Project **Insurance contracts**

Topic **Outreach summary**

What is this paper about?

1. The objective of this paper is to summarise, at a very high level, the feedback received from outreach activities on the insurance contracts project being conducted jointly by the IASB and FASB ('the boards').

2. Staff and some board members undertook a programme of outreach activities to complement the formal consultation provided by comment letters. Those activities included live and recorded webcasts, Q&A sessions, participation in conferences, and meetings with insurance industry trade groups, individual preparers, accountants, actuaries, auditors, regulators and users (investors and analysts) from a wide variety of geographical regions.

3. The comment period for the IASB's exposure draft, *Insurance Contracts* ('the ED'), ended on 30 November 2010 and at the time of writing, [xx] comment letters have been received. The comment period for the FASB's discussion paper, *Preliminary Views on Insurance Contracts*, ('the DP') ends on 15 December 2010.

4. This paper does not contain staff views or recommendations and is provided for information only. It is intended as an input to the process of setting priorities for work over the next few months and is not intended to replace the comment letter analysis that will be presented next month.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Summary of significant comments and issues

5. Paragraphs 6-96 summarise:

   (a) comments about the need for an insurance contracts standard (paragraphs 6 and 7).

   (b) comments on the timetable and process (paragraph 8).

   (c) critical issues for redeliberations (paragraphs 9-45).

   (d) a summary of feedback on other proposals in the ED (paragraphs 46-96).

Need for an insurance contracts standard

6. In IFRSs, IFRS 4 *Insurance Contracts* permits diversity in accounting and presentation, which includes allowing many practices that do not provide users of financial statements with information that is relevant and representationally faithful. Consequently, there is generally a high level of support for the IASB developing an IFRS for insurance contracts. Many users and preparers of financial statements prepared under IFRSs believe that it is important and urgent to replace IFRS 4 and that it would be better to have an imperfect standard than no standard at all.

7. In contrast, the accounting for insurance contracts is addressed in US GAAP and has evolved over many years as a result of new insurance products, terms and features. US GAAP requires application of different models depending on the nature of the insurance contract—one for short-duration insurance contracts (that is, for most property and liability contracts) and others for long-duration insurance contracts (that is, most life and annuity contracts). Some US constituents have expressed doubts about whether there is any need for change to US GAAP and whether the proposals would result in an improvement over existing US GAAP. In particular, some in the US are satisfied with the current accounting model for insurance entities under US GAAP, especially for non-life insurance contracts.

However, others believe the variety of US GAAP accounting models that are used for most life contracts makes understanding the financial statements difficult.

Timetable and process

8. In spite of the perceived urgency for replacing IFRS 4, many insurers and some others have concerns about the current timetable for completion of the project, as follows:
   (a) Some stated that the proposals in the IASB's ED and the preliminary views in the FASB's DP were not fully developed and, as a result, there is insufficient detail to make it possible to understand how the standard would be applied in practice. Some also state that clarification is needed on several vital elements in the proposed model. In Europe, many have commented that the lack of clarity for the proposals on unbundling make it difficult to interpret how to apply the proposals.
   (b) Some stated that the comment period was too short, especially because of the extent of the change proposed compared to existing practice[1]. In Europe, some are concerned that there is insufficient time to evaluate the proposals and to comment on them because many insurers are heavily involved in the QIS 5 studies (undertaken in connection with Solvency II). As a result, they believe they are not able to participate fully in the field testing activities or to evaluate the proposals or comment on them.
   (c) Many disagree with the IASB's stated intent of finalising a standard in accordance with what they believe to be an artificial deadline imposed by the rotation of the IASB's membership. They would rather the boards take more time to adequately consider the implications of the various proposals and disagree that this would necessarily cause significant delays to the project.

[1] The comment period was 122 days for the ED and 89 days for the DP.

(d) Some state that more comprehensive field testing is needed and that sufficient time should be permitted for this.

Critical issues for redeliberations

9. In this section, we describe the issues that we think the boards will need to spend most time on in the redeliberations, either because differing views existed in the deliberations preceding the publication of the ED and DP or because interested parties have proposed alternatives that we think the boards would need more time to evaluate.

10. The critical issue raised in almost all jurisdictions is the volatility that would arise in profit or loss under the proposed model. Most constituents also believe that the unbundling principle is unclear and they are concerned about loss of volume information from the primary statements in the proposed presentation approach. Non-life insurers are not convinced that the modified measurement approach for short-duration contracts represents a simplification from the main model and are concerned about the eligibility criteria. These issues are discussed as follows:

    (a) volatility in profit or loss (paragraphs 11-20)

    (b) unbundling (paragraphs 21-23).

