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| Project | Insurance contracts | | |
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| Paper topic | Summary of comment letters on the IASB ED <i>Insurance Contracts</i> | | |
| CONTACT(S) | Andrea Silva | asilva@ifrs.org | +44 (0)20 7246 6961 |
| | Joanna Yeoh | jyeoh@ifrs.org | +44 (0)20 7246 6481 |
| | Andrea Pryde | apryde@ifrs.org | +44 (0)20 7246 6491 |

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This paper reproduces, without change, Agenda paper 3E *Summary of comment letters on the IASB ED Insurance Contracts* from the January 2011 meeting. It is reproduced for ease of reference to Agenda paper 2C *Comparison of the IASB's tentative decisions to the comment letter summary* at this meeting.

What is this paper about?

1. The objective of this paper is to provide an overview of the main issues raised in the comment letters received on the IASB's exposure draft *Insurance Contracts* (the ED).
2. This paper reflects the letters from 247¹ respondents that had been received at the time of writing. An analysis of those comment letters by constituent type and geographical region is included as Appendix A. We have analysed the comment letters by respondent type and we comment where there are any specific messages from each group. A fuller analysis for each constituent type is available to Board members from the staff on request.
3. This paper also reflects feedback from meetings and activities that supplemented the formal consultation provided by the comment letters, as follows:
 - (a) some IASB and FASB staff and board members undertook a programme of outreach activities. Those activities included live and

¹ Some comment letters have been received in parts. As a result of administrative inconsistencies, some were labelled as sub-parts (eg 2, 2A, 2B, 2C) and others had separate numbers (eg 4 and 114). In total we received 253 letters from 247 respondents.

recorded webcasts, Q&A sessions, participation in conferences, and meetings with insurance industry trade groups, individual insurers, accountants, actuaries, auditors, investors, analysts, and regulators from a wide variety of geographical regions.

- (b) the IASB and FASB held roundtables in Tokyo (9 December), London (16 December) and Norwalk (20 December) to develop further our understanding of the issues raised or alternatives proposed in the comment letters. Therefore this comment letter analysis integrates the views expressed during the roundtables. The roundtables focused on the following areas:
- (i) volatility and discount rate
 - (ii) margins
 - (iii) unbundling
 - (iv) modified approach for short-duration contracts
 - (v) presentation
 - (vi) (Norwalk only) cash flows included in measurement of the insurance contract.

4. This paper does not provide quantitative review of the comments received or capture a complete record of all issues and recommendations raised in the comment letters. This paper is intended for both Boards but focuses on the IASB ED and not the FASB Discussion Paper (DP). We do not ask for any decisions at this meeting.
5. We have not included in this analysis any letter that was addressed only to the FASB and did not respond to the questions in the IASB ED. Agenda paper 3F provides a separate analysis of the 73 letters received on the FASB's discussion paper, *Preliminary Views on Insurance Contracts*.

Structure of this paper

6. This paper summarises:
- (a) views on the development of an insurance contracts standard (paragraphs 7 - 13).

- (b) overall views on the proposed model (paragraphs 14 - 17).
- (c) a summary of feedback on the specific proposals in the ED (paragraphs 18-137), starting with those on the critical issues for redeliberations (paragraphs 18-67).

The development of an insurance contracts standard

Need for insurance contracts standard

7. In IFRSs, IFRS 4 *Insurance Contracts* permits diversity in accounting and presentation. It permits 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 from all types of respondent for the IASB developing an IFRS for insurance contracts. Many interested in financial statements prepared in accordance with 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.
8. In contrast, the accounting for insurance contracts is addressed in US GAAP. US GAAP requires different models for different types of insurance contract—one for short-duration insurance contracts (that is, for most property and casualty 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 changes to US GAAP, especially for insurers that write mainly non-life contracts, and question whether the proposals would result in improved accounting for those insurers. Those holding this view are concerned with replacing insurance standards that they believe have served preparers and users well for decades with a potentially untested model. However, others believe the variety of US GAAP accounting models that are used for most life contracts makes understanding the financial statements of insurers difficult and that even the accounting for non-life insurance contracts would benefit from improvement.

Costs and benefits

9. Most believe that the benefits of moving to a global standard on insurance contracts outweigh the costs and see great value in international alignment of accounting standards.
10. Some regulators believe that the costs of applying the proposed standard outweigh the benefits for small insurers because of the significant costs of system changes.
11. Many state that the benefits and costs of the proposals can only be judged when field testing is complete or the model refined.

Process and timetable

12. In spite of the perceived urgency for replacing IFRS 4, respondents express concerns about the current timetable for completion of the project, as follows:
 - (a) Some stated that the proposals in the IASB's ED 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.
 - (b) Some are concerned that there was insufficient time to evaluate the proposals in the ED and to comment on them. Some stated that the comment period was too short, especially because of the extent of the change proposed compared to existing practice². In Europe, many insurers were heavily involved in the Qualitative Impact Studies (QIS 5) undertaken in connection with Solvency II and believe that, as a result, they were not able to participate fully in the field testing activities or to evaluate the proposals or comment on them.
 - (c) Some perceive the June 2011 target date for finalising the IFRS to be an artificial deadline imposed by the rotation of the IASB's membership. They would rather the Board take more time to consider the implications of the various proposals more thoroughly and they stress the importance of allowing for sufficient time for critical issues to be redeliberated. Many state that this would not necessarily cause

² The comment period was 122 days, in accordance with IASB due process.

significant delays to the project. Many insurers believe that it would be challenging for the Board to finalise the standard by June 2011 and are concerned that timing should not compromise quality.

- (d) Some urge the Board to develop a converged insurance contracts standard with the FASB, and believe that doing so should take precedence over finalising a standard in June 2011.
 - (e) Some state that more comprehensive field testing is needed to better understand the impact of the new standard and to identify implementation issues. They state that sufficient time should be permitted for this.
 - (f) Some are concerned that they will not have adequate opportunity to comment on any changes that might be made before an IFRS is finalised and some suggest there may be a need for a second exposure draft.
13. Some recommend that the Board addresses the issues arising from the exposure draft through enhanced dialogue with the industry and support the International Association of Insurance Supervisors' (IAIS) recommendation that a technical advisory group should be set up as soon as possible to do this.

