a result, we are aware of widely divergent estimates of illiquidity factors based on recently developed theoretical models that have not been fully tested in practice. The divergent estimates have resulted from taking into account the high degree of volatility in illiquidity premiums prevalent through some economic cycles. See Appendix A to our letter for a proposal to use a benchmark discount rate to address, inter alia, the practicality concern about determining illiquidity adjustments.

Question 3(c) – Discount rate - *Misrepresents the economic substance of long-duration contracts*

B12. Yes, the concerns are valid. We think that the discount rate proposed in the Exposure Draft would not provide relevant information to financial statement users because the proposed discount rate does not faithfully represent the underlying economics of the transactions. To address these concerns, see Appendix A to our letter for the discount rate proposals that we think would provide more relevant information to financial

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statements users by reporting the effects of the key risk exposures arising from insurance activities separately.

Question 4 – Risk adjustment versus composite margin

B13. We strongly support using a separately measured risk adjustment because this approach would provide more useful information and is consistent with how insurers manage insurance contracts. We think that a composite margin would not provide useful information to users of an insurer’s financial statements because it would not be re-measured to reflect any increases in risk and uncertainty, or to reflect any changes in the price for bearing risk and uncertainty. As a result, a composite margin would not be a current measure and would be internally inconsistent with the rest of the measurement model. We also think that breaking a measurement down into separate components helps, whenever possible, to bring more discipline to the calculation and results in a measurement that represents the underlying economic phenomena more faithfully. Thus, we think the benefits exceed the costs of separately determining and reporting the risk adjustment.

B14. We recognize that some may argue that measuring a risk adjustment separately provides an illusion of precision to a measurement that is subjective. However, as the Exposure Draft indicates, several approaches have been developed by the actuarial profession for identifying and measuring risk. The ability to determine risk adjustments has been demonstrated by Canadian insurers, which have been determining margins for adverse deviations for financial reporting and regulatory purposes for more than twenty years. Such an approach would also be consistent with other IFRS literature, such as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, its proposed replacement currently under development and IAS 36 *Impairment of Assets*.

Question 5(a) – Risk adjustment – *Concept and description*

B15. Yes. We strongly agree with the notion that the risk adjustment is the “maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected”.

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B16. We are concerned that the description sounds like an exit value approach to determining the risk adjustment, whereas the model proposed for valuing insurance liabilities is based on a fulfillment notion. To avoid any confusion, we suggest that the risk adjustment be defined as “an explicit and unbiased estimate of the margin that an insurer would require to assume the risk that the ultimate fulfilment cash flows exceed those expected.”

Question 5(b) – Risk adjustment - *Techniques for estimating risk adjustments*

B17. No. We strongly disagree with limiting the choice of techniques for estimating risk adjustments because the prescription of specific methods is not a principles-based approach and would exclude other techniques that may be more appropriate in certain circumstances. Furthermore, limiting the choice of techniques may require insurers who currently use more sophisticated measurement techniques to revert to using techniques that would provide a less faithful representation of the risk. This approach would also preclude the adoption of techniques developed in the future that would more faithfully represent the risk.

B18. We think that permitting the use of other methods would not affect the comparability of financial information between insurers significantly because the three methods proposed would already result in significant variation in how risk adjustments are estimated.

B19. Therefore, we think that the principles-based approach as outlined in paragraphs B68 to B72 is sufficient, and that an insurer should select a technique for estimating a risk adjustment that best meets the objective, characteristics and application guidance for estimating a risk adjustment relative to its contracts.

B20. For example, we think that rigorous methods that estimate the risk adjustment on an assumption by assumption basis and meet the objective should be permitted. To require further rigor, an insurer should also be required to use “a technique that is consistent with generally accepted actuarial methodologies” and with the information reported internally to key management personnel and those charged with oversight

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responsibilities. Such a requirement would be consistent with guidance in other IFRSs when an accounting requirement is based on methodologies used by valuation experts. For example:

- (a) Paragraph 17 of IFRS 2 *Share-based Payment* states that “the valuation technique shall be consistent with generally accepted valuation methodologies for pricing financial instruments”;
- (b) Paragraph 5.4.2 of IFRS 9 *Financial Instruments* that a valuation technique “is consistent with accepted economic methodologies for pricing financial instruments;” and
- (c) Paragraph 34 of IFRS 7 *Financial Instruments: Disclosures* states that “for each type of risk arising from financial instruments, an entity shall disclose summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity ... for example the entity’s board of directors or chief executive officer.”

An entity in a jurisdiction that does not have generally accepted actuarial standards could use standards that have been developed in a different jurisdiction. Refer to our response to Question 18.