    (c) residual vs composite margin (paragraphs 24-29).

    (d) presentation (paragraphs 30-36)

    (e) short-duration contracts (paragraphs 37-45)

Volatility in profit or loss

11. Volatility arises in profit or loss for the following reasons:

    (a) Most entities would measure financial assets held to fund insurance contracts at fair value, so as to be consistent with the current measurement of the insurance liability. The removal of the available-for-

sale (AFS) category for financial assets in IFRS 9[2] means that all changes in the fair value of those assets would be presented in profit or loss.

(b) Fluctuations in credit spreads on the financial assets would not be matched without corresponding changes in the measurement of the insurance liability. This effect was exacerbated during the financial crisis.

12. Some entities believe the proposals penalise insurers compared to banks because banks can reduce reported volatility using amortised cost in accordance with IFRS 9.

Discount rate

13. The ED and DP state that the discount rate used to determine the present value of fulfilment cash flows should be the risk-free rate, adjusted for liquidity. Many disagree with this rate and are sceptical that a liquidity adjustment can be estimated reliably. Alternatives proposed by constituents include using:

(a) an asset-based rate, possibly adjusted to reflect defaults and other adverse deviations to the investment return (eg an economic default adjusted rate). This might include rates that reflect the investment return that the insurer uses to price the contract.

(b) the discount rate proposed in the ED but locked-in at inception (resulting in a measurement described by some as 'amortised cost').

(c) a discount rate based on sector non-performance risk, eg by using a reference rate, such as a high quality corporate bond rate.

14. Some also suggest that the boards consider an approach in which the insurance contract is measured using a rate reflecting the characteristics of the liability, as the boards propose, but with the changes in the measurement of the contract divided into an amount presented in profit or loss and an amount presented in the statement of financial position. The amount presented in profit or loss would reflect changes in one of the rates listed in paragraph 13.

[2] The FASB have not yet determined whether to retain an available-for-sale category.

15. Other discount rate issues (which are not directly related to volatility) are discussed in paragraphs 50-51.

Interaction with IFRS 9

16. Although most preparers support the use of a current measurement model for insurance liabilities, many IFRS preparers are concerned that the proposals in the ED would, in effect, prevent them from measuring some financial assets at amortised cost as permitted in IFRS 9, even though the IASB decided that amortised cost was an appropriate measurement in some circumstances. If the assets are measured at amortised cost, a current measurement of the liability results in an accounting mismatch. Consequently, most preparers expect that the proposals in the ED would cause them to elect the fair value option and measure the assets at fair value through profit or loss. However, they are concerned about the volatility in profit or loss that results from fair value measurement of the assets.

17. If the assets backing insurance liabilities are interest-bearing assets carried at fair value through profit or loss, volatility would arise:

    (a) if credit spreads widen on assets, with no corresponding effect on liabilities. This effect is exacerbated by exclusion of non-performance risk from the liability measurement.

    (b) from interest rate changes if the duration of the insurance liabilities is not matched by the duration of the assets that the insurer holds (eg because assets are not available with sufficiently long durations). Some, but not all, insurers accept that the measurement model should report the effect of economic mismatches such as duration mismatches.

18. Volatility would also arise because of market price fluctuations if the assets funding the insurance liabilities are equity investments that are measured at fair value, either through profit or loss or through other comprehensive income. Furthermore, some insurers are concerned that under IFRS 9 there is no recycling if equities are carried at fair value through other comprehensive income. (In US

GAAP, the proposed ASU *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* would allow certain debt securities, as well as equities, to be measured at fair value through other comprehensive income with the changes in the fair value measurements being recycled out of other comprehensive income through profit or loss when the resulting gains and losses are realized.)

Suggestions for reducing volatility

19. Most preparers believe that this volatility does not reflect the often long-term nature of insurance contracts, especially long-duration contracts. Many preparers also think that the proposals would reduce the comparability between deposits and loans issued by banks and similar types of insurance contracts since banks would be allowed to use amortised cost for those deposits and loans. The effects may be significant for long-duration contracts and accordingly, some preparers believe that this may have an adverse effect on product pricing and design.

20. Some have suggested other ways that they believe would prevent this volatility:

    (a) Many suggest using a different discount rate. We list the alternative discount rates proposed by constituents in paragraph 13.

    (b) Some insurers suggest using other comprehensive income for some gains and losses (sometimes expressed in Europe as a wish to retain 'shadow accounting'). However, few have been clear about what they mean and most seem to want some change to the IFRS 9 treatment of assets so that they can apply to their assets accounting similar to that for available-for-sale assets. Some life insurers support the use of OCI for some changes in the carrying amount of the insurance liability, but with recycling.

