Staff Paper

Project **Insurance contracts**

Topic **Comment Letter Summary**

Purpose of This Memo

1. The purpose of this memo is to provide the Boards with a summary of significant comments received on the FASB Discussion Paper, *Preliminary Views on Insurance Contracts* (DP), issued on September 17, 2010, before commencing redeliberations. The comment period for the DP closed on December 15, 2010. Because of the compressed time frame between the close of the comment letter period and the commencement of redeliberations, the staff is providing the Boards with a summary of each of the issues addressed in the comment letters. We want to assure the Boards that the staff will address, in depth, each of the significant issues highlighted in this memo as part of our analyses brought to the Boards in future memos.

2. A summary of the outreach activities was presented to the Boards during the December joint meetings as part of Agenda Paper 54C and should be considered in conjunction with this paper.

3. The remainder of the paper is structured as follows:

   (a) General observations

   (b) Significant issues

      (i) Discount rate

      (ii) Cash flows

(iii) Margins

(iv) Modified approach

(v) Presentation

(vi) Disclosure

(vii) Transition

(viii) Unbundling Reinsurance.

(c) Other issues:

(i) Contract boundary

(ii) Recognition

(iii) Definition

(iv) Scope

(v) Extended effective date and field testing.

4. This paper is provided for informational purposes only and contains no staff recommendations. We are not asking the Boards to make decisions with regard to the content provided.

General Observations

5. The FASB received 74 comment letters on its DP. The summary provided herein includes comments received from a variety of constituents; none of the comments received were unique to a particular entity being private or public. The composition of the respondents to the DP is as follows:

Type	Count	Percent of Total
Preparer	45	62.1%
Industry Organization	10	13.5%
User	6	8.1%
Auditor	4	5.4%
Professional Organization	4	5.4%
Individual	2	2.7%
Actuary	1	1.4%
Regulator	1	1.4%
Total Respondents	74	100.0%

6. In this section, the staff provides what it believes to be respondents'comments that did not necessarily address a particular question posed in the FASB's DP but rather offered commentary that was pervasive enough that the staff felt the Board should be aware of the general comments.

7. In general, respondents commented that they are concerned with the pace of the redeliberation timetable to meet the projected timing of a final standard by the IASB. While the majority of respondents support the efforts of the Boards to produce a converged standard, they are concerned that the current differences between the IASB's Exposure Draft, *Insurance Contracts* (ED), and the FASB's DP are fundamental differences that should be reconciled before the issuance of a final standard. For example, the American Council of Life Insurers (CL #1) commented:

> … the differing IASB and FASB views on critical components… need to be resolved before issuing a final standard. The due process necessary to achieve convergence should not be constrained by a June, 2011 target date. Setting a target is integral in the planning process of any project, but it is more important to get it right (quality accounting standard) than getting it done.

8. Although the above quote was taken from one particular respondent to the DP, the staff notes that the sentiment is indicative of general responses received as well as what was conveyed during our extensive outreach activities.

9. Several respondents strongly urged the FASB and the IASB to redeliberate and resolve the key differences and issue/reissue an Exposure Draft that reflects a common view. Many respondents encouraged the FASB and the IASB to reach a single converged standard even if this would delay the issuance and adoption of a final standard. In addition, they stated that in the long run, business and capital markets will be better served with a single, global standard. Regardless of the timetable for the release of a final standard by either Board, many respondents suggested that both Boards provide for (a) extensive field testing before the release of a final standard to determine the effect the standard will have on the industry and (b) significant lead time for adoption upon release of a final standard, given the significant effect of the proposed guidance.

10. Many respondents suggested that extensive field testing should be performed to determine the extent of change required to current systems and to facilitate an assessment of whether those changes would improve financial reporting enough to warrant such significant changes. Respondents noted that if the differences between the FASB and the IASB are reconciled and the improvements from current U.S. GAAP are significant enough to warrant the changes to current financial reporting, sufficient lead time should be provided for adoption of the standard.

11. A few respondents noted that the FASB should consider the costs to preparers and users of financial statements before issuing guidance that is not fully converged. If full convergence cannot be accomplished, a few respondents stated that changes

should not be made to U.S. GAAP at this time while others believe that targeted changes may be warranted.

12. In general, many property and casualty and health respondents do not see the need to change the model for short-duration contracts as currently accounted for under U.S. GAAP. They see the need for a new model to be a problem particular to the life insurance business. A typical comment provided by Endurance Specialty Holdings Ltd. (CL #67) was indicative of most of the comments regarding this particular notion:

> We believe that the current U.S. GAAP model for insurance and reinsurance contracts is a complete, comprehensive set of standards which have successfully produced high quality financial reporting for many years. This model has been tried and tested over a number of years and provides users with relevant, reliable, transparent, and decision-useful information which is comparable year over year and among insurance and reinsurance companies. This model is familiar to users and does not have serious issues which need to be corrected.

Significant Issues

13. In this section the staff presents what it considers to be the significant issues noted by respondents throughout the majority of the comment letters. This memo provides a summary of the responses received from respondents, and a full analysis of the issues will be provided as part of the redeliberations process, incorporating the responses provided herein.