Question 5(c) – Risk adjustment – *Disclosing the confidence level*

B21. No. We disagree with the proposal that insurers should disclose the confidence level if either the conditional tail expectation or the cost of capital method is used because it would be misleading. A confidence level would not faithfully represent a measurement determined using either a conditional tail expectation or the cost of capital method because the distribution is not even or skewed (i.e., a fat tail). We are also concerned that there could be a divergence in practice in converting a conditional tail expectation or cost of capital method into a confidence level.

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- B22. We also are concerned about the negative consequences that could result from this disclosure requirement. We have been advised that the confidence level approach is the least sophisticated of the methodologies the IASB proposes to permit. Insurers currently using more sophisticated techniques may choose to use the confidence level technique to avoid having to run a second model for disclosure purposes, thereby reducing the reliability of the measurement.
- B23. If a common disclosure of the risk adjustment is to be required, we recommend that disclosure of the conditional tail expectation range be required instead of the confidence level.
- B24. If the proposed disclosure requirement is retained in the final standard, we recommend that guidance be added on how to determine the confidence level when the necessary data are not available.

Question 5(d) – Risk adjustment – *Measure at portfolio level*

- B25. Yes. We agree that an insurer should measure the risk adjustment at a portfolio level of aggregation. However, based on our experience in Canada, we have found that measuring the risk adjustment at a more granular level within a portfolio (for example, by separately assessing mortality, morbidity or lapse rate) results in a measurement that provides a more faithful representation of the risk adjustment for the portfolio. Therefore, we recommend that insurers be able to determine the risk adjustment by measuring each factor within a portfolio when such a measurement would result in a more faithful representation. Permitting the risk adjustment to be measured “within a portfolio” would be consistent with the unit of account used to determine the residual margin.

Question 5(e) – Risk adjustment – *Appendix B guidance at right level of detail*

- B26. We agree with the objective and characteristics of a risk adjustment and the application guidance in Appendix B (paragraphs B68-B72 and B91-B101). As we do not agree with limiting the determination of the risk adjustment to the three methods proposed (see our response to question 5(b)), we do not agree with providing the guidance on the

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techniques and features of those techniques in Appendix B (paragraphs BC73-BC90) to the exclusion of guidance on other methods.

Question 6(a) – Residual/composite margin – *Not recognizing a gain at initial recognition*

- B27. Paragraph BC125 describes the residual margin as consisting of several factors, such as compensation for cost and effort of obtaining contracts and compensation for product development. We note that some of these factors, and there may be more to consider, could support the view that an insurer has fulfilled a performance obligation on initial recognition and, therefore, income should be recognized. Such an approach would be consistent with the Exposure Draft *Revenue from Contracts with Customers*. Conceptually, if the required measurement model provides a relevant and faithful representation of a liability, any resulting income or expense should be recognized.
- B28. For insurance contracts, we prefer a direct measurement approach that results in measuring the characteristics of the liabilities rather than a process that allocates the expected customer consideration to performance obligations. Thus, we prefer the separate accounting for the residual margin proposed in the Exposure Draft to combining it with the risk adjustments into a “composite margin” or to allocating it in some fashion to the other building blocks. However, we think the Board should acknowledge that the residual margin is a mathematical plug that results from the Board’s decision that an insurer should not recognize any gain at initial recognition of an insurance contract. We also think that the Board should acknowledge that deferring the recognition of income is not neutral and introduces bias into the measurement that is justified only by the subjectivity and measurement uncertainty associated with insurance liabilities.
- B29. We disagree with describing the residual margin as a gain. The Conceptual Framework defines revenue as arising “in the course of ordinary activities of an entity” and that gains “represent other items” that “may or may not arise in the course of ordinary activities of an entity,” such as the disposal of non-current assets (paragraph 4.29-4.31).

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As the summarized margin approach does not result in reporting “revenue,” we recommend that the residual margin be included in “insurance income” because the residual margin arises from the ordinary activities of an insurer.

Question 6(b) – Residual/composite margin – *Not less than zero*

B30. As recognizing a loss on an onerous contract is consistent with existing standards on other topics, insurance industry practice and the proposal in the Exposure Draft *Revenue from Contracts with Customers*, we 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.

Question 6(c) – Residual/composite margin – *Measure at portfolio level of aggregation*

B31. We think that the residual margin should be estimated at the portfolio level or within a portfolio in order that the unit of account used to measure insurance contracts is consistently applied.

B32. We do not support an approach that uses a composite margin (see our response to Question 4).