    (c) Many want to explore some means of adjusting the residual margin if estimates (either all estimates or non-financial estimates) change.

    (d) Some of the concerns expressed about unbundling (see paragraphs 21-23) relate to a desire to measure the unbundled component at amortised cost and thus match it to financial assets measured at amortised cost.

Unbundling

21. The ED proposes that an insurer would account for investment and service components separately from the insurance component when those components are not closely related to the insurance component. This is referred to as 'unbundling'. Many state that it is unclear when unbundling is required, as follows:

    (a) Paragraph 8 of the ED provides examples of components that are not closely related to insurance coverage. Some believes it is unclear how these examples are intended to interact with the 'closely related' principle. In other words, if an insurer determined that one of the components described in that paragraph is closely related to the insurance coverage, would it still need to unbundle that component? Most believe that the principle should take priority. There is concern in Europe that the three examples of 'not closely related' are likely to gain the status of rules, in the way that similar examples in IAS 39 have been interpreted.

    (b) Some state the intention of the proposal to unbundle account balances is unclear. For example, should unit-linked contracts, participating insurance contracts or participating investment contracts be unbundled? Some claim that universal life contracts would not be unbundled because they do not pass all the investment return to the policyholder, even though such contracts seems to have been the FASB's main target in developing the proposal.

    (c) The proposal states that an investment component should not be regarded as closely related unless it reflects an account balance for which the crediting rate is based on the investment performance of the underlying investments. Some find this proposal unclear.

    (d) It is unclear whether asset management services relate to goods and services that should be unbundled.

    (e) It is unclear whether the ED proposes to require issuers to unbundle investment contracts with a discretionary participation feature. Some

(f) Some request clarification of some details of how the unbundling proposals would be applied, including the allocation of items such as premiums, expected profit and acquisition costs between the insurance contract component and the unbundled component, and whether specific components, such as policy loans should be unbundled.

22. Unbundling involves costs to preparers and some question whether the benefits justify those costs. In particular, some question the benefits of unbundling when the unbundled component would be measured at fair value, rather than a current value based on fulfilment (as it would be if it were not unbundled). However, some insurers are considering whether they would like to unbundle contracts so that they would be able to measure the investment component at amortised cost and thus match assets measured at amortised cost in accordance with IFRS 9 or ASC 320. (There was no amortised cost option in the FASB's proposed ASU.)

23. There were geographical differences in the feedback on unbundling, possibly due to different product designs. For example, unbundling is a concern in Europe and in France, where an issue of prime importance is whether unbundling is required for investment contracts with discretionary participation features . In contrast, Japanese and Australian insurers generally do not believe that the unbundling proposals will create implementation problems. This may reflect the relative scarcity of such products in Australia and that Japanese insurers are accustomed to unbundling deposit elements under Japanese GAAP.

Residual vs composite margin

24. The IASB ED proposes that the insurance liability should reflect the effects of uncertainty about the amount and timing of future cash flows by including an explicit risk adjustment in its measurement. In addition, the IASB proposes that the measurement of an insurance liability should include a residual margin, calibrated to eliminate gains at inception. Some note that the residual margin will include margins to recover general overheads (including all acquisition costs not included in cash flows, risk of unknown uncertainties, costs of infrastructure and IT, assumption errors, income taxes, etc) and the insurer's expected profit. However, there are conflicting views about whether the residual margin will be small or substantial.

25. In contrast, in the FASB's preliminary views, risk and uncertainty would be reflected implicitly through a single composite margin rather than through a separate risk adjustment margin.

26. Many US insurers and Japanese life insurers do not support an explicit risk adjustment. Some think that determining the risk adjustment will involve significant set-up costs and will be difficult to account for. Some also believe that the risk adjustment should not be included in the measurement of the liability because it is equivalent to deferred profit and therefore should not be explicitly measured and presented. However, a risk adjustment is explicitly measured when accounting for some insurance contracts in Australia, New Zealand, Canada and China and is consistent with the approach used in Solvency II in Europe. Some believe that there should be consistency in the way that the insurance contracts standard and Solvency II calculations use risk adjustments.

27. Some are concerned that an explicit risk adjustment may give users a misleading impression about the precision of liability measurement. There is also a concern that the risk adjustment is not observable, making it difficult to determine whether the assumptions were reasonable and the objective of its measurement were met. Some state that the amount determined as a risk adjustment would be arbitrary. Some also believe that an explicit risk adjustment does not contain decision-useful

information because the amount of the risk adjustment does not indicate whether an entity has been conservative in making assumptions, or genuinely has a different risk profile.