Overall views on the model

14. There is general support for a building block approach that measures an insurance contract directly using current, discounted estimates of future cash flows arising from the contract, revised at each reporting date. Most believe that the ED is a significant improvement over the IASB's discussion paper of 2007, specifically in the move from current exit value to the fulfilment notion. However, significant issues have been raised on each of the building blocks in the proposed model and on the way those building blocks interact. If those issues are resolved, many think that the proposed model would provide a reliable source of data and useful information for users of financial statements. For others, the significance of those issues leads them to state that they do not support the proposed model.

15. Users generally support a current measurement model and a building block approach with a separate and explicit risk margin because they think it will give them a clearer picture of the profit drivers and earnings streams of insurers. However many users are concerned that the proposed model is highly dependent on estimates and volatile, and that this will eventually lead to a lack of comparability.
16. In some jurisdictions there is already a current measurement model for insurance contracts. Some respondents from those jurisdictions agree that the proposals may be an improvement for others, but are concerned that the specific proposals in the ED may be a retrograde step for them. For example, in Canada, the insurance accounting model is similar to the proposal in the ED other than in the residual margin and in the selection of the discount rate. Many Canadians believe that the discount rate proposed in the ED would decrease the quality of information compared to their existing GAAP. Similarly, in Australia, some regard a locked-in residual margin as being inferior to their existing model which has an unlocked margin.
17. Most insurers think that the building block approach (or a variant of it) is appropriate for measuring life insurance contracts. However, many think that the building block approach would be overly complex for short-duration contracts. Many non-life insurers that apply US GAAP believe that the ED fails to recognize important distinctions between non-life and life insurance contracts. The current US GAAP approach for non-life contracts forms the basis of accounting for most non-life contracts globally and some believe this approach is time-tested, readily understood, and should be retained. While they acknowledge the existing US GAAP accounting model is not perfect, they believe it to be clear in its presentation and that it allows a user of financial statements to readily understand the relationships between the premiums received to accept risk and the payments made to fulfil the obligation under these same contracts.

Critical issues for redeliberations

18. Paragraphs 19-67 describe the issues that we think we will need to spend most time on in the redeliberations, either because differing views existed in the

deliberations preceding the publication of the ED or because respondents have proposed alternatives that we think would need more time to develop or evaluate.

These issues are:

- (a) volatility in profit or loss (paragraphs 19-24).
- (b) discount rate (paragraphs 25- 32).
- (c) residual vs composite margin (paragraphs 33-38).
- (d) remeasurement of the residual margin (paragraphs 39-42).
- (e) unbundling (paragraphs 43-47).
- (f) presentation (paragraphs 48-56).
- (g) short-duration contracts (paragraphs 57-67).

Volatility in profit or loss

19. The critical issue raised in almost all jurisdictions and from most respondent types is the volatility that would arise under the proposed model. This volatility would affect both profit and loss and equity and almost all insurers think that it would not be a faithful representation of their performance. In addition, there seems to be greater concern that volatility in profit or loss in particular will result in financial statements that will be difficult to explain, lack comparability and be neither relevant nor reliable.
20. Some state that this volatility results from a failure to reflect the asset-liability management inherent to the insurance business model. The measurement approach in the ED applies only to insurance contracts and not to the assets that insurers hold to back those contracts. The assets would be accounted for in accordance with IFRS 9, as follows:
 - (a) some financial assets must be measured at fair value through profit or loss.
 - (b) some financial assets may be measured at amortised cost. However, this would result in an accounting mismatch if the insurance liability is measured using a current discount rate. Many insurers are concerned that current measurement of insurance liabilities (specifically for

interest rates) 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. Many suggest that this places them at a disadvantage compared to banks, which compete with insurers in attracting investor capital.

- (c) some equity instruments may be measured at fair value through other comprehensive income, with no recycling of the cumulative gains and losses on ultimate disposal.

21. When assets backing insurance contracts are measured at fair value (either through profit or loss or through OCI), the measurement of such assets reflects the risk of non-performance by the borrower. In contrast, the proposed measurement approach for insurance liabilities excludes the risk of non-performance by the insurer. Thus, fluctuations in credit spreads on the financial assets would not be matched with corresponding changes in the measurement of the insurance liability. When changes in fair value are presented in profit or loss, this mismatch causes volatility in profit or loss. This effect was exacerbated during the financial crisis.
22. Another cause of volatility occurs when the measurement of insurance liabilities and the measurement of assets that an insurer holds to back those liabilities respond in different ways to changes in interest rate. This can occur:
 - (a) when an insurer has not matched the duration of the insurance liabilities with the duration of the assets that it holds (eg because assets are not available with sufficiently long durations); or
 - (b) when the insurance contract includes minimum interest rate guarantees.
23. Some, but not all, respondents believe that the measurement model should report the effect of duration mismatches or mismatches caused by minimum interest rate guarantees.
24. Respondents' proposals to address their concerns about volatility can be grouped in four main areas:

- (a) Some propose that a different discount rate would reduce volatility arising from what they believe to be accounting mismatches. This approach was strongly promoted in Canada. In addition, some propose that the discount rate should be locked-in at the inception of the contract. Discount rate is discussed in paragraphs 25-32.
- (b) Some propose that the effects of volatility could be presented in a more useful way, in particular by presenting some components of economic volatility in other comprehensive income. For example, some suggest an approach in which the changes in the measurement of an insurance contract are divided into an amount presented in profit or loss and an amount presented in the other comprehensive income. One way to divide the changes in measurement would be to present in profit and loss the results of using one discount rate, and to present in other comprehensive income the difference between those results and the results of using a different rate used to determine the liability in the statement of financial position. Those proposing this approach believe it would ensure that key performance indicators are not overshadowed by short-term market volatility. Participants at the Tokyo roundtable advocated use of OCI to present some components in the change in insurance liabilities.
- (c) Some propose that the residual margin should be used as a means of absorbing volatility that is expected to have no ultimate effect on profitability. In addition, some believe that locking in the residual margin at the inception of the contract results in counterintuitive results and argue that the residual margin should be remeasured, regardless of the effect on volatility. This is discussed in paragraphs 39-42.
- (d) Some propose widespread use of unbundling (see paragraphs 43-47) for components that could be measured at amortised cost and are backed by financial assets also measured at amortised cost. However, most of those that propose this approach imply that they would prefer to explore other ways of addressing the volatility issue first.