Discount Rate

Common Responses

14. The selection of the discount rate appears to be the most controversial topic of the FASB's DP. As currently written, the preliminary views expressed in the DP are consistent with the proposal set forth by the IASB's ED. That is, insurance contracts would be discounted utilizing a rate that is composed of the risk-free rate plus an illiquidity premium. Overwhelmingly, the majority of respondents to the

DP do not agree with the selection of the discount rate. Overall opposition to the preliminary views about the discount rate included the following:

(a) Calculation of the illiquidity premium

(b) Volatility in profit and loss—short-term fluctuations caused by accounting mismatches and fluctuations in rates are not indicative of the long-term business model for insurance contracts.

15. The majority of respondents questioned how the calculation of the illiquidity premium could be made operational. Respondents commented that no standard calculation for an illiquidity premium has been developed or widely accepted in the market and any attempt by entities to develop their own method of calculation would introduce subjectivity and judgment to a level that would render the measurement unreliable and reduce comparability. If the FASB were to maintain the notion of an illiquidity premium as part of the construct of the discount rate, significantly more guidance for the calculation of the premium would be required to provide for comparability between entities.

16. Some respondents commented that the introduction of an illiquidity premium was not based on sound conceptual or accounting reasoning regardless of the calculation. The International Association of Insurance Supervisors (CL #9) noted the following:

> The introduction of an illiquidity premium is inconsistent with the concept of fulfillment value. Policyholders' greater or lower ability to liquidate insurance contracts has no demonstrated impact on the insurer's liability towards these policyholders. The value of an insurance liability – which has the same illiquidity feature at any point in time since its origin – is usually not influenced when markets' perception of liquidity of financial instruments change.

17. Other respondents suggested that the FASB add to its agenda a project that focuses solely on discounting of all liabilities. While those respondents believe that a long-term project for discount rates is warranted, they also acknowledge the resources that would be required to accomplish such a task. Several respondents suggested that as a short-term practical solution, the Boards propose to use for

non-linked contracts a high-quality corporate bond rate similar to *FASB Accounting Standards Codification*® Topic 715 on retirement benefits.

18. While calculation of the illiquidity premium is a concern for most respondents, it is a secondary concern to the potential accounting volatility created by discounting recorded to profit and loss. Many respondents cited the differences between the current value measurement of insurance contract liabilities under the DP and the measurement allowed for the assets backing those liabilities, whether under IFRS 9, *Financial Instruments*, or any potential final standard for financial instruments released by the FASB. Many respondents argued that the accounting mismatch created by the current value measurement of insurance liabilities and fair value measurement of the assets backing those liabilities is not indicative of the economics of the insurance business and should not be reflected in profit or loss.

19. Furthermore, many respondents noted that the short-term fluctuations in interest rates that would be reflected in the current value measurement through discounting are not reflective of an insurance entity's long-term business model. However, most respondents agree that an entity's own credit risk should not be considered in determining the discount rate as a potential solution to this problem.

20. Respondents proposed several potential solutions that the staff will explore as part of the redeliberation process. Some of the solutions suggested include the following:

    (a) Locking in the discount rate at inception while updating the measurement for changes in nonfinancial assumptions

    (b) Utilizing a discount rate based upon pricing of the products

    (c) Utilizing a standard discount rate for all discounting such as a highly rated corporate bond

    (d) Utilizing two discount rates (that is, one rate for balance sheet changes one rate for income statement changes with differences in measurement recoded in other comprehensive income)

(e) Reflecting changes in measurement due to the discount rate (that is, financial changes) in other comprehensive income

(f) Providing for a measurement election for financial assets backing insurance liabilities under IFRS 9 or a new FASB standard on financial instruments

(g) Cost of capital rate.

Life Insurance Preparers

21. For life insurance preparers, the discussion of discount rate primarily centered on the business model of life insurance, which is to sell products that provide long-term benefits that will be settled by the entity. Life insurance preparers noted that pricing of those products reflects investment income that will be earned over time to off-set the cost of the benefits provided. In particular, life insurance preparers are concerned with the following:

(a) Onerous contracts on day one for products that ultimately will be profitable.

(b) Risk-free rate plus an illiquidity premium does not account for how entities price their products.

(c) Short-term fluctuations in interest rates can have a significant effect on long-term contracts from a measurement perspective.

22. Life insurance preparers are particularly concerned that the discount rate selected will place many contracts that they currently offer in an onerous position on day one. Because of the terms of 20, 30, or sometimes 50 years, utilizing a risk-free rate plus an illiquidity premium for discounting has a significant effect on the present value calculation. Life insurance entities price their products by contemplating the investment earnings that will be made on cash inflows from the contracts. These investment earnings over the long-term will, more often than not, make up for disparities in cash outflows resulting in a contract that is ultimately profitable. These entities argued that if forced to use a discount rate that does not

contemplate how they price their products, they will need to increase prices on certain products. These price increases could potentially make offering the products uneconomical.