28. The IASB ED states that the risk adjustment shall be the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. Some have questioned whether risk adjustments are more consistent with an exit value notion and therefore should not be reflected in an approach based on fulfilment value.

29. Some constituents have proposed that entities should measure the insurance contract using a composite margin, but disclose any risk adjustment that is significant to the overall liability.

Presentation

30. The ED proposes a presentation approach that highlights the underwriting margin, experience adjustments and interest on insurance contract liabilities. The boards regard these items as the drivers of profitability for an insurer.

31. Although some support the approach in the ED, most are uncomfortable with eliminating from the statement of comprehensive income information about premiums, claims and expenses. Some also do not agree with the boards' proposal to prohibit the presentation of premiums and expenses in the statement of comprehensive income. Some state that not presenting premiums as revenues would significantly reduce revenues of insurance companies. Those with this view believe that eliminating information about premiums distorts the 'size' of insurance companies and would make it difficult to compare insurers to other companies. For example, they state that this approach would result in few, if any, insurance companies being included in the Fortune 500.

32. Many users do not appear to rely on the primary statements but use other, more detailed sources of information instead. Nonetheless, many non-life users believe that the current presentation model works well for non-life contracts. Some life

insurer analysts are cautiously supportive. Users in Canada, where a similar source of earnings disclosure is required, generally support the presentation approach. However, some disagree with the approach and question whether the new presentation model will provide better information for life contracts. Most users have indicated that the critical information they look for is:

(a) growth (indicated by adjusted premium volume);

(b) ratios such as loss ratio, expense ratio and combined ratio (which requires the presentation or disclosure of premiums, losses and expenses);

(c) operating income (currently a non-GAAP measure and not always defined consistently across entities);

(d) book value per share; and

(e) yield on investment portfolio.

33. Most US users indicated that the consolidated financial statements are not typically used other than at a very high level. Instead, the users typically request additional supplementary information and use US statutory data for non-life (specifically, 'Schedule P', which is a claim development table by line of business). Users generally support the proposal to require disclosure of the claim development tables.

34. Some users state that information about 'free cash flow' is critical to their analysis and that the proposals do not provide sufficient cash flow information. Free cash flow is the amount of cash generated that could be available to shareholders in the form of dividends. Some users comment that existing cash flow information does not meet their needs.

35. As discussed in paragraph 20, some preparers want to explore alternatives that would permit separate presentation of economic volatility.

36. Some are concerned that the presentation proposals might be modified once more as a result of the boards' project on financial statement presentation.

Short-duration contracts

37. The ED proposes a modified approach (premium allocation approach) for the pre-claims liabilities of some short-duration contracts.

Need for modified approach

38. Some want to keep the existing unearned premium approach for non-life contracts, because users find it useful. A few believe that the modified approach is superior to the proposed building block approach and that it should be the default requirement. Some of those with this view believe that the building-block approach should be applied only when there is significant risk of variability of future cash flows (for example because of embedded options).

39. Most perceive the modified measurement approach as being over-engineered and some question how much relief it provides. For example, some state that features such as interest accretion in the pre-claims period, the inclusion of a risk adjustment in the onerous contract test and discounting the expected future premiums complicate the model and will make it difficult for users to understand an insurer's operations.

40. Many believe the onerous contract test should be performed at a higher level of aggregation than is being proposed, or should be required only in the event of a trigger.

41. Some stakeholders, especially preparers that write both life and non-life business, would like the modified approach to be permitted rather than required. There are mixed views as to whether there should be a different presentation approach for the modified approach compared to the building block approach.

Eligibility criteria

42. The ED proposes that the modified approach would apply to contracts that do not contain embedded options or other derivatives and for which the coverage period is approximately one year or less.

43. Some are concerned that there will be practical difficulties with a one-year cut off for eligibility for the modified approach, for the following reasons:

(a) Some want to apply the modified approach to all non-life (property and casualty) contracts.

(b) Some question whether the proposal to use the modified approach only for contracts with a duration of approximately one year excludes one-year reinsurance contracts that reinsure all one-year underlying contracts written during that year. They believe that reinsurance contracts should be accounted for using the same approach as the underlying insurance contract (see paragraphs 82-87).

(c) Some believe that the proposal will result in different accounting for similar products with different durations. For example, some non-life contracts may have a duration longer than one year. Examples cited include surety contracts that insure a construction period which may be 3-5 years, contracts for fire coverage in Japan, which are typically 1-5 years but may be up to 30 years when bundled with mortgage loans, and contracts in a business combination, in which an acquiring entity will write longer coverages to align the effective dates with their existing blocks of business. Some contend such contracts are similar in nature to equivalent contracts that have a duration of less than one year.