Discount rate

25. The ED stated that, for non-participating contracts, the discount rate used to determine the present value of fulfilment cash flows should be the risk-free rate, adjusted for liquidity. Accordingly, the discount rate excludes the risk of non-performance by the insurer.
26. Some insurers believe that the single most significant problem in the proposed standard is the determination of the discount rate. There was some support amongst insurers and actuaries - at least at a conceptual level - for the proposed risk-free plus liquidity adjustment approach, and most respondents agreed with the exclusion of an insurer's non-performance risk, although a few suggested that in conditions of financial crisis a measure of the insurance industry credit risk should be included in the measurement. However:
- (a) Although most insurers agree that the discount rate should reflect the characteristics of the liability, many disagree that the proposed risk-free rate plus liquidity adjustment adequately captures the characteristics of the liability.
 - (b) Users and others raise concerns regarding the comparability and objectivity of an illiquidity adjustment that, in their view, cannot be observed in any market.
 - (c) Some, particularly actuaries, state that the final standard should provide more guidance on the determination of the liquidity premium and on the determination of the risk-free rate in emerging economies or in periods of financial crisis when 'instruments that expose the holder to no or negligible credit risk' do not exist.

Consequently, most suggest that there should be a more pragmatic approach to determining the discount rate than the risk-free plus liquidity adjustment proposed in the ED.

27. Most insurers suggest alternative methods for calculating the discount rate to mitigate the volatility in profit or loss. Some insurers recommend alternative discount rates that they believe better reflects the characteristics of the liability. These include:

- (a) using an asset-based rate, adjusted to reflect the risk of defaults and (possibly) the risk that defaults might be greater than expected (eg an economic default adjusted rate). This might include rates that reflect the investment return that the insurer uses to price the contract, such as a reference or actual asset portfolio based rate. Some comment that there would be a need for disclosures about how this rate is determined.
 - (b) using a discount rate that includes the market price of credit (and not the price of credit for the specific liability), eg by using a reference rate, such as a high quality corporate bond rate.
 - (c) permitting insurers to select a rate, with full disclosure provided for the benefit of users.
28. Some users could accept a discount rate that reflects asset characteristics with an adjustment for expected defaults as long as this rate is clearly defined. Those users acknowledge that a specifically prescribed discount rate might act as an artificial incentive to invest in particular assets. Users in Canada strongly support an asset-based rate that links the measurement of the insurance liability with the asset/ investment-side and very few support the reflection of the insurer's own credit risk.
29. Some also suggest a discount rate, either the rate proposed in the ED or another rate based on expected investment returns, that is locked-in at inception. A locked-in discount rate would be equivalent to amortised cost for financial instruments. Those supporting an 'amortised cost option' for insurance contracts argued that it could avoid some accounting mismatches and would be consistent with the approach in IFRS 9. However most users and some insurers state that assets held by insurers are constantly traded and include equity instruments, which would not or should not qualify for measurement at cost.
30. Some propose that a locked-in discount rate could apply to particular types of contracts or particular activities (ie a 'business model test'). Candidate contracts might include annuity contracts with fixed returns, and contracts where the backing assets are measured at cost when so permitted by IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 9 or IAS 40 *Investment property*.

31. Some (regulators and standard-setters) recommend that the board consider a cross-cutting project on the discount rate for long-term liabilities. Other discount rate issues (which are not directly related to volatility) are discussed in paragraphs 84 and 85.
32. Agenda papers 3A-3D for this meeting describe further the groups of discount rate we propose to examine over the next few months and examine the top-down approach proposed by many respondents. We plan to begin to ask the Board for decisions on discount rate in February.

Residual vs composite margin

33. The 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 ED proposes that the measurement of an insurance liability should include a residual margin, calibrated to eliminate gains at inception. In contrast, in the FASB's preliminary views, risk and uncertainty would be reflected implicitly within a single composite margin rather than through a separate risk adjustment.
34. The comment letters and the roundtables indicated that views on an explicit risk adjustment varied greatly by geographic region. Support for a separate risk adjustment (and residual margin) is correlated to the approach in existing GAAP and whether existing or proposed regulatory requirements prescribes a risk adjustment. Most respondents were predominantly in favour of an explicit risk adjustment, with the notable exception of many US insurers and Japanese life insurers. Some note that a risk adjustment is explicitly measured when accounting for some insurance contracts in Australia, New Zealand, Canada and China and is proposed for Solvency II in Europe. Views on an explicit and separate risk adjustment varied to a lesser extent on the type of respondent, though there was strong support for an explicit and separate risk adjustment from audit firms and actuaries.
35. Those that support an explicit risk adjustment believe that that it would provide more transparent and useful information about the compensation an insurer receives for bearing risk. Some also believe that there should be consistency in the

way that the insurance contracts standard and Solvency II calculations use risk adjustments. Reasons for supporting an explicit risk margin include the following:

- (a) An explicit risk adjustment allows for a current measure of an insurer's assessment of risk. Some note that assessing and quantifying risk is an essential part of an insurer's business.
- (b) The allocation of the composite margin may conceal useful information about contract performance and the reconciliation may be difficult to explain.
- (c) For non-life insurance, claims liabilities are often substantially larger or smaller than the corresponding pre-claim liability. The degree of uncertainty can also change dramatically at or after the time of claim. Some think that it is not clear how a composite margin can adequately reflect these changes.

36. Those that oppose an explicit risk adjustment are concerned that an explicit risk adjustment is not observable, making it difficult to determine whether the assumptions were reasonable and the objective of its measurement was met. In particular, most users are concerned that the risk adjustment may be extremely subjective and not comparable between insurers. In addition:

- (a) Some believe that the risk adjustment should not be included in the measurement of the liability because they view it as equivalent to deferred profit and therefore consider that it should not be explicitly measured and disclosed.
- (b) 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 insurer has been conservative in making assumptions, or genuinely has a different risk profile.
- (c) Some believe the explicit measurement and reporting of the risk adjustment introduces bias which will reduce the usefulness and comparability of the information provided in the financial statements.