23. In addition to the potential for onerous contracts on day one, life insurance entities are concerned that short-term fluctuations in discount rates (risk-free rate plus illiquidity) that do not reflect the change in the credit spread of the assets backing those liabilities creates an accounting mismatch that does not faithfully represent the economics of the underlying transactions. Life insurance entities argued that reflecting duration mismatches that are economic in nature is appropriate; however, utilizing a discount rate that introduces elements that do not faithfully represent the underlying economics is not appropriate. For example, the Group of North American Insurance Enterprises commented:

> Any notional extension of the current yield curve that in essence projects an extension of the current term structure introduces unwarranted volatility in the measure, since the discounted value of unmatchable cash flows is highly sensitive to changes in the discount rate. Once again, such volatility is spurious in that current interest rates are irrelevant in predicting yields 20 or more years into the future.

Property / Casualty and Health Preparers

24. The majority of property / casualty preparers in the United States disagree with discounting liabilities as expressed in the FASB's DP. The majority of U.S. property / casualty preparer respondents believe that the model for short-duration insurance contracts (as defined currently under U.S. GAAP) is fundamentally different from that of long-duration contracts and, therefore, a different measurement model should be applied. In general, most respondents commented that the discounting of such contracts would be immaterial for short-tail claims and, therefore, the incremental costs and efforts to discount outweigh any benefits that would be gained. For certain long-tail claims, the amount and timing of payment is unpredictable and discounting adds uncertainty. Discounting is appropriate for other long-tail claims in which the amount and timing of payments are fixed and reliably determinable on an individual claim basis. Most property /

casualty respondents commented that undiscounted liabilities that are supplemented with appropriately designed claim development tables provide investors with the most transparent information.

25. The Group of North American Insurance Enterprises (CL #10) commented:

> The introduction of discounting would impair the ability of investors and other financial users to assess the underwriting performance of insurers, and the insurers' ability to estimate claims reserves accurately.

Cash Flows

Expected Cash Flows

26. Both Boards agree on the first building block of the insurance model, which includes an explicit, unbiased, and probability weighted estimate (that is, expected value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfills the insurance contract. Most respondents support a model based upon expected cash flows and the proposed measurement attribute based on fulfillment value rather than exit value.

27. Some respondents requested that the Boards provide additional examples of what types of cash flows to include in the expected cash flows. Several respondents commented that overhead expenses should be included in expected cash flows.

28. Some respondents commented that the Boards should clarify the guidance to specify that in certain situations, it would be inappropriate to treat the cash flows and the discount rate as independent building blocks if the cash flows are dependent on the interest scenarios (that is, minimum interest guarantees).

29. Several respondents noted their agreement with including participating benefits in expected cash flows. However, a few respondents commented that the provision for policyholder dividends should be for in-force policies only and not future policyholders.

30. A few respondents suggested measuring expected cash flows on a portfolio basis and defining *portfolio* in a principles-based manner. Others suggested defining *portfolio* utilizing current U.S. GAAP guidance (that is, contracts subject to broadly similar risks and managed together as a single pool consistent with the insurers' manner of acquiring, servicing and measuring the profitability of insurance contracts).

31. A few respondents commented that the remeasurement of assumptions should only take place if certain triggering events necessitate a change in assumptions and not each reporting period. In addition, several respondents suggested that the Boards permit recording all remeasurement adjustments for assumptions to other comprehensive income.

Probability Weighted Cash Flows

32. Some respondents are concerned about the amount of detail required to determine the probability weighted estimate in practice. In particular, those respondents interpret the FASB's DP to require the performance of stochastic modeling in all instances. Many respondents, particularly property / casualty preparers, believe that the objective of the measurement model should be to calculate the statistical mean and allow other methodologies for that calculation. For example, some respondents want to retain the usage of deterministic (managements best estimate) modeling. Respondents are concerned that if the intent of the DP was to perform stochastic modeling in all instances, that significant time and costs would be required to implement that methodology with little to no difference in the actual outcome, which would provide little to no incremental benefit.

33. The American Academy of Actuaries (CL #23) commented:

> We are concerned that the wording in the current DP overemphasizes the term "probability-weighted" and may imply that identification of and assigning probabilities to every scenario of commercial substance may be required. There are many ways of producing appropriate estimates of mean value measures including methods that do not involve explicit identification of and assigning probabilities to every scenario and we do not see why preparers should be restricted in their approaches. Any approach used should be appropriately disclosed.

34. Many property / casualty and health preparers commented that applying a range of scenarios that reflects a full range (every scenario of commercial substance) of possible outcomes is impractical, if not impossible, and would not increase relevance and comparability at a justifiable cost. This is especially impractical for low frequency and high severity exposures that would require losses to be recorded before the event giving rise to the loss has occurred. An example would be catastrophe losses in which the most likely scenario is that the event will not occur but, if it does, the net cash flows will likely deviate significantly from the expected probability weighted estimate.

35. Several respondents noted that accounting standards should not govern the actuarial profession or how actuarial estimates are derived.

Acquisition costs

36. Many respondents agree that acquisition costs should be included in the cash flows as part of the first building block. However, a few respondents requested more guidance about which costs should or should not be included. Additionally, a few respondents commented that U.S. GAAP language regarding the capitalizing of advertising costs should be included so that it is clear that direct marketing costs that meet the criteria can be included in the expected cash flows.