44. Suggestions to address these concerns include:

(a) permitting immaterial multi-year business to use the modified approach.

(b) making application of the model an option.

(c) developing a principle for when the modified approach can be used in place of the arbitrary one-year cut-off. Some suggestions include:

(i) investment income potential over the coverage period is not a major portion of the business model;

(ii) the period of time between premium receipt and date of loss is not significant;

(iii) the contract is primarily based on risk protection, rather than being interest-rate sensitive;

(iv) when the expected claims are level with the premiums.

Other areas for clarification

45. Some ask for clarification on how the presentation proposals in the ED would apply to short-duration contracts, in particular how profit or loss should report the risk adjustment associated with claims incurred: on the same line as claims expense, or on a separate line as change in risk adjustment.

Summary of responses on other proposals in ED

46. In paragraphs 47-96 we discuss the remaining main areas in the ED as follows:

(a) Fulfilment cash flows (paragraph 47-49).

(b) Discount rate issues other than volatility (paragraphs 50-51).

(c) Risk adjustment and margin issues other than residual vs composite (paragraphs 52-62).

(d) Acquisition costs (paragraphs 63-66).

(e) Contract boundary (paragraphs 67-72).

(f) Definitions (paragraphs 73-79)

(g) Scope (paragraph 80)

(h) Disclosure (paragraph 81)

(i) Reinsurance (paragraphs 82-87).

(j) Unit of account (paragraphs 88-89).

(k) Recognition (paragraphs 90-93)

(l) Transition (paragraphs 94-96).

Unbiased probability-weighted estimate of fulfilment cash flows

47. Most support a model based on expected cash flows and the proposed measurement attribute based on fulfilment value rather than exit value. However,

some are concerned about the amount of detail required to determine the probability-weighted average in practice, and whether all possible scenarios need to be included in the determination of the liability. Many preparers, especially non-life preparers, believe the boards should use the term ‘statistical mean’ and allow other methodologies to estimate the statistical mean. Some preparers are concerned that significant time and costs would be required to implement a full probability-weighted methodology with little to no difference or benefit.

48. Some preparers question whether the estimate of cash flows can be unbiased given that two different insurers will calculate a different estimate for the same coverage in almost all scenarios, because entity-specific historical experience is used, which reflects the different composition of their portfolios.

49. A few ask for clarification of whether the cash flows would include taxes based on investment returns.

Discount rate issues other than volatility

Discount rate for participating contracts

50. Paragraph 32 of the ED proposes that ‘if the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the measurement of the insurance contract shall reflect that dependence.’ There is a widespread misinterpretation that this paragraph proposes that entities should use an asset-based rate for all cash flows arising from participating contracts. On 8 November 2010, the staff posted a staff paper on the project website to explain the proposal in paragraph 32 of the ED with the aid of an example. That paper indicated that a single discount rate and a single approach to discounting will not represent faithfully the different behaviours that result when participating contracts generate sets of cash flows that behave in different ways in response to asset returns.

Discounting non-life contracts

51. Some preparers do not believe non-life contracts should be discounted because they believe that discounting adds complexity for little or no added value. For most non-life products, the majority of the claims are paid relatively shortly after the incurred date and discounting is therefore immaterial. This is particularly true for health insurance and personal lines such as car and homeowners' insurance. However, there could be significant costs to apply discounting and it can be difficult to estimate the timing of expected cash out flows. Some recommend that discounting should apply only to lines of business where more than a specified percentage of claims are paid after a specified number of months.

Risk adjustment and margin issues other than residual vs composite

Methods for determining risk adjustment

52. The ED proposes three acceptable techniques for estimating a risk adjustment. There are mixed views about this limitation. Some support a principles-based approach, rather than limit the techniques for determining the risk adjustment to three. They note that a principles-based approach would not preclude entities from using new and better methods for estimating risk adjustments that may emerge in the future. A few support the boards' proposal to limit the number of approaches to improve comparability. However other constituents argue that even a limited number of approaches will result in a lack of comparability because different techniques can result in significantly different results.

Disclosure of implied confidence level

53. Many disagree that the boards should require disclosure of the implied confidence level and observe that the Basis for Conclusions to the ED makes it clear that the implied confidence level approach is likely to be less appropriate than the other two methods in many cases. They argue that this calculation will be burdensome and result in limited value to users.

Level of aggregation for risk adjustment

54. The ED proposes that the risk adjustment should be determined at the level of a portfolio of insurance contracts. Some disagree with this proposal because they believe that the risk adjustment should reflect the effect of diversification between portfolios.