37. Some have questioned whether risk adjustments are more consistent with an exit value notion than with a fulfilment notion, because the 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. They believe that these words imply transfer to a market participant and are therefore inconsistent with an approach based on fulfilment value. However, other respondents indicate that the proposed wording is consistent with a fulfilment objective. Some suggest alternative wording that they believe would make the objective of the risk adjustment more consistent with the fulfilment notion.

38. Other issues relating to risk adjustment are discussed in paragraphs 87-92.

Remeasurement of the residual margin

39. Some note that the residual margin will include margins to recover all acquisition costs (including those not incremental at a contract level), general overheads, risk of unknown uncertainties not identified and hence not captured by a risk adjustment, 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, although the fact that the residual margin includes the effect of discounting, and the level of protest on the proposed transition requirements (see paragraphs 135-137) suggest it might be substantial.
40. The ED proposes that the residual margin would be fixed at inception of the contract and allocated over the coverage period in a systematic way. One consequence of this proposal is that changes in estimates would be recognised immediately in profit and loss. Many disagree that the residual margin should be fixed at the inception of the contract for the following reasons:
- (a) It could lead to a situation in which an insurer recognises losses in a period, even though there will be gains from the release of the margin in future periods. Many believe this effect is counterintuitive and will be difficult to explain to users.
 - (b) It results in a hybrid approach in which only part of the insurance contract is measured at a current value.

- (c) It appears inconsistent with the proposals in ED *Revenue from Contracts with Customers*, which do not account for changes in estimates of cash flows arising from unsatisfied performance obligations unless a contract becomes onerous.
- (d) It might give a distorted view of the profitability of a portfolio when assumptions change because the pattern of profit release will be affected by the way inputs are set at inception, irrespective of whether the actual experience remains consistent throughout the contract term.
- (e) It might introduce an ability to influence profit for the period by manipulating assumption changes. Furthermore, fixing the residual margin at inception could result in the building block model reporting a significantly different earnings pattern compared with the premium allocation approach for the same contract or portfolio.

41. Accordingly, many suggest that the residual margin should be remeasured or adjusted when estimates change. Proposals include the following:

- (a) Adjust the residual margin for changes in non-financial inputs and estimates. If the assets backing insurance contracts are measured at fair value through profit or loss, some think that the effect on insurance liabilities of changes in the discount rate should not be reflected in the residual margin, but should be shown in profit or loss.
- (b) Adjust the residual margin for changes in estimates relating the future.
- (c) Use the residual margin as a 'shock absorber', whereby the changes in the cash flows are absorbed by the residual margin.
- (d) Re-determine the residual margin at each reporting period to reflect changes to best estimate assumptions and changes to risk distributions, or changes in the capital charge rate (if a cost of capital approach is chosen to determine the risk adjustment).

42. We plan to discuss whether the residual margin should be unlocked and possible ways of unlocking or remeasuring it beginning in March.

Unbundling

43. 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'.
44. Some support the principle that non-insurance components should be unbundled from insurance contracts. Most users agree with the proposals regarding unbundling if unbundling is possible and if investment components or simple (cash-like) elements can be clearly segregated. However, there appeared to be different motivations in the feedback on unbundling:
- (a) Unbundling introduces complexity and involves costs to insurers. Some question whether the benefits justify those costs. In particular, some question whether there would be a material difference after 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). Accordingly, there is widespread preference amongst insurers and actuaries for minimal unbundling. Some suggest that there should be no unbundling for contracts unless the insurer manages the components of the contract separately.
 - (b) Some insurers and auditors suggest unbundling contracts so that the investment component can be measured at amortised cost and thus match assets measured at amortised cost in accordance with IFRS 9.
45. Many state that the proposals in the ED for unbundling are unclear and that different interpretations can be given to these proposals.
- (a) Paragraph 8 of the ED provides examples of components that are not closely related to insurance coverage. Some insurers believe 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 insurers believe account balances that are closely related should not be unbundled. There is concern 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 applied. Some suggest that the standard includes additional guidance on the meaning of "not closely related"

- (b) Some state the intention of the proposal to unbundle account balances is unclear. For example:
 - (i) 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 main target of the proposal.
 - (ii) 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 question the meaning of this condition.
 - (iii) Some question whether investment contracts with a discretionary participation feature should be unbundled. Some state that to do so would largely negate the proposal to include these contracts within the scope of the insurance contracts standard, rather than the financial instruments standards. (The FASB DP proposes that investment contracts with discretionary participation feature should **not** be included within the scope of the insurance contracts guidance).
- (c) It is unclear whether asset management services are an example of services that should be unbundled.
- (d) 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 component and the unbundled component, and whether particular components, such as policy loans, should be unbundled.
- (e) Some find unclear whether unbundling applies to unit-linked contracts.

46. There were geographical differences in the feedback on unbundling, possibly due to different product designs. For example, many in Europe complain that the proposed requirements on unbundling are unclear. Furthermore, in France an issue

of prime importance is whether unbundling is required for investment contracts with discretionary participation features. In contrast, Australian insurers generally do not raise implementation issues in their comment letters.

47. We plan to discuss unbundling starting in February. However, the final requirements on unbundling will depend on other decisions to be taken by the boards, in particular on measurement (because it affects the difference in the accounting for the insurance and unbundled components) and presentation (because views on what should be unbundled depend partly on whether insurers present volume information in the statement of comprehensive income).