Question 6(d) – Residual/composite margin – *Methods for releasing the residual margin*

B33. We support releasing the residual margin in a systematic way that best reflects the exposure from providing insurance coverage on the basis of the passage of time (i.e., the coverage period of the insurance contract) or the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

B34. We are concerned about the effect on some contracts of the second criterion (in paragraph 50(b)), which is to consider the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time. For some non-life policies (such as those that insured asbestos claims from the 1940s that are still being settled today), the residual margin would need to be released over a significantly longer time period than the insurance coverage period. We recommend

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that additional guidance be provided to explain how the second criterion should be applied when claims are reported and benefits paid over a much longer period than the coverage period.

B35. Given the complexity of this proposed approach, we think other simpler methods that result in recognizing the residual margin as the insurer is released from risk should be considered. For example, the residual margin could be recognized in proportion to the release of the risk adjustment. Thus, as the risk and/or the uncertainty subsequently increases and decreases, the amount of residual margin recognized in income would reflect those changes.

Question 6(e) – Residual/composite margin – *Methods for releasing composite margin*

B36. No. We do not support the composite margin approach. However, under that approach, we are uncertain how an insurer would determine the period over which the composite margin is to be released because the proposed requirement is based on considering both the coverage period and the claims handling period. For non-life insurers, those periods can be very different. The coverage period could be one year, yet the claims arising from that contract could take years or even decades to settle in some cases (refer to our response to question 6(d)).

Question 6(f) – Residual/composite margin – *Accrete interest*

B37. Yes. We agree that interest should be accreted on the residual margin and that the interest rate used to accrete interest would be the discount rate used to discount the cash flows when measuring the liability upon initial recognition.

B38. We do not support an approach that uses a composite margin (see response to Question 4).

Question 7 – Acquisition costs

B39. We agree that only incremental acquisition costs should be included in the initial measurement of an insurance contract as cash outflows. However, we think that the

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definition of incremental acquisition costs as proposed in the Exposure Draft is too narrow and requires clarification.

B40. Limiting the acquisition costs included in the measurement of contract liabilities to those that are incremental at the individual contract level would exclude many of the costs incurred for selling, underwriting and initiating insurance contracts – the type of costs identified as acceptable in the Exposure Draft. Those costs are fixed at the contract level but are incremental at the portfolio level. For example, underwriting and sales staffs are incremental and essential to acquiring insurance contracts. Some of the costs of their contribution to acquiring contracts would not be recognized under the Exposure Draft proposal unless their activities were outsourced by the insurer and remunerated on a commission basis by individual contract. We think that the recognition of costs should not be different when the costs incurred are essentially the same, but are paid to an external vendor versus internally to staff. Also, not recognizing many of these costs in the measurement of contract liabilities at the outset of a contract would result in an artificially higher residual margin. Thus, we recommend that incremental acquisition costs be assessed at the portfolio level. Assessing acquisition costs at a portfolio level would be consistent with the level at which the contract cash flows and the risk adjustment are determined.

B41. We also recommend that additional guidance be provided on the types of costs that meet the definition of incremental acquisition costs so that the standard can be consistently applied. This should ensure that costs only indirectly related to the portfolio, such as various corporate overhead costs, are not included by allocation.

Question 8(a) – Modified Measurement Approach – *Require short duration method or not*

B42. We support the modified measurement approach for pre-claims liabilities of short duration contracts, as proposed in the Exposure Draft, because we think that:

- (a) the unearned premium would be a reasonable approximation of the present value of fulfillment cash flows and the residual margin in many cases;

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- (b) the modified measurement approach would achieve a result that is not materially different from the building block approach, but would do so at a lower cost; and
- (c) the modified measurement approach is consistent with the customer consideration approach proposed in the Exposure Draft *Revenue from Contracts with Customers*.

B43. However, we think that requiring the modified measurement approach to be applied to all short duration contracts may have some unintended consequences. For example, a life insurer may have both short-duration and long-duration contracts in the same portfolio. Requiring such an entity to use the modified measurement approach would mean that it would have to use a short cut approximation of the building block approach for part of its portfolio, resulting in two different measurement methodologies for the same type of contracts. As a result, we recommend that insurers be permitted but not required to use the modified measurement approach.

Question 8(b) – Modified Measurement Approach – *Proposed criteria*

B44. We agree with the conditions for using the modified measurement approach, but we think that the coverage period outlined in paragraph 54(a) of the Exposure Draft should be extended. By limiting the use of the modified measurement approach to contracts of one year or less, the modified measurement approach would not be available for some non-life policies (e.g., two year insurance policies or indefinite insurance policies that expire only when cancelled) and for a material portion of the contracts of a few specialty insurers (e.g., insurers focusing on surety contracts).

B45. Therefore, we think that the modified measurement approach should be permitted for contracts longer than one year when the method can be demonstrated to provide a reasonable proxy for liability values and the emergence of profit that would occur under the building block method.