Allocation of the residual margin

55. The ED proposes that the residual margin should not be remeasured in later periods as a result of changes in estimates of cash flows or risk. Instead it would be recognised over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage. The ED describes a systematic way as one based on the passage of time, or on the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

56. Some question how to determine the 'systematic way' to amortise the residual margin for life contracts–for example, over the expected life period, the benefit reserves, the in-force, or some other factor, and the extent to which the passage of time would be the default. They also question whether the pattern of recognition should be adjusted when estimates change.

57. A few have suggested that the residual margin should be recognised over the coverage and claims handling periods (rather than just the coverage period, as proposed) and believe that the reference to recognition on the basis of the expected timing of incurred claims and benefits indicates that recognition could be over the coverage and settlement period.

Allocation of the composite margin

58. The FASB's preliminary view in the discussion paper is that the composite margin should be recognized in profit or loss over the coverage and claims-handling periods. In the FASB's view, this approach reflects the insurer's exposure to uncertainties related to the amount and timing of net cash flows.

59. Some propose that the composite margin should be recognised only over the coverage period. Others believe that the remaining composite margin should be released when all of the significant costs to process the claim have been incurred– for example, for claims that are subject only to procedural delays in payment.

Current measurement of residual or composite margin

60. One consequence of recognising the residual or composite margin on an allocated basis is that an entity may recognise losses in a period, even though there will be gains from the margin in future periods. Some believe this effect will be difficult to explain to users.

61. Many argue that the residual or composite margin should be recognised on a basis other than allocation and suggest that the residual or composite margin should reflect current measurement. In particular, they believe that the residual or composite margin should absorb changes in cash flow estimates relating to non-financial variables. This view has frequently been expressed in Europe and the Far East. However, there are many variations on this theme and no specific proposal yet.

Interest accretion on the residual margin

62. The ED proposes that interest should be accreted on the residual margin. Some believe it overcomplicates the model to accrete interest and then amortise it, especially because some view the residual margin as merely a deferred credit. They also argue that interest accretion does not provide relevant information to the users of insurers’ financial statements.

Acquisition costs

63. The ED and DP state that incremental acquisition costs for contracts issued should be included as contractual cash flows in the initial measurement of the insurance liability.

64. Most believe the boards' definition of acquisition costs is too narrow and oppose its restriction to costs incremental at the contract level because this would exclude from acquisition costs many of the costs of obtaining and underwriting new contracts. In particular, they note that the proposals would result in differences in deferred acquisition costs depending on an entity's distribution system (that is, whether the entity performs contract acquisition service in-house or sources it externally) and sales compensation plans.

65. Many argue that acquisition costs should be determined at the portfolio level, rather than at the contract level because the unit of account for most of the rest of the ED and DP is the portfolio (see paragraphs 88 and 89).

66. The FASB recently issued Accounting Standards Update No. 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* (ASU 2010-26), a consensus of the FASB Emerging Issues Task Force. ASU 2010-26 requires that entities capitalize as deferred acquisition costs the following costs incurred in the acquisition of new and renewal insurance contracts:

    (a) incremental direct costs of a successful contract acquisition;

    (b) the portion of the insurance entity employee's total compensation and payroll-related fringe benefits directly related to time spent performing acquisition activities for a contract that has actually been acquired.

    Some believe this guidance should be considered.

Contract boundary and participation features

67. The ED and DP states that the boundary of an insurance contract would be the point at which an insurer either:

    (a) is no longer required to provide coverage, or

    (b) has the right or the practical ability to reassess the risk of the policyholder and, as a result, can set a price that fully reflects that risk.

68. There are concerns in the following areas:

(a) Some observe that it is different from the proposed boundary in Solvency II.

(b) Some seek clarification as to whether discretionary payments for universal life contracts are within the contract boundaries.

(c) Some are concerned about the effect of regulatory restrictions on pricing—for example, how the contract boundary applies to health insurance contracts for which the rates are reset annually or in which the rate increases are limited by government (see paragraph 71).

(d) In cases in which the insurer can reset the price for a contract rider (ie an additional provision attached to a contract), it is unclear whether the contract boundary test applies to the whole contract or separately to that rider.

69. Paragraphs B61(j) of the ED states that cash flows within the boundary of an insurance contract include payments to current or future policyholders as a result of a contractual participation feature that provides policyholders with participation in the performance of a portfolio of insurance contracts or pool of assets. Some find the purpose of this requirement unclear. (The paragraph is intended to address distributable surpluses included in the financial statements but not yet allocated to individual policyholders.)

70. The proposal that payments to current or future policyholders arising from participating features should be included in the measurement of insurance contracts in the same way as for any other contractual cash outflows is of particular concern to co-operatives and mutual insurance companies. That proposal would result in many such entities reporting little or no equity. Furthermore, those entities might have difficulties in determining whether benefits are participating or not.