Presentation

Summarised margin presentation

48. The ED proposes a summarised margin presentation approach that highlights the underwriting margin, experience adjustments or changes in estimates and interest on insurance contract liabilities. The boards regard these items as the drivers of profitability for an insurer.
49. Many, including a majority of users, find the information given by a margin-based approach helpful and valuable information. However, there is limited support for the summarised margin presentation approach, because it eliminates from the statement of comprehensive income information about premiums, benefit payments and claims expenses. Most users state they want to see such information in the statement of comprehensive income. Many are uncomfortable with providing this information only in the notes because they see such information as key to providing insight into the amount of new business written by insurers and the strain that this new business places on the resources of the insurer. They imply that the quality of new business is a critical driver of future profitability.
50. Nonetheless, some comment letters, and some roundtable participants, acknowledge the difficulty of combining the gross presentation with the proposed measurement model. Most alternatives offered in the comment letters focus on grossing up the margins that result from the measurement model to reflect written or earned premiums received. While acknowledging the limitations of this

approach, many see premium information as a proxy for the revenue presented in other sectors.

51. A few respondents propose a model which shows the relation between the estimated premiums in new contracts, estimated fulfilment cash flows (expenses and benefits, as well as the risk adjustment) and residual margin with regard to those contracts as well as the effect of changes in estimates to the movements in the insurance liability. They argue that the estimated premiums of new contracts portray the activity of the insurer in attracting new business.

Presentation in the modified approach for short-duration contracts

52. The ED proposes that insurers that apply the modified approach for short-duration contracts should provide additional information about premium revenue, claims and expenses incurred and amortisation of acquisition costs. Most users and insurers support the presentation proposals for the modified approach for short-duration contracts. However, many are unclear about how the presentation approach for the pre-claims liability and that for the post-claims liability interact and some disagree that a short-duration contract should have two different presentation approaches, depending on whether it is in the pre-claims or post-claims period. Some ask for clarification on how the presentation proposals in the ED would apply to the risk adjustment for short-duration contracts. Some also state that the same presentation approach should apply to all contracts, whether short-duration or not.

Other presentation points

53. Most agree that an insurer should present all income and expense arising from insurance contracts in profit or loss. One integrated regulator strongly supported recognising all changes in the insurance liabilities in profit and loss based on its jurisdiction's experience in applying a current value model for insurance contracts. Some users disagree with any use of OCI, although some could support the use of OCI for some changes to the insurance liability if it were used to distinguish operating profit that is not subject to mark-to-market volatility. However, some also comment that operating profit could equally be distinguished within profit or loss.

54. A few were concerned about how a cedant should present reinsurance, and whether reinsurance assets should be offset against underlying insurance contracts.
55. Some are concerned that the presentation proposals might be modified once more as a result of the boards' project on financial statement presentation.
56. We plan to begin considering presentation in February.

Short-duration contracts

57. As noted in paragraph 17, many think that the building block approach would be overly complex for short-duration contracts and some suggest it should be applied only when there is significant risk of variability of future cash flows (for example because of embedded options). Consequently, many, including most users, welcome the proposal to develop a modified approach for short-duration contracts. However, there are some concerns about the premium allocation approach proposed. Some insurers suggest the unearned premium approach, in which the liability is measured initially at the premium and subsequently at the unearned portion of that premium, would provide better information about an insurer's obligation to policyholders.
58. The main concerns about the proposals for short-duration contracts are:
 - (a) whether the modified approach should be further simplified.
 - (b) the contracts for which the modified approach should be applied (including how the contract boundary between short and long-duration contracts is determined).
 - (c) whether the modified approach should be permitted rather than required.
 - (d) as described in paragraph 52, some question how the presentation proposals for short-duration contracts interact with those for the building block approach.
59. The ED proposed a single model for all insurance contracts, with simplification for some types of contract. In February, we plan to ask the boards for a tentative view on whether to pursue this approach. If the boards do pursue this approach:

- (a) we plan to consider the issues in paragraph 58 together with other issues relating to the modified approach, in April, once we have a clearer idea of the refinements that will be made to the building blocks approach.
- (b) in considering issues before April, we plan to assess how the building blocks approach might apply to contracts that might be within the scope of the modified approach.
- (c) in April, we plan to re-assess whether to continue with a single model for all insurance contracts, with simplification for some types of contract.

Simplification

60. Although some believe the modified approach might provide a reasonable approximation to the building block approach, most, including many users, 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.
61. Some believe that the onerous contract test will ultimately result in a full, but indirect application of the building block approach. Alternative approaches were proposed as follows:
- (a) Many believe the onerous contract test should be performed at a higher level of aggregation than is being proposed (ie at entity, rather than contract, level) so that the effects of diversification across portfolios would be recognised.
 - (b) Many believe that an explicit onerous contract test should be required only in the event of a trigger and felt that the ED did not permit such an approach.
 - (c) Some US insurers suggest that the expected loss model for the onerous contract test proposed in the ED should be replaced with an incurred loss model, similar to the unexpired risk provision in US GAAP.

62. Many insurers that write mainly non-life contracts, particularly in North America, believe that discounting for non-life contracts adds complexity for little or no added value. This view was also expressed by some regulators and standard setters. For most non-life products, especially health, car and homeowners' insurance, the majority of the claims are paid relatively shortly after the incurred date and discounting is therefore immaterial. However, there could be significant costs to apply discounting and it can be difficult to estimate the timing of expected cash out flows because these out flows generally have greater variability in amount and timing than most other insurance contracts. 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.

Eligibility criteria

63. 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.
64. 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 contracts, and 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 assumed 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.
 - (b) As described in paragraph 82, some believe insurers should be able to apply the modified approach to annually renewable contracts, even if law or regulation constrains the insurer's ability to reprice the renewal.

- (c) Some believe that a cedant should account for reinsurance contracts using the same approach as the underlying insurance contracts (see paragraph 123). Thus they are concerned, for example, that reinsurance contracts that reinsure all one-year underlying contracts written during a specified year would not be eligible for the modified approach.