37. A majority of the respondents commented that acquisition costs should be calculated at the portfolio level and not the individual contract level. Those respondents noted that the treatment of acquisition costs appears to be inconsistent

with the rest of the model that calculates the elements of the measurement at the portfolio level. In particular, they noted that this treatment 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 services externally) and sales compensation plans.

38. Other respondents commented that the treatment of acquisition costs should be consistent with Accounting Standards Update No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* (a consensus of the FASB Emerging Issues Task Force), which requires an entity to 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.

39. A few respondents noted that they should have the option of expensing certain costs when incurred rather than including them within the expected cash flows.

40. Respondents also commented that the adoption of two standards with different treatments within such a short time span would be costly and burdensome for preparers and, therefore, does not make sense.

Margins

41. The IASB's ED proposes that the insurance liability reflects the effects of uncertainty about the amount and timing of future cash flows by including an explicit and separately identified risk adjustment in its measurement. In addition, the IASB proposes that the measurement of an insurance liability includes a residual margin, calibrated to eliminate gains at inception. In contrast, the FASB's DP explains that under its preliminary views, risk and uncertainty would be reflected implicitly through a single composite margin.

42. Differences in measurement between the two views of the building blocks approach do not arise at initial recognition of an insurance contract because both views calibrate the residual margin and composite margin to the present value of consideration received or receivable from the policyholder (unless the contract is onerous upon initial recognition).

Risk Adjustment

43. Many respondents to the FASB's DP do not support an explicit risk adjustment. Many of the respondents commented that the determination of the risk adjustment generally will involve significant set-up costs, will be difficult to account for, and will add an element of judgment and subjectivity that may impair comparability and allow for potential manipulation of results. Specifically, respondents 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, which would make it difficult to determine whether the assumptions were reasonable and the objective of its measurement were met. As a result, some respondents believe that the amount determined as a risk adjustment would be arbitrary and, therefore, does not contain decision-useful information. In particular, 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.

44. For example, the Group of North American Insurance Enterprises (CL #10) commented:

> The two margin (risk adjustment plus residual margin) approach is most likely to mislead users into thinking that the information reflects precision (that does not exist in these calculations), or that the residual margin is a pure profit provision rather than what it is – an arbitrary division of the available margin that consists largely of premium intended to cover general administrative expenses and overhead not included in the first building block. We are concerned that most analysts will remove the risk adjustment margin and residual margin, and replace it with their own view of what margin is required without having the required information to do so in a proper way. The costs of

> theoretically calculating a risk adjustment will far outweigh any benefits.

45. The IASB's ED states that the risk adjustment would be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected. Most respondents do not believe that the objective of the risk adjustment is understandable. Some respondents to the FASB's DP commented that the wording of the proposed guidance on risk adjustment appears to be consistent with an exit value notion as opposed to a fulfillment notion and, therefore, contradicts the notion of fulfillment value. In addition, respondents commented that the objective is confusing because while the above references what an insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected, paragraph 22(c) of the IASB's ED states that the building blocks include "an explicit estimate of the effects of uncertainty about the amount and timing of those future cash flows." Some respondents believe this makes the objective unclear because uncertainty would include higher and lower expectations, not just higher as stated above, and the term *exceed* should be replace with *differ from* or *vary from.*

46. Although many respondents noted their opposition for the use of an explicit risk adjustment, many of them also mentioned that if an explicit risk adjustment is required, the techniques for calculating the adjustment should not be limited to the three techniques expressed in the IASB's ED, but rather should state the principle and allow the actuarial profession to develop an appropriate methodology based on the business mix at each individual company.

47. The American Academy of Actuaries (CL #23) commented:

> ...we do not agree with limiting the techniques that could be used in estimating risk adjustments. We believe that while there are situations where the three techniques noted in the ED could be used to properly estimate a risk adjustment, there are other methods that could also be used and there are other situations where none of the three methods may be appropriate.

48. Many respondents noted that using the three alternatives and a single set of claim data produces materially different results that would not be easily understood.

49. Finally, a few respondents believe that the risk adjustment should include asset related risks.

Composite Margin

50. Very few respondents commented that insurers should recognize a gain at initial recognition of an insurance contract and, therefore, do not believe there should be a margin, but believe that these situations would be infrequent.

51. Although many respondents to the FASB's DP recommended the use of a composite margin because they do not support the recognition of a gain at inception of the contract or for the reasons noted above, many did not necessarily agree with the run-off methodology prescribed in the DP. Some respondents commented that the formulaic approach expressed in the DP would not necessarily be appropriate for all contracts because it would delay profit recognition beyond (a) the period in which all risk protection services are provided, and (b) the majority of the costs and efforts to settle the claims have been expended.

52. Additionally, a few respondents requested guidance on how to allocate the premiums, especially for certain life insurance and financial guaranty insurance contracts.

53. One respondent is concerned that the recognition of the composite margin as proposed in the FASB's DP would result in previously earned composite margin potentially being reversed in a subsequent period if the estimate of ultimate cash flows increases because this will affect the denominator of the ratio. This would add volatility to the results and would not represent the underlying economics.