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Question 9 – Contract Boundary – *Principle*

B46. Yes. We agree with the proposed contract boundary principle. We recommend that the guidance of when an insurer has the right or practical ability to reassess the risk of the particular policyholder be clarified to focus on identifying when the economic substance of the contract is revised. Thus, paragraph 27(b) should require an insurer to identify if it has the right or practical ability to reassess either the compensation it receives for providing the risk coverage (the price) or the level of benefits a policyholder receives, to reflect the risk of the policyholder.

B47. We understand there have been suggestions that the boundary of a reinsurance contract should be the same as the boundary of the underlying insurance contract. There are situations in which the boundary of a reinsurance contract is legitimately different from the boundary of the underlying insurance contract. For instance, a reinsurer may agree to pay for any catastrophe claim in excess of a specified amount incurred by the direct insurer within a one-year period, even though the boundary of the underlying insurance contract could be different. In this case, we think that the boundary of the reinsurance contract should be the one-year period. Thus, we would not agree with including such a requirement in the final standard because it would be contrary to the underlying economics of the reinsurance contract.

Question 10(a) – Participating features – *Expected present value*

B48. Yes. We agree that the measurement of insurance contracts should include participating benefits on an expected present value basis because participating benefits form part of the expected future cash flows. The premiums charged on such policies are higher because of the expectations of future participating benefits. Excluding the expected benefits from the determination of the contract outflows would create an artificial residual margin at inception and would not properly reflect the contract economics.

Question 10(b) – Participating features – *Scope*

B49. We think the guidance for financial instruments with discretionary participation features should be within the scope of the IFRS on insurance contracts because the

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principles are the same as those for discretionary participation features in insurance contracts. We understand that, at least in Canada, financial instruments with participating features are issued almost exclusively by entities that also issue participating insurance contracts. Consequently, it is simpler and more convenient for stakeholders to include that guidance in one standard – the IFRS on insurance contracts.

Question 10(c) – Participating features – *Definition*

B50. Yes. We agree with the definition of a discretionary participation feature in the Exposure Draft.

Question 10(d) – Participating features – *Financial instrument measurement modifications*

B51. Yes. We agree with the modifications made to the measurement proposals in paragraphs 64 and 65 of the Exposure Draft because we agree that they make the measurement proposals suitable for financial instruments with discretionary participation features.

Question 11(a) – Definition and scope – *Insurance contract*

B52. Yes. We agree with the definition of an insurance contract. As some insurance contracts result in paying benefits to a beneficiary selected by the party that purchases the insurance coverage, we recommend that the definition of an insurance contract be clarified to include both parties.

B53. We also note that the definition of an insurance contract, specifically the requirement in paragraph B25 of the Exposure Draft, may exclude some reinsurance contracts from the definition of an insurance contract.

B54. Some contracts reinsure defined groups of policies in aggregate, for example quota share treaties by which the reinsurer assumes a stated percentage of premiums and claims on a defined group of policies from the direct insurer. The individual policies could each qualify as insurance contracts, but when combined as a group of policies and reinsured, it is often difficult or impossible to demonstrate a significant possibility

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of a loss on the group of policies in the aggregate. US GAAP (codification paragraph 944-20-15-53 in *Financial Services Insurance*, or SFAS 113.11) provides for instances in which the insurance risk transferred is not significant in the aggregate, but substantially all of the insurance risk that relates to the reinsured portions of the underlying insurance contracts is transferred to the reinsurer. Such arrangements are required to be accounted for as insurance contracts. The Exposure Draft proposals do not include a corresponding provision.

B55. Thus, the circumstances described in the preceding paragraph appear to contradict the IASB's expectation that the addition of the test, as described in paragraph BC 191(c), would not lead to a change from practice under current IFRS 4. Therefore, we recommend that the exception in FASB codification paragraph 944-20-15-53 be included in the final standard.

B56. We recommend that the final standard include the implementation guidance regarding the definition of an insurance contract in the current version of IFRS 4 as this information is useful for determining the types of contracts that meet the definition.

Question 11(b) – Definition and scope – Exclusions

B57. No. We do not agree with scoping out product warranties from the insurance contracts standard. Consistent with our response to question 15 of the Exposure Draft *Revenue from Contracts with Customers*, we think that the accounting for all forms of warranties should be the same and all warranties should be accounted for as insurance contracts. Therefore, we think that warranties should be scoped out of the revenue standard and included in the insurance contracts standard. Alternatively, all warranties could be included in the revenue standard if that were more convenient for stakeholders, provided that the accounting required was the same as in the insurance standard.