65. Suggestions to address these concerns include:

- (a) permitting the modified approach to apply to contracts with a coverage period of less than three years. Some respondents believe that this would capture most non-life insurance contracts.
- (b) permitting the modified approach for the whole of a portfolio that combines long and short-duration contracts if those long-duration contracts are insignificant in the context of the entire portfolio or the insurer's business.
- (c) developing a principle for when the modified approach can be used in place of the arbitrary one-year cut-off. Some suggestions include permitting the modified approach:
 - (i) for contracts that meet the existing definition of 'short-duration' in US GAAP.
 - (ii) where investment income potential over the coverage period is not a major portion of the business model.
 - (iii) when the period of time between premium receipt and date of loss is not significant.
 - (iv) if the profitability of the contract is primarily from underwriting income or loss rather than investment results.
 - (v) when the claims payment period is short.
 - (vi) for contracts for which there is relatively little uncertainty over the amount and timing of claims.
 - (vii) when applying the measurement determined in the modified approach is not materially different from that determined in the main measurement model.

Permit or require

66. Most think the modified approach should be permitted rather than required. This view was articulated vocally at each of the roundtables, and particularly in the comment letters from insurers that write both life and non-life contracts. Although mandatory application of the modified approach for specified contracts might improve comparability, it would also cause composite insurers to apply two different models to similar products. Furthermore, some state that permitting an option to apply the modified approach would be more consistent with the view that the modified approach is a simplification of the building block approach, rather than an alternative model.
67. A small number think that the modified approach should be mandated. This includes many, but not all, users.

Summary of responses on other proposals in ED

68. In paragraphs 70-141 we discuss the remaining main areas in the ED as follows:
- (a) Unbiased probability-weighted average of fulfilment cash flows (paragraphs 70-80).
 - (b) Contract boundary (paragraphs 81-83).
 - (c) Discount rate issues other than volatility (paragraphs 84 and 85).
 - (d) Risk adjustment and margin issues other than residual vs composite (paragraphs 86-100).
 - (e) Scope (paragraphs 101-108).
 - (f) Definitions (paragraphs 109-112).
 - (g) Discretionary participation features (paragraphs 113 and 114).
 - (h) Recognition (paragraphs 115-118).
 - (i) Reinsurance (paragraphs 119-124).
 - (j) Disclosure (paragraphs 125- 129).
 - (k) Unit-linked contracts (paragraphs 130-132).
 - (l) Unit of account (paragraphs 133-134).

- (m) Transition (paragraphs 135-137).
 - (n) Implementation period (paragraphs 138-141)
69. The critical path diagram in agenda paper 3 indicates the expected timetable for discussing these issues.

Unbiased probability-weighted estimate of fulfilment cash flows

Probability-weighting

70. Most support the use of probability-weighted expected cash flows in principle. However, insurers and actuaries are concerned about the amount of detail required to determine the probability-weighted average in practice. In particular, they are concerned that significant time and costs would be required to implement a full probability-weighted methodology with little to no difference or benefit compared to considering only a limited number of scenarios. Some believe that the standard should clarify that the objective is to determine the statistical mean of the cash flows and to be explicit that a full stochastic approach or consideration of every remote scenario is not always required and that other methodologies to estimate the statistical mean may be used. Insurers with non-life contracts raised the difficulty of calculating probability-weighted cash flows when the insured event is of low frequency and potentially high severity.
71. Most regarded the level of application guidance provided as being at the appropriate level of detail for a principles-based standard. Some actuaries and preparers suggested that the boards rely on the actuarial profession as an authoritative source of more detailed guidance to implement the proposed principles.

Acquisition costs

72. The ED states that incremental acquisition costs for contracts issued should be included as contractual cash flows in the initial measurement of the insurance liability.
73. Most of those commenting believe the definition of acquisition costs proposed in the ED is too narrow and oppose its restriction to costs incremental at the contract level because this would exclude 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 insurer's distribution system (that is, whether the insurer performs contract acquisition services in-house or sources it externally) and sales compensation plans.

74. 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 is the portfolio (see paragraphs 133 and 134).
75. 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; and
 - (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 that this guidance should be incorporated in the final standard.

76. Some raise concerns about the inconsistency between the ED's proposed treatment of acquisition costs for insurance contract and the treatment of such costs for investment contracts within the scope of the revenue recognition ED, which does not permit acquisition costs to be deferred.

Cash flows from discretionary participation features

77. There was general support for the inclusion of payments arising from participating features in the measurement of insurance contracts in the same way as any other contractual cash outflows (ie on an expected present value basis).
78. 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 may result in many such insurers reporting little or no equity.

79. 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 do not understand the purpose of the reference to future policyholders. (The paragraph is intended to address distributable surpluses included in the financial statements but not yet allocated to individual policyholders.)

Tax

80. Some believe that taxes which are not based on the taxable profit of the insurer, but paid out on returns on invested assets on behalf of policyholders, should be included in the cash flows. In some jurisdiction, such taxes have features that lead insurers to apply IAS 12 *Income Taxes* to them. This has two effects that many respondents in those jurisdictions believe do not represent the insurer's activity faithfully:
- (a) the tax expense is unintuitively high.
 - (b) discounting is not applied to those taxes.

Contract boundary

81. The ED 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 individual policyholder and, as a result, can set a price that fully reflects that risk.
82. Most agree with the proposed contract boundary principle. However, some are concerned about how the contract boundary applies to contracts for which the pricing is assessed at the portfolio level, eg because regulation obliges the insurer to renew contracts and restricts the insurer's ability to re-price them. Many insurers currently account for such contracts using an unearned premium approach, but these contracts may not be eligible for the modified approach for short-duration contracts depending on how the term 'individual policyholder' in paragraph 79(b) is interpreted, eg if it refers to individual persons or to individual

employers. Applying the building block approach to such contracts would require them to estimate cash outflows they consider to be uncertain and that they believe will be largely or wholly covered by related future premiums. Accordingly, some propose that the contract boundary should be set to exclude from the measurement of an insurance contract cash flows for which the insurer 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. This issue is of particular relevance to health insurers and products such as compulsory auto or third-party liability insurance.

83. In addition, there are concerns in the following areas:

- (a) Some seek clarification as to whether discretionary payments for universal life contracts are within the contract boundary.
- (b) Some have indicated that there should be additional guidance regarding contract modifications and contract riders (ie an additional set of terms attached to a contract) and whether they result in a replacement contract or a continuation of the existing contract.
- (c) Some observe that the proposed contract boundary is different from the boundary proposed in Solvency II and that different boundaries would increase compliance costs.