71. Some question whether the contract boundary should include contracts that can be re-priced at a portfolio level, but not an individual contract level, and seek clarification as to whether ‘individual policyholder’ refers to individual persons or

to individual employers. Such contracts are currently accounted for using an unearned premium approach, but do not appear to be eligible for the modified approach for short-duration contracts (see paragraphs 37-45). Applying the building block approach would require them to estimate cash flows occurring after the contracts' coverage period that they consider to be uncertain. Accordingly, some propose that the contract boundary proposals should be modified so that the following would be outside the contract boundary:

(a) Cash flows for which the entity can set a price that fully reflects the risks of the contract, within the bounds of any regulatory restrictions that may impose limitations on the premium rates charged to a policyholder.

(b) Cash flows for which the entity can set a price that reflects the risk of the particular policyholder or portfolio (ignoring restrictions that have no commercial substance; that is, no discernible effect on the economics of the contract).

72. Some have indicated that there should be additional guidance regarding contract modifications and whether they result in a replacement contract or a continuation of the existing contract.

Definitions

Definition of an insurance contract

73. The proposed definition of an insurance contract is based on the existing IFRS 4 definition (that is, the transfer of significant insurance risk to the insurer), with two changes in the supporting guidance to reflect existing US GAAP.

74. Some criticise the decision to modify the existing guidance on the definition of an insurance contract. They argue that the existing guidance worked well and there was little merit in this change for those applying IFRSs. Some have asked whether there will be specific transitional arrangements for insurance contracts that no longer meet the definition of insurance contracts under the new proposals.

75. One of those two changes in guidance introduces the need for the possibility of a loss over the whole life of the contract. Some believe that this change would require substantial additional work, especially for reinsurers, for little benefit because the result will be the same. They propose that if the boards proceeds with this proposal, the boards should include the following US GAAP guidance for reinsurance contracts:

   (a) that risk transfer is deemed to be significant if the reinsurance contract transfers substantially all of the risk in the underlying contracts; and

   (b) that detailed testing is not required if risk transfer is reasonably self-evident.

Definition of discretionary participation feature

76. The ED and DP would retain the definition of a discretionary participation feature in IFRS 4 with the addition of a new condition that the contract must share in the same pool of assets as participating insurance contracts. Most oppose the new condition.

77. Contrary to the information that the staff received in developing the ED, many preparers have informed us that there are examples of such contracts being in separate pools. A related question is what happens if the pool originally contains no participating insurance contracts but subsequently acquires them, or the converse.

Definition of a portfolio

78. Some state that lack of clarity in the definition of a portfolio could result in diversity in the level of aggregation and accordingly, in the extent to which diversification effects are reflected. This is a concern particularly for the determination of the risk adjustment (see paragraphs 24-29). They note that current practice on determining a portfolio is diverse. However, no specific alternatives have been proposed.

79. The following questions have also been raised:

    (a) If the portfolio is determined within a subsidiary, can the level of aggregation change at the group level?

    (b) How are portfolios determined when business units cross the boundaries of legal entities?

    (c) Does purchased reinsurance become part of the portfolio for the underlying contracts?

Scope

80. There are a number of issues relating to the scope of the proposed standard:

    (a) Some question whether bank-issued financial guarantees should be within the scope of this standard, or whether an impairment model would be more appropriate. It is unclear whether, in some cases, the financial guarantees described might be loan commitments and therefore be outside the scope of the proposed standard.

    (b) Credit insurers prefer to be included within the scope of the standard

    (c) Some (in France at least) want to keep travel assistance within the scope of the standard so they can apply the same standard to all contracts they issue. Some suggest that travel assistance should be accounted in the same way as a warranty. This would mean that these arrangements would be within the scope of the proposed standard if they are issued by a third party insurer, but outside of the scope if they are issued by a supplier.

    (d) It is unclear which fixed fee service contracts are excluded from the scope of the standard.

    (e) Whether investment contracts with discretionary participation features should be included within the scope of the insurance contracts standard.

Disclosure

81. Many express concerns about the volume and complexity of the disclosure requirements in the ED and DP. Some criticise the disclosures as not being founded on a clear objective and state that they appear to be a collection of requirements from other standards. Specific areas of concern include:

    (a) The objective of the sensitivity and measurement uncertainty information is unclear and their usefulness is doubtful.

    (b) The reconciliation of insurance liabilities appears overly prescriptive and onerous.

    (c) The requirement to disaggregate information about different reportable segments by type of contract and geography is seen by some as being too voluminous.