B58. We agree with the other scope exclusions in paragraph 4(b)-(g).

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Question 11(c) – Definition and scope – *Financial guarantee contracts*

B59. Yes. We agree that contracts currently defined in IFRSs as financial guarantee contracts should be within the scope of IFRS on insurance contracts.

Question 12 – Unbundling

B60. No. We recommend that the IASB reconsider whether unbundling policy account balances and embedded derivatives is required given the measurement and presentation models proposed in the Exposure Draft. Though legislation and regulations in Canada restrict insurers from selling goods and services that are not closely related to the insurance coverage, we agree that such goods and services should be unbundled and accounted for in accordance with the applicable IFRS.

B61. The Exposure Draft proposals on unbundling are based closely on the US GAAP approach in SFAS 97. Unbundling is necessary under existing US GAAP because insurance contracts are accounted for on a cost basis. Therefore, non-insurance portions of a contract must be unbundled in order to account for them at a current value. The Exposure Draft proposes that insurance contracts be measured at current values. We question the need to unbundle non-insurance portions of a contract because the entire contract would be measured on a current value basis. As fair value is a current measure, we note that requiring an insurance contract to be unbundled in these circumstances is inconsistent with the following IFRS 9 requirement:

“If a hybrid contract contains a host that is not an asset within the scope of this IFRS, an embedded derivative shall be separated from the host contract and accounted for as a derivative under this IFRS if, and only if ... the hybrid contract is not measured at fair value with changes in fair value recognized in profit or loss (i.e. a derivative that is embedded in a financial liability at fair value through profit or loss is not separated)” (IFRS 9, par. 4.4.3).

We also note that unbundling would require a considerable amount of effort by preparers but, because insurance liabilities would be measured at current values, it would provide little or no benefit to financial statement users.

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B62. If the unbundling guidance is retained in the final standard, we recommend the following:

- (a) Removing the example of unbundling outlined in paragraph 8(a) because the requirement to unbundle does not add to the transparency of the underlying contract. It is not clear that all universal life policies would fall under paragraph 8(a) and, therefore, there may be variation in practice. If the examples are maintained, additional examples should be added to demonstrate the universal life contracts that should not be unbundled.
- (b) Including additional guidance in the final standard as to whether different types of contracts are closely related to the insurance contract, such as a contract with a variable death benefit or a contract whereby the insurer, as a matter of practice (but not out of obligation of the contract or any marketing representations), resets the crediting rate periodically based upon the performance of the general account segment.
- (c) Addressing the treatment of policy loans, specifically whether policy loans should be included in the policy cash flows or treated as a separate financial instrument.

Question 13(a) – Presentation – *Using the summarized margin approach*

B63. Yes. We strongly agree that the summarized margin approach is the best way to present the performance of insurance contracts. We think that this approach best portrays the results in a manner consistent with the measurement proposal (building blocks) and is consistent with the proposals currently being developed in the revenue recognition project.

B64. To avoid two significant changes to underlying reporting systems, we urge the IASB to ensure that the proposed presentation requirements are not changed substantively by the subsequent finalization of the Financial Statement Presentation project. We have been advised that, even for Canadian companies already using a measurement model similar to that being proposed, it would take at least two years prior to the date from which

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comparative information must be provided (see our response to question 17(d)) to modify systems to adopt the new presentation approach.

- B65. If the IASB does not pursue a revised approach for the discount rate similar to our recommendation (refer to Appendix A of our letter), we recommend that the IASB clarify how an insurer is to present changes in estimates of discount rates and interest on insurance liabilities on the statement of performance in a manner that highlights their relationship with the investment return on the assets backing those liabilities. An example demonstrating how this requirement could be satisfied would be helpful.
- B66. We recognize that the presentation approach for short-duration contracts would be inconsistent with the summarized margin approach for long-duration contracts. This inconsistency could confuse users of financial statements, particularly when an insurer applies the presentation for short-duration contracts to some of its lines of business and the summarized margin approach to others. Guidance and examples should be included in the final standard to illustrate the appropriate disclosure in such cases.
- B67. We agree with the presentation of unit-linked contracts as a single line item as this segregates the general fund assets from the assets included in the unit-linked funds and reflects the important legal separation of the unit-linked assets from the insurer's general fund assets.
- B68. Paragraph 23 of IFRS 8 *Operating Segments* requires entities to disclose revenues from external customers in the notes to their financial statements. It is not clear what would meet the definition of "revenue" under the summarized margin approach. We recommend that the IASB provide guidance on which elements of the summarized margin approach meet the definition of revenue. Alternatively, the disclosure requirement of IFRS 8 could be modified for entities applying the insurance contracts standard.