Discount rate issues other than volatility

Discount rate for participating contracts

84. 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 insurers 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. Some respondents commented specifically on that paper, but not all agreed with the approach described.

Discounting for non-life contracts

85. As described in paragraph 62, many insurers that write mainly non-life contracts do not believe those contracts should be discounted.

Risk adjustment and margin issues other than residual vs composite

Gains and losses on inception

86. The ED proposes that the measurement of an insurance contract includes a residual margin, calibrated so that there is no gain at inception. Most respondents agreed that there should be no gains at inception of an insurance contract and that any losses at inception should be recognised in profit or loss (though some in Canada and South Africa disagree that there should be no gains at inception). However, some insurers commented that their views on losses assumed that the boards would resolve the issues they raise relating to the measurement of insurance contracts, particularly with respect to discount rate. Some commented that there would be no need for a residual margin if the insurer could include all relevant cash flows in the measurement of the insurance contract.

Methods for determining risk adjustment

87. The ED proposes three acceptable techniques for estimating a risk adjustment. There are mixed views about this limitation:
- (a) Many support a principles-based approach, rather than limiting the techniques for determining the risk adjustment to three. They note that a principles-based approach would allow insurers to use new and better methods for estimating risk adjustments that may emerge in the future, and could be supported by enhanced disclosures to improve comparability. Some suggest that there should be a rebuttable presumption that an insurer should use one of the three techniques unless another technique is demonstrably more relevant.

- (b) A few support the proposal to limit the number of approaches to improve comparability and some go further to suggest that there should be only one approach permitted because even the limited number of techniques proposed can result in significantly different results.

Disclosure of implied confidence level

88. The ED proposes that if an insurer uses the conditional tail expectation or cost of capital approaches to determine the risk adjustment, it should translate the resulting risk adjustment into an implied confidence level for disclosure. Most insurers and actuaries disagree with that proposal. Their reasons for disagreement include:

- (a) It results in additional costs for insurers applying techniques other than CTE;
- (b) In order to avoid the additional costs under (a), insurers might decide to adopt a CTE technique even if it is not the most appropriate technique.
- (c) 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.
- (d) It may provide misleading information to users since the confidence level only provides a formal impression of comparability among fundamentally different methodologies.

89. Most users doubt whether disclosing a confidence level would improve comparability.

90. Some propose that the disclosure should be replaced with enhanced disclosures about the inputs to the method the insurer uses to determine the risk adjustment.

Level of aggregation for risk adjustment and residual margin

91. The ED proposes that the risk adjustment should be determined at the level of a portfolio of insurance contracts and that the residual margin should be determined at a level that aggregates insurance contracts into a portfolio of contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period (ie a cohort level).

92. Many disagree with the level of aggregation proposed for the risk adjustment. Those with this view believe that the risk adjustment should reflect the effect of diversification between portfolios, because they see such diversification as an integral part of insurers' business model. Therefore they propose that the risk adjustment should be determined at the reporting entity level. Their view is supported by many users, who would like to have the diversification effects within an insurer to be more visible, particularly for potentially offsetting risks between portfolios. Some also mention that potential regulatory constraints regarding liquidity of funds within a group should be taken into account.
93. Some, in particular the actuaries, believe that the residual margin should be assessed at a portfolio level, rather than at a cohort level because it would be more practical. Some state assessment at a cohort level would require a significant increase in record keeping and therefore costs. Some actuaries propose that the level of measurement of the residual margin should be determined based on the level of recognition of losses (eg by individual contracts or by portfolios). Some require more guidance on whether calculating the residual margin on an individual contract level is acceptable because there may be practical advantages of calculating the residual margin at a contract level. Some insurers think that the standard should not prescribe the level of measurement of the residual margin.

Allocation of the residual margin

94. The ED proposes that the residual margin should 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.
95. Paragraphs 39-42 describe the views of those that do not support a locked-in residual margin at initial recognition. Regardless their views on whether the residual margin should be remeasured or locked-in, many also commented on the proposed method of allocating a locked-in residual margin, as follows:
- (a) Some support the ED proposal.
 - (b) 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 liability, the in-force, or some other factor, and the extent to which the passage of time would be the default.

- (c) Some believe that it would be inappropriate to defer profits to the time when claims are actually incurred, and think that the release of the residual margin should be based only on the passage of time.
- (d) Some believe risk should not drive the release because that is reflected by the risk adjustment.
- (e) 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.

- 96. Some wanted clarification of whether the expected timing of claims and benefits was intended to mean the original expectation or expectations updated over time.
- 97. Some suggested that the residual margin in **insurance contracts** with discretionary participating features (dpf) should have the same release pattern as required under paragraph 64 of the ED for **financial instruments** with dpf.

Allocation of the composite margin

- 98. 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 preliminary view, this approach reflects the insurer's exposure to uncertainties related to the amount and timing of net cash flows. The ED asked for respondents' views on the proposed method of releasing the composite margin, if the final IFRS were to include a composite margin.
- 99. Many insurers question the proposed allocation of the composite margin. 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.

Interest accretion on the residual margin

100. 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. However, some agree with the accretion of interest on the residual margin, provided the effect is material and the complexity does not outweigh the benefits of this approach. Some believe the interest rate should not be locked in at inception, but that current rates should be used.

Scope*Financial guarantee contracts*

101. We received 12 comment letters that addressed only the issue of whether financial guarantee contracts that meet the definition of an insurance contract should be in the scope of the insurance contracts standard. This issue was also of particular interest to banks and bank assurers. Some, in particular the banks, think that these contracts should be excluded from the scope of the insurance contracts standard. Others, in particular the credit insurers, argue that these contracts should be included in the scope of the insurance contracts standard. Many suggest that the Board retain the current option in IFRS 4 that permits insurers to account for financial guarantee contracts using either the insurance contracts standard or the financial instruments standards (a combination of IFRS 9/IAS 39 with IAS 37), perhaps with some reference to the business model of the issuer. (Other entities would continue to be required to apply IAS 37 and IAS 39/IFRS 9.) However, some regulators welcome the proposal that there should be consistent accounting for financial guarantee contracts.
102. Some argue that the current treatment used by banks and other financial institutions works well in practice and that these entities do not manage financial guarantees on a portfolio basis. They state that implementing the proposals is likely to be onerous for those entities.