54. Because of the issues described above, respondents suggested revising the model to (a) amortize the composite margin over the coverage period, (b) amortize the composite margin over the risk period, or (c) provide a weighting to the inflows (premiums) and outflows (claims).

55. However, several respondents commented that the final standard should not provide a rules-based methodology for determining run-off but rather a principles-based approach that aligns the amortization of the composite margin with the insurers release from risk.

Remeasurement of the Composite Margin

56. Many respondents commented that one consequence of recognizing the composite margin (or residual margin under the IASB's ED) on an allocated basis is that an entity may recognize losses in a period even though there will be gains from the composite margin in future periods. Some respondents believe this effect will be difficult to explain to investors.

57. There were some respondents who suggested that the composite margin should be recognized on a basis other than allocation and should reflect current measurement. In particular, they believe that the composite margin should absorb changes (both positive and negative) in cash flow estimates relating to non-financial variables. Many justified this thought process by comparing the composite margin to the rest of the model. They stated that it would be inconsistent to base the entire model on a current value notion and leave the composite margin locked.

58. The IASB's ED sates that the residual margin should be adjusted if few contracts are in force at the end of a period that was expected. Several respondents noted that the margin also should be adjusted if more contracts than expected remain in force.

59. Some respondents noted that the composite margin (and residual margin under the IASB's ED) includes the present value of amounts included in premiums to cover non-incremental acquisition costs, such as general and administrative expenses

and taxes. As such, the amortization of the composite margin should coincide with the incurrence of these expenses and should not be adjusted to reflect changes in assumptions. Alternatively, these expenses should be included in expected cash flows such that the composite margin would represent a risk adjustment and deferred profit (and the residual margin would represent deferred profit). Therefore, the margin should be unlocked for subsequent measurement of the expected cash flows.

Interest Accretion

60. Most respondents noted that they agree that interest should not be accreted on the composite margin as expressed in the FASB's DP. Those respondents generally believe that it overcomplicates the model to accrete interest and then amortize it given that those respondents view the composite margin as a deferred credit. Furthermore, those respondents do not believe interest accretion provides users of insurers' financial statements with useful information.

Modified Approach

61. The FASB's DP does not provide a preliminary view for a modified approach but rather expresses the Board's consideration that a different approach may be necessary for specific types of contracts (for example, short duration). The DP provides the IASB's modified approach and requested respondents' feedback on the appropriateness and usefulness of such an approach and whether any improvements could be made to the model. As a result, many of the responses were directed specifically to the modified approach and the issues respondents had with such an approach. The IASB's ED proposes a modified approach for the pre-claims liabilities of some short-duration contracts, defined as contracts that do not contain embedded options or other derivatives and for which the coverage period is approximately one year or less.

62. Although users did not submit many letters (5 of 74 were from users), one user appears to support the notion that property / casualty and life insurance are different business models. Dowling and Partners Securities (CL #62) commented:

> From an analyst's perspective, there are numerous differences between life and PC businesses that suggest different measurement models are entirely acceptable, and preferable if the goal is to deliver meaningful information to investors. …Accounting should match as closely as feasible the underlying economics of the business. If two different businesses have differing economics (which I believe is true for PC and life), there is neither need nor value in forcing both into the same model.

63. The majority of respondents, in particular property / casualty and health preparers, expressed opposition for the one-year cut off for eligibility for the modified approach. This opposition primarily stems from the fact that under current U.S. GAAP, the contracts these particular entities write are considered short-duration contracts and do not always fall within a one-year, brightline rule. These respondents believe that the determination of short-duration contracts under current U.S. GAAP is well understood and used in many jurisdictions and, therefore, should be used in the final standard or, alternatively, some other principles-based approach that focuses on the purpose of the insurance contract.

64. Aside from wanting to keep the U.S. GAAP criteria, there were practical concerns that respondents addressed as well. For example, some respondents questioned how the one-year eligibility requirement affects one-year risk attaching reinsurance contracts that reinsure 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.

65. Additionally, some respondents believe that the proposal will result in different accounting for similar products with different terms. For example, some non-life contracts may have durations longer than one year. Examples cited include surety contracts that insure a construction period for three to five years and multi-year property coverage. In a business combination, an acquiring entity may write longer coverages to align the effective dates with their existing blocks of business.

Respondents believe this is an issue because such contracts are similar in nature to equivalent contracts that have a duration of less than one year.

66. In addition to eligibility requirements, many respondents (particularly property / casualty preparers) want to maintain the existing unearned premium approach for non-life contracts because users find it useful. Many of these respondents believe that the modified approach (with specific changes) should be treated as a separate measurement model as opposed to a “modification” to the proposed building blocks approach. Some of these respondents believe that the building blocks approach would be applied only when there is significant risk of variability of future cash flows (for example, because of embedded options). Other respondents believe that the building blocks approach is only applicable to long-term contracts (as defined by U.S. GAAP).