Question 13(b) – Presentation – *All income and expense in profit or loss*

- B69. Refer to Appendix A of our letter for the discussion of the discount rate and the method that we propose for the presentation of income and expenses from insurance contracts.

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Question 14(a) Disclosures - *Principle*

B70. Yes. We agree with the proposed disclosure principle.

Question 14(b) – Disclosures – *Requirements meet the objective*

B71. Yes. We agree with the proposed disclosure requirements because we think that they would achieve the proposed objective of helping “users of the financial statements understand the amount, timing and uncertainty of future cash flows arising from insurance contracts”. However, we think the guidance should be improved in respect of the following matters:

- (a) When a level of aggregation higher than a portfolio is used, we think it would be beneficial to include a requirement to disclose a reconciliation of the portfolios to the aggregation levels selected for disclosures, and a reconciliation of the aggregation levels selected to the operating segments.
- (b) We think that additional guidance should be included in the final standard to clarify certain disclosure requirements. See our response to question 13(a) for details.

Question 14(c) – Disclosures – *Are additional disclosures needed, or are some not needed*

B72. Given the proposals in the Exposure Draft, users would be able to determine the movements during the year in each of the building blocks in the fulfillment model, which is valuable for determining the source of the earnings recognized during the period. However, premiums, claims and direct incremental acquisition costs would not be shown on the statement of profit or loss (or comprehensive income). As a result, it would be difficult for a user to assess the volume or growth of an insurer’s activities and to calculate some key ratios, such as the combined ratio, that users rely on when assessing an insurer’s performance. As a direct method statement of cash flows is not required, we recommend that insurers should be required to disclose in the notes to financial statements written premiums and earned premiums, broken out by type of insurance coverage, and deposits, claims and direct incremental acquisition costs.

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B73. We also think that it would be very informative to require disclosure of:

- (a) A numerical reconciliation of the portfolios to the aggregation levels selected for disclosures, and a reconciliation of the aggregation levels selected to the operating segments. See our response to question 14(b);
- (b) A change in estimates due to a revision in measurement technique or the use of better data separately from a change in estimates due to a change in conditions during the period. See our response to question 2(a); and
- (c) The expected versus actual return on assets and any change in the long-term expected rate to help users judge an entity's investment performance (refer to Appendix A of our letter, paragraph A48).

B74. In the final standard, we recommend that more guidance, including some examples, be provided concerning:

- (a) Period-to-period reconciliations of risk adjustments and residual margins;
- (b) The nature of quantitative information that should be provided about inputs to material measurements; and
- (c) The type of measurement uncertainty analysis required.

Question 15 – Unit-linked contracts

B75. Yes. We support the proposals in the Exposure Draft and think that the approach is preferable to the other approaches considered in the Discussion Paper. We agree with the definition of a unit-linked contract in the Exposure Draft. However, we recommend several improvements as explained below.

B76. We agree with the proposed requirement that an insurer should recognize the underlying assets of unit-linked contracts that currently result in an accounting mismatch and measure them at fair value through profit or loss in order to eliminate such mismatches. Not to do so would make an insurer's financial statements less relevant and less understandable. However, we observe that adding the requirement to recognize an insurer's own shares and property that it occupies at fair value would

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eliminate only some of the existing accounting mismatches. Thus, we recommend that controlling interests in other entities held in unit-linked asset pools also be measured at fair value and not consolidated according to IAS 27 *Consolidated and Separate Financial Statements* and its successor for the following reasons:

- (a) Controlling interest investments should be measured on a basis that is consistent with the liability, in order to enable users to evaluate an insurer's net exposure arising from unit-linked contracts.
- (b) The investment company guidance that the IASB is developing, as proposed, would not likely apply. The draft guidance would require unit-linked asset pools, in preparing their separate financial statements, to measure controlling interests at fair value. An insurer would not qualify as an investment company, and thus, in its financial statements, an insurer would not be permitted to report controlling interests held in segregated funds at fair value.
- (c) Requiring an insurer's own shares to be re-measured at fair value and reported as an asset, instead of deducted from equity, contravenes the accounting for treasury shares required by IAS 32 *Financial Instruments: Presentation* (paragraphs 33 and 34) and the notion of an asset. Reporting an insurer's own shares as an asset is circular as the share represents a holder's right to a residual interest in the assets of an entity after deducting its liabilities. If eliminating a mismatch justifies an exception for an insurer's own shares, we think an exception from consolidating controlling interests in other entities is more than equally justified. The investment is an asset and would simply be included in the insurer's financial statements on a different, more relevant, measurement basis.