Reinsurance

82. The ED and DP state that the same accounting should apply to insurance contracts and reinsurance contracts that an insurer holds. In addition, the ED and DP describe an expected loss model for reinsurance assets, in which the measurement of the reinsurance asset would incorporate a reduction from the expected (ie probability-weighted) present value of losses from default or disputes.

83. The ED and DP state that cedants would recognise day one gains but not day one losses when they apply the proposed model. In contrast, they would recognise day one losses, but no day one gains for the underlying contracts. Some disagree with this difference.

84. Similarly, some believe that the amount of the residual margin being ceded (and therefore recognized) should be proportionate to the residual margin on the underlying contract rather than being calculated separately (though they recognise this is more difficult to apply to non-proportional coverage).

85. Some are concerned about how to apply the proposal for contracts in which the coverage period for reinsurance contracts does not match the coverage period of the underlying contract or is non-proportional. For example, in some cases, the cedant may have already entered into a reinsurance contract, but the underlying direct contracts have not yet been issued. There are also questions about how the accounting for reinsurance contracts would interact with the modified approach for short-duration contracts (for example if a reinsurance contract for three years covers direct coverage contracts of one year).

86. Many also note that it is not clear how the building block approach applies to reinsurance, as follows:

    (a) whether the risk adjustment should be determined on a net basis or separately on a gross and ceded basis. Some believe that, in some cases, there will be different results, especially for non-proportional reinsurance.

    (b) whether the modified approach for short-duration contracts could be applied to reinsurance contracts.

87. Some request addition guidance on:

    (a) How to apply the model to amendments to reinsurance contracts. The ED and DP requires risk transfer analysis only at inception of the contract. However, it is common to amend reinsurance contract and this could allow for abuse if the contract is not re-assessed at the time of the amendment.

    (b) What 'significant' means with respect to reinsurance risk.

    (c) Whether credit risk for reinsurers should be based on historical experiences or on credit spreads.

Unit of account

88. Some observe that the ED and DP specify a number of different units of account:

    (a) portfolio level in general

(b) cohort level for the residual or composite margin

(c) contract level for acquisition costs.

89. Some believe that the unit of account should be consistent throughout the standard. They believe that the portfolio is the appropriate unit of account. Accordingly, they would assess incremental acquisition costs and the onerous contract test at portfolio level, and they note this is consistent with the way that entities manage them.

Recognition

90. A few have expressed concerns about the proposed requirement to require contracts to be recognised from when the insurer is first exposed to risk under the contract. They believe this might require onerous bookkeeping before the coverage period starts, perhaps for little benefit.

91. Some preparers are concerned that movements in discount rates could result in a loss on a contract before the effective date of that contract when there has been no change in assumptions.

92. Some ask for clarification on how this proposal would apply to the following:

(a) investment contracts with discretionary participation features, given that such contracts do not transfer significant insurance risk.

(b) reinsurance contracts that are not co-terminous with the underlying contracts

93. Some request that the boards clarify presentation in the pre-binding period.

Transition

94. No-one we have spoken to agrees with the proposal in the IASB ED[3] that, on transition, an entity would measure each portfolio of insurance contracts at the

[3] The FASB DP did not set out proposed transitional requirements.

present value of the fulfilment cash flows, without any residual margin. The ED proposes transitional provisions that would include no residual margin in the measurement of insurance contracts in existence at the date of transition, both at transition and subsequently. For life contracts, this effect could be significant. The alternatives suggested are:

(a) Some preparers would prefer retrospective application, except when impracticable. This is consistent with the general approach in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Some suggest that retrospective application might be practicable for insurers producing embedded value information.

(b) Some support an approach in which the residual margin is calibrated to the pre-transition carrying amount.

(c) Some preparers are investigating whether a reasonable proxy for the residual margin at transition would be the difference between the liability determined using the building block approach and the fair value of the insurance contracts, determined by applying the business combination guidance.

95. Some request that the boards clarify the transition for reinsurance assets.

96. Some suggest that the boards should consider specific arrangements to ease transition to the insurance contracts standard in the context of the new requirements in IFRS 9 *Financial Instruments* and any new US GAAP arising from the FASB's projects on financial instruments. These include:

(a) support for the boards' proposal to align the effective date of the insurance contracts standard with IFRS 9 or with any new US GAAP on financial instruments, even if this were to mean delaying the effective date of IFRS 9 for a year.

(b) permitting entities to redesignate financial assets as measured at fair value or at amortised cost if entities are required to apply IFRS 9 or any new US GAAP before the effective date of the insurance contracts

standard. Some note that the ED proposed that entities would be permitted to redesignate financial assets as measured at fair value when they apply the insurance contracts standard for the first time, and believe that a similar approach should be applied for amortised cost.