67. Many respondents want to maintain the existing unearned premium approach as defined under U.S. GAAP because they perceive the modified measurement approach as being over-engineered, and some question how much relief it provides (notwithstanding the eligibility requirements) from the building blocks approach. For example, the respondents believe that features such as interest accretion in the pre-claims period and discounting the expected future premiums complicate the model with immaterial change and will make it difficult for users to understand an insurer’s operations. In addition, the inclusion of a risk adjustment in the onerous contract test under the IASB’s two margin approach is seen as complicating the model.

68. Additionally, many respondents commented that 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 in much the same manner as under current U.S. GAAP. They noted that entities do not knowingly enter into contracts that are onerous on day one.

69. Finally, the majority of respondents, especially preparers that write both life and non-life business, would like the modified approach to be permitted rather than required.

Presentation

70. The IASB's 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.

71. Most respondents believe that there should be consistent reporting for all types of insurance contracts. One respondent noted that it believes that the fundamental differences between short-duration and long-duration contracts would not cause a need for different presentation formats.

72. The majority of respondents disagree with the assertion that the margin presentation approach would provide more decision-useful information. Most respondents are uncomfortable with eliminating from the statement of comprehensive income information about premiums, fee income, claims/benefits, and investment income and expenses.

73. Anecdotally, the staff learned through its extensive outreach that many users do not appear to rely on the primary statements but use other, more detailed sources of information instead. Most U.S. users indicated that the consolidated financial statements are not typically used other than at a very high level. Rather, the users typically request additional supplemental information and utilize U.S. statutory data for non-life (specifically, "Schedule P," which is a claim development table by line of business) and supplemental quarterly and annual data provided by life insurers.

74. Nonetheless, many users believe that the current presentation model works well for insurers. Most respondents indicated that the main types of information they utilize include:

(a) Growth (indicated by adjusted premium volume, premiums written, premiums earned, and fee income)

(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) Operating expenses

(e) Change in benefit and claim liabilities

(f) Book value per share

(g) Yield on investment portfolio.

75. Several property / casualty preparers disagree with reporting either a net asset or net liability for each insurance portfolio and would prefer separate reporting of claim reserves, unearned premium reserves, other pre-claim reserves, uncollected premium, and deferred acquisition costs.

76. If a summarized margin approach is adopted, a few respondents suggested a supplementary table to comprehensive income that would include information about premiums and claims and source of earnings.

Disclosure

77. A majority of respondents expressed concerns about the volume and complexity of the proposed disclosure requirements. Some criticized the proposed disclosures as not being founded on a clear objective and commented 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 the usefulness 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.

78. Some respondents questioned the usefulness of some of the proposed disclosures. In particular, some preparers commented that the proposed disclosure of the implied confidence level, when an explicit risk adjustment is recorded under the IASB's ED, would not add to comparability between entities. In addition, they observed that the basis for conclusions makes it clear that the implied confidence level approach to determine the risk adjustment is the most limited of the three methods. They argued that this calculation would be burdensome and result in limited value to users.

79. Some preparer respondents commented that the volume and detail of the proposed disclosures border on providing proprietary information that possibly could put them at a competitive disadvantage.

80. Many property/casualty insurers support the additional disclosure of loss development.

81. One respondent noted that many of the non-GAAP disclosures commonly requested by users today, for example, operating earnings, adjusted book value and embedded value, should be required.

82. Some respondents support enhancement to disclosures about products, risks, pricing, assumptions, and performance for the contracts, including how estimates change period to period.

Transition

83. Although the FASB's DP does not address transition, many of the respondents either attached their submission of response to the IASB's ED or addressed transition as part of their general concerns. The majority of respondents are overwhelmingly concerned with the proposal in the ED. The ED proposes that an entity, on transition, would measure each portfolio of insurance contracts at the present value of the fulfillment cash flows without any residual margin. For insurance contracts in force at transition, the measurement, both at transition and subsequently, does not include a residual margin, which would be a different measurement approach than for new business written. For life contracts, this effect could be significant because it would result in an overstatement of equity at the time of transition and an understatement of earnings from the in-force business in the future, significantly changing the profit emergence of in-force business. The following alternatives to determine the deferred profit / residual margin were suggested:

    (a) Retrospective application except when impracticable

    (b) An approach that calibrates the residual margin to the difference between the pre-transition carrying amount and the calculated fulfillment value.

    (c) An approach that applies the business combination guidance with the deferred profit / residual margin being set to the calculated value of business acquired.

    (d) An approach that sets the residual margin to the difference between the insurance liability measured using the building blocks approach with original assumptions and with current assumptions, prorated.

84. Some respondents suggested that the Boards consider specific transition arrangements to ease the first-time application of the insurance contracts standard in the context of the new requirements in IFRS 9 and the FASBS's guidance in proposed Update, *Accounting for Financial Instruments and Revisions to the*

Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815). These include:

(a) Align the effective date of the insurance contracts standard with IFRS 9 or the FASB's proposed financial instruments Update, even if this were to mean delaying the effective date of IFRS 9 for a year.

(b) Permit an entity to redesignate financial assets as measured at amortized cost if an entity is required to apply IFRS 9 or the FASB's proposed financial instruments Update before the effective date of the insurance contracts standard. The IASB's ED proposes that an entity would be permitted to redesignate financial assets as measured at fair value when it applies the insurance contracts standard for the first time.