B77. We also encourage the IASB to clarify what the accounting would be when the total interest of the insurer and one of its unit-linked contracts in a third-party entity may result in control. We recommend that consolidation not be required due to the fact that the insurer is holding these investments for a policyholder for investing purposes and not for operation by the insurer. The investments are held in specifically identified

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accounts that are similar to trust arrangements and, as a result, the investments are legally protected from the insurer's creditors other than the policyholders and not available to its equity investors.

- B78. We agree with the proposal that assets and liabilities arising from unit-linked contracts be reported on an insurer's statement of financial position, instead of in the notes (i.e., not off-balance sheet). We also agree that these assets and liabilities should not be combined with general fund assets and liabilities, as separate presentation accurately reflects the fact that unit-linked contracts are legally separate from an insurer's general fund assets and liabilities (as described in the previous paragraph).
- B79. We agree with the proposal to present the income and expenses separately for unit-linked contracts and the pool of assets underlying those contracts. However, the wording of paragraph 78 is unclear as to whether income and expenses from unit-linked contracts should be netted and shown as one line item on the statement of comprehensive income, or whether one line would be required for income and another line for expenses. It is also unclear whether income and expenses from the pool of assets underlying unit-linked contracts should be netted and shown as one line item on the statement of comprehensive income, or whether one line would be required for income and another line for expenses. We recommend that paragraph 78 be revised to require a single line presentation by netting income and expenses of unit-linked contracts and a single line presentation by netting income and expenses from the pool of assets underlying the unit-linked contracts.

Question 16(a) – Reinsurance – *Expected loss model*

- B80. Yes. We support the use of an expected loss model for reinsurance assets because it is consistent with the measurement model for the underlying insurance contract liabilities. In particular, we agree with the consistent treatment of risk adjustments and residual margins. We also agree with using an expected-loss model rather than an incurred-loss model for assessing losses from reinsurer default or disputes.

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B81. Paragraph 43 of the Exposure Draft requires the measurement of a reinsurance contract to be in accordance with paragraph 17 (expected present value of fulfillment cash flows plus risk margin and a residual margin). This would imply that the short duration treatment is not available for the measurement of the reinsurance asset. As a result, the measurement of the reinsurance contract asset would be inconsistent with the liability associated with the underlying insurance contract. Therefore, we recommend that reinsurers be able to apply the modified measurement approach for short duration reinsurance contracts.

Question 16(b) – Reinsurance – *Other comments*

B82. We have the following additional comments related to the reinsurance proposals:

- (a) When an insurer recognizes an immediate loss upon issuing an insurance contract that is accompanied by the recognition of an immediate gain on a related reinsurance contract, and when the gain on the reinsurance exceeds the loss on the underlying insurance, an immediate net gain would result. We think that the recognition of a gain in this scenario is appropriate because it is the result of the reinsurance contract, not the underlying insurance contract. This should be made explicit in the standard.
- (b) In the case of reinsurance, one possible interpretation of the recognition guidance in paragraph 14 is that a reinsurer should recognize a liability under existing reinsurance treaties for insurance contracts not yet written (i.e., when the underlying insurance policies have not yet been written). We suggest that a clarifying statement be added to indicate that this is not the intention of paragraph 14.
- (c) Paragraph 44 requires a cedant to “... consider the risk of non-performance by the reinsurer on an expected value basis ...” We suggest making the following italicized insertion in that paragraph: “... consider the risk of non-performance by the reinsurer, *giving appropriate consideration to any rights of set-off or*

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collateral, on an expected value basis ...” in order to ensure that all characteristics of the liability are properly reflected.

- (d) Given paragraphs BC233 and BC235, the IASB should clarify that the identification of a short duration contract is based on the ultimate direct business covered, regardless of the term of the reinsurance contracts.

Question 17(a) – Transition and effective date – *Proposed requirements*

B83. No. We strongly disagree with excluding a residual margin on policies in force at transition because that would misstate an insurer’s financial position on the transition date and understate future earnings on those policies, in some cases for many years. Though the proposed transition approach is simple and verifiable, it would not provide relevant information to users to assess an insurer’s business, such as predicting the future earnings of an insurer. We recommend that insurers be required to record a residual margin on policies in force at the transition date.

B84. We are willing to assist the IASB in identifying measurement methods that would enable insurers to transition to the new IFRS on insurance contracts in an unbiased and cost effective manner. In discussing possible approaches, we noted that the transition residual margin could be determined using one of the following methods for in force policies:

- (a) The difference between the present value of future cash flows determined using the original pricing assumptions and the present value of fulfillment cash flows;
or
- (b) Full retrospective application, when the necessary information is available.

B85. If the current transition guidance is maintained in the final standard, we recommend that guidance be provided specifically for reinsurance contracts. The following are some of the transition issues related to reinsurance contracts.

- (a) Presumably, a reinsurance asset existing at time of transition should be treated in a manner consistent with the underlying insurance contracts (i.e., under the

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current proposals, there would be no residual margin created). We suggest that this be clarified in the final standard.

- (b) We think that the final standard should provide guidance on how a cedant should account for a reinsurance contract entered into after transition on a portfolio of pre-transition in-force insurance contracts. The fact that the contract is entered into after transition suggests that a residual margin is permitted when there is a loss (even though there is no residual margin on the underlying insurance contracts under the current proposals), and similarly a gain is permitted.
- (c) We also think that the final standard should provide guidance on how a reinsurer should account for a reinsurance contract entered into after transition on a portfolio of pre-transition in-force insurance contracts. From the reinsurer's perspective, this is a post-transition transaction, and yet pre-transition treatment by the insurer and post-transition treatment by the reinsurer could result in a significant accounting arbitrage opportunity. Thus, we recommend that the transition rules apply to reinsurers on post-transition reinsurance contracts entered into on pre-transition underlying insurance contract portfolios.

Question 17(b) – Transition and effective date – *FASB's proposed transition requirements if the composite margin approach is adopted*

B86. No. We disagree with the FASB's tentative decision that on transition the composite margin would be set to the risk adjustment because we do not agree with the removal of the residual margin on transition (see response to question 17(a)).

Question 17(c) – Transition and effective date – *Align effective date with IFRS 9*

B87. We think it would be preferable if the effective date of the insurance contract standard is aligned with that of IFRS 9. If the mandatory effective date of IFRS 9 is prior to the mandatory effective date of the insurance contracts standard, insurers in Canada would most likely have to classify most of their financial assets backing insurance contract liabilities at amortized cost based on the criteria for amortized cost classification under IFRS 9. The fair value option would not be available in most cases because there would

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be no accounting mismatch given current Canadian insurance accounting policies that would be applied in accordance with IFRS 4. As a result, we recommend that the Board should either:

- (a) set the same effective dates for the insurance contract standard and IFRS 9; or
- (b) permit insurers to re-designate their financial assets backing insurance contract liabilities upon implementation of the insurance contract standard.

Question 17(d) – Transition and effective date – *Time to adopt requirements*

- B88. Canadian insurers would need a minimum of three years (i.e., two years prior to date from which comparative information must be provided) to adopt the proposed standards in order to revise their measurement models, financial statements and note disclosures, and update the systems used to generate that information. We think that completing those changes within two years would be aggressive but possible for Canadian insurers because they already use a measurement model for insurance contracts and prepare a source of earnings analysis that are similar to the Exposure Draft proposals.
- B89. Insurers in some other jurisdictions would likely need additional time to develop their measurement models and financial reports, especially when their existing accounting approach is significantly different from the approach proposed in the Exposure Draft.
- B90. Overall, the implementation of these changes, and the potential changes to systems, processes, and controls that may be required, would require a significant amount of time. We encourage the IASB to provide a long enough period of time for all insurers to make the necessary changes, time for software vendors to develop updated or new software, and time for consensus to form about the implications of implementing the final standard. We also anticipate that a long period of time would be needed by regulators, analysts, and boards of directors to modify their performance measurement and capital adequacy measurement tools.

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Question 18 – Other comments

Encourage consistent practices world-wide

B91. We agree that a standard must be principles-based in order to accommodate the different types of insurance contracts that exist worldwide. Although we support a principles-based approach, we think that more specific guidance needs to be provided in some areas (for example, in the determination of risk margins), where practices vary and greater consistency is needed. We suggest that the evolution toward more consistent practices might be accelerated by acknowledging in the standard how it might be achieved, for example through the work of the actuarial profession globally.

Clarification of recognition principles

B92. We recommend clarifying the recognition criteria in paragraphs 13-15 as to whether a non-life insurer should recognize a provision for contracts that the insurer may not know it is on risk for because brokers may have sold policies and received premiums but not yet remitted them (i.e., a liability for an issued but not yet reported policy).

Question 19 - Benefits and costs

B93. On balance, we think that globally the IASB's objective of creating a consistent financial reporting model for the measurement of insurance contracts across multiple jurisdictions, and the better risk management capabilities that may result from the proposals, is worth the cost of implementation. We think the cost/benefit relationship would be significantly improved by implementing our recommendations, in particular the discount rate proposal and the permitted techniques for determining risk adjustments.

B94. We note that many Canadian constituents do not agree that the benefits of the proposed insurance contracts standard justify the costs of providing it, if the discount rate proposal is not revised. In their view, the proposed insurance contracts standard would result in a significant step backwards for Canadian financial reporting.