Unbundling

85. Many of the respondents to the FASB's DP noted that the proposed requirements for unbundling should be further clarified if the Boards decide to maintain those requirements. The Boards described unbundling, whereby an insurer would account for noninsurance elements separately from the insurance component in some circumstances. Specifically, if a component is not closely related to the insurance coverage specified in a contract, an insurer would account for that component as if it were a separate contract and apply the relevant standard to that component. Many respondents commented that it is unclear when unbundling is required. General comments were as follows:

(a) The examples do not adequately convey the principle and without further guidance or additional examples, the principle may not be consistently applied.

(b) Some of the examples do not seem to appropriately explain the principle.

(c) 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 universal life contracts would not be unbundled because they do not pass all the investment returns to the policyholder.

86. More specific examples of lack of clarity included the following:

(a) It is unclear whether 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.

(b) It is unclear whether asset management services are contractual terms relating to goods and services that should be unbundled.

(c) It is unclear how some items should be allocated between the insurance contract component and the unbundled component, including premiums, expected profit, acquisition costs, and backend loads.

(d) It is unclear whether policy loans should be unbundled as a separate financial asset or should be part of the insurance contract expected cash flows. This is important as there is diversity in practice today under IFRS 4, *Insurance Contracts*

87. Unbundling involves costs to preparers and some respondents questioned whether the benefits justify those costs. Some respondents consider the exercise to be arbitrary while not producing results that are any more transparent or useful to the user of financial statements. Goldman Sachs (CL #58) commented:

> Unbundling as proposed in the DP and the ED would be arbitrary and even unbundling of contracts with an explicit account balance draws artificial distinctions between products. Account balance product elements are priced with internal subsidies, which would lead to misleading presentation if separated. ...While unbundling introduces complexity in accounting, it will not produce transparency for financial statement users. There is currently insufficient guidance to

ensure that all preparers will produce the same measurement under the same circumstances.

88. A few respondents believe that unbundling components of an insurance contract that are not closely related to the insurance coverage would be necessary to alleviate some of the issues caused by the discount rate mismatches in certain products and to more appropriately reflect the nature of the components.

89. One respondent believes that it is appropriate to expand unbundling to all significant pre-funding of non-participating contracts such that these components would be accounted for consistently with financial instruments and reduce the opportunity for structuring contracts to achieve accounting results.

90. Several respondents commented that they believe it is inappropriate to unbundle certain components of insurance contracts because insurance policies are priced on an integrated basis, components are not managed separately, and unbundled results would not be materially different.

91. Others commented that unbundling should be required only for embedded derivatives bifurcated under current U.S. GAAP (although one respondent noted that the current different treatment of death benefits and living benefits should be eliminated) and goods and services combined in a contract for reasons with no commercial substance.

92. Some respondents commented that account balances of deposit-like insurance contracts should not be unbundled because those are closely related components and, therefore, should be measured as part of the insurance contract. However, these respondents believe the unit-linked or separate account contract assets and related liability should be presented separately and the comprehensive income statement should be presented on a net basis.

93. A few respondents support unbundling for product features that are not interdependent with the host insurance contract, for example, if an option value is determined solely on its own without any reference to the value of the insurance host contract.

94. A few respondents noted that unbundling should be required only for components that are separately managed and priced. Others stated that it should only be required when insurance risk and cash flows are not affected by and are completely independent of the separated financial elements.

95. A few respondents asked that the guidance clarify whether services that could potentially be considered closely related to the insurance contract, such as premium collection or benefit payment services but that are sold on a standalone basis from an insurance contract, should be bundled together as if they were one contract.

Reinsurance

96. Many respondents noted that there should be more overall guidance on reinsurance, specifically, (a) when and how often a contract is assessed for whether it is insurance or not, (b) whether significant risk is present in an insurance contract on a standalone contract basis or whether all insurance contracts connected to that contract should be taken into consideration, and (c) to address the treatment of loss portfolio transfers, commutations, other retroactive arrangements, and funds withheld arrangements.

97. In addition, several respondents noted the following observations :

  (a) Netting reinsurance commissions against ceded reinsurance premiums would alter underwriting component metrics between direct and net business.

  (b) The calculation of the risk adjustment/residual margin or composite margin should be calculated as gross less net equals ceded versus gross less ceded equals net, which can result in material different results.

98. Many respondents do not agree with allowing ceding entities to recognize a gain at the inception of a reinsurance contract.

99. In addition, some respondents do not agree that reinsurers should recognize a day one loss on reinsurance contracts because this typically would be only an accounting loss as a result of assets being recorded at fair value and liabilities being recorded at fulfillment value.

100. Most respondents commented that the reinsurer should apply the same recognition and measurement approach because the ceding entity does for the underlying insurance contracts.

101. Several respondents commented that they do not support an expected loss model for reinsurance recoverable given that these recoverable typically have a higher priority in bankruptcy than general liabilities and are closer to policyholder obligations.

Other Issues

Contract boundary

102. The FASB's DP provides the preliminary view 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.

103. Some respondents are concerned about the effect of regulatory restrictions on pricing—for example, how the contract boundary would apply to certain health and property / casualty insurance contracts whereby rate resets are annual but rate increases may be limited by a particular entity (for example, government, regulator, etc.) and where insurers are prohibited from declining insurance coverage to an applicant and from cancelling coverage for any individual or group.

104. If the contract boundary language is retained, it should be enhanced to indicate that an insurer's assessment of the ability to reprice to fully reflect risk must be made within the bounds of regulatory constraints.

105. Some respondents suggested that the contract boundary should include contracts that can be repriced at a portfolio level, but not an individual contract level, and should clarify whether the term *individual policyholder* refers to individual persons or to individual employers. This is of particular concern for contracts that are not meant to be multi-year contracts because the provider would have to include expected cash flows that go beyond the current coverage periods and those amounts are not yet known. These respondents are concerned that there would be potential volatility due to the uncertainty of whether or not the coverage will continue.

Recognition

106. The FASB's DP provides the preliminary view that an insurer would recognize an insurance obligation when it becomes a party to the contract, which is defined as the earlier of the date on which the insurer is bound by either of the following:

(a) The terms of the contract; or

(b) Initial exposure to risk under the contract.

107. Many respondents are concerned about:

(a) Inappropriate duplication of coverage obligations in which a replacement policy is bound before termination of the existing policy

(b) An offer of coverage or renewal without an affirmative acceptance (for example, open enrolment for group contracts—in some cases, the insurer has the ability to adjust the price depending on the volume of acceptance)

(c) Treatment / recognition of reinsurance contracts covering underlying insurance contracts in which the underlying insurance contract has not yet been written and the price, coverage, and terms may change

(d) Remeasurement of the insurance contracts before being on risk

(e) Extensive system modifications.

108. Most respondents recommended that the initial recognition of an insurance obligation should be at the coverage effective date because the insurer is not yet exposed to possible claim incidence or "on risk" in the pre-coverage period. One respondent provided the date of the first monetary transaction as an alternative.

109. If recognition of an insurance obligation is required before the coverage effective date, one respondent recommended allowing the margins to be reset when the final terms of the contract are known.

Definition

110. Most respondents agree with the definition of *insurance contracts;* however, several non-life respondents object to the term *compensation* replacing the current *indemnification* term as benefits paid indemnify the policyholder for an insured loss and is intended to put the policyholder in the same position as before the loss.

Scope

111. The majority of respondents agree that the scope of the insurance contracts standard should be based on the definition of an insurance contract rather than on the type of entity issuing the contract.

112. Respondents generally agree with the scope of the standard. However, they provided commentary on particular contracts:

    (a) Many respondents agree that financial guarantees written by insurers should be included in the scope of the final standard, but other respondents questioned whether bank-issued financial guarantees should be included or whether an impairment model would be more appropriate. However, others believe that financial guarantees that meet the definition of insurance should be accounted for as insurance whether it is written as an insurance contract or as a derivative.

    (b) One respondent noted that if banking products that compensate holders of instruments on events of default are outside of the scope of insurance contracts, it would be inconsistent to include mortgage insurance and financial guarantee in the scope of the final standard. This would result in economically similar instruments being accounted for inconsistently.

(c) Many respondents agree that investment contracts with discretionary participation features should not be within the scope of the final standard because it does not meet the definition of insurance.

(d) The majority of respondents commented that employer provided health care benefits should not be included in the scope because health care benefits are generally considered a form of employee benefits and therefore compensation costs. However, a few participants want clarification on treatment of certain insurance coverage to employees of insurance entities in which the premium charged to the employee is equivalent to the premium charged to third-party employees and insurance contracts issued to the insurers defined benefit plan (typically an annuity with investments in separate accounts) and corporate-owned life insurance, both when the executive is employed and after termination or retirement.

(e) A few respondents noted that title insurance should be removed from the scope of the final standard because of the unique nature of the insurance or that current U.S. GAAP language that addresses this uniqueness be included in the final standard.

(f) A few respondents requested additional examples to clarify the scope of excluding fixed-fee service contracts. Health insurers requested clarification that capitation arrangements between managed care insurers and health care providers would be excluded from the scope of the final standard.

(g) One respondent noted that the guidance should clarify that intra-entity guarantees for loans and financial commitments as well as agreements that indemnify a third party should be removed from the scope of the final standard.

113. A few respondents commented that the fair value option for insurance contracts should still be allowed.

Extended Effective Date and Field Testing

114. Respondents generally requested that the Boards perform extensive field testing and provide for an extended lead time for an effective date as most believe the costs to implement the standard could be significant. Respondents generally cited the following as potential incremental costs of implementing a new standard:

(a) New systems (administrative systems, actuarial valuation systems, and general ledger, forecasting and reporting tools, etc.)

(b) System changes to capture and funnel data in new ways

(c) Development of a new framework for presentation and disclosure

(d) Education of management, staff, and investors

(e) Processes, internal controls, and risk management

(f) Contract redesign and pricing

(g) Modification of investment and hedging strategies.

115. Most respondents noted that it is difficult to quantify the above changes given the fundamental differences requiring reconciliation between the FASB's DP and the IASB's ED; however, some provided an implementation range between three to six years.