103. Some regulators believe that further application guidance is needed for banks and other non-insurers if financial guarantee contracts are accounted for as insurance contracts.

Financial instruments with discretionary participating features

104. Most insurers believe that financial instruments with discretionary participation features should be within the scope of the ED. However, some disagree, stating that such contracts should be in the scope of the financial instruments standards on conceptual grounds. However, even those that disagree comment that IAS 32 does not adequately address the accounting for such contracts. Accordingly, they suggest that, as a pragmatic measure, such contracts should be included in the scope of the insurance contract standard until equivalent guidance is developed in the financial instruments standards.
105. Most disagree that investment contracts with discretionary participation features should be included in the scope of the standard only if the contract shares in the same pool of assets as participating insurance contracts. Contrary to the information that the staff received in developing the ED, many respondents 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 issues them, or the converse.

Other scope issues

106. 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 for 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.
107. Some health insurers think that fixed-fee service contracts should be in the scope of the insurance contracts standard. Some state it is unclear which fixed-fee service contracts are excluded from the scope of the standard.

108. A few comment letters comment that it is unclear whether or how entities should apply the proposed standard to Takaful arrangements, an alternative form of protection that is designed to be compliant with Shariah law.

Definitions

Definition of an insurance contract

109. 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.
110. Some criticise the decision to modify the existing guidance on the definition of an insurance contract. They note that a change would introduce additional costs to review whether contracts meet the new definition and argue that there is little merit in this change for those applying IFRSs because the existing guidance worked well. 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.
111. One of those two changes in guidance introduces the need for the possibility of a loss over the whole life of the contract. Some insurers 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 this proposal is confirmed, the standard 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 a portfolio

112. 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 33-38). They note that current practice on determining a portfolio is diverse.

Issues relating to discretionary participation features

113. Some request more guidance on how to account for unallocated surpluses (specifically in the context of UK with-profits contracts in ring fenced funds). Some suggest that all of the surplus within with-profit funds should be presented as a liability on the balance sheet and that profits should be recognised when performance obligation is satisfied. However, mutual insurers argue that unallocated surpluses (for instance 'estate' or 'mutual equity') should not be recognised as a liability because a portion of these funds represents equity. They see such surpluses as risk capital, rather than an insurance liability.
114. Some insurers suggest disclosure of the expected discretionary participation distributions included in the liability.

Recognition

115. Most insurers disagree with the proposed requirement to recognise insurance contracts from the earlier of the date that the insurer is bound by the contract and the date it is first exposed to risk under the contract. They believe it will be costly to capture this data because it is currently not recorded until the contract term begins. Some insurers are concerned that movements in discount rates could result in a gain or loss on a contract before the effective date of that contract when there has been no change in assumptions. Some question whether the benefits outweigh the operational costs.
116. Alternatives suggested include:
- (a) insurers should be allowed to choose between the bound date and date of first exposure in recognising insurance contracts.
 - (b) an onerous contract test should be performed between the contract recognition date proposed in the ED and the date the contract begins only if there are indicators that the contract is onerous.

117. Some ask for clarification on how the recognition approach would apply to investment contracts with discretionary participation features, given that such contracts do not transfer significant insurance risk.
118. Some request that clarification of presentation in the pre-binding period.

Reinsurance

119. The ED states that the same accounting should apply to insurance contracts and reinsurance contracts that an insurer holds. In addition, the ED describes 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. Most support an expected loss model for reinsurance assets. Some suggest that the expected loss model for reinsurance be developed in a manner that is co-ordinated with the boards' current project on the impairment of financial assets.
120. The ED states 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 the recognition of day-one gains for reinsurance contracts, including most users (who argue that profits should be released over the coverage period) and regulators (who think that the treatment of a reinsurance contract should be consistent with the treatment of the underlying contract).
121. Similarly, some believe that the amount of the residual margin included in the measurement of the reinsurance contract should be proportionate to the residual margin on the underlying contract rather than being calculated separately (though they recognise this is difficult to apply to non-proportional coverage).
122. Some are concerned about how to measure the reinsurance contract when 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.
123. 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). Those that comment state that the reinsurance contract measurement should be consistent with the underlying insurance contracts. For example, if a cedant uses the modified approach for underlying contracts, it should use the same approach for the related reinsurance contracts.

124. Many also request further guidance on how the building block approach applies to reinsurance, in particular, whether the risk adjustment should be determined on a net basis or separately on a gross and ceded basis. Some actuaries suggested that the risk adjustment should be determined taking into account the effect of reinsurance otherwise the measurement would fail to faithfully represent the effective an insurer's exposure to risk.

Disclosure

125. Many express concerns about the volume and complexity of the disclosure requirements in the ED. Although supportive of the objective-based approach proposed in the ED, some criticise the supporting disclosures as not being consistent with that approach and suggest they appear to be an aggregation of requirements from other standards. Some comment that the volume of disclosures in IFRS 4 was appropriate only because of the need to explain the diversity IFRS 4 permitted and therefore believe that disclosures should be reduced in the new standard. Some argue that a principle-based standard should not prescribe the required disclosures in such detail. Specific concerns raised 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 and will require significant cost and effort for limited added value.
 - (c) The requirement to disaggregate information about different reportable segments by type of contract and geography is seen by some as being too voluminous.
126. Many users highlight the importance of segmental, or even more detailed, information. Some users would like to see how the insurer's current cost of debt

compares to the risk-free rate. Some users want to have disclosures of vintage analyses. Many users urge changes to the cash flow statement of insurers, to focus on free cash flow available to shareholders, and excluding cash flows that 'belong' to policyholders.

127. Insurers did not propose any significant new disclosure.
128. Some regulators proposed additional disclosures, in particular, about how appropriate assumptions or techniques are determined when significant management judgement is required (eg about changes in discount rates, the risk adjustment technique used and any change to that technique). Some regulators also proposed a reconciliation to regulatory reporting.
129. We plan to consider disclosures across a number of projects, and intend to present a paper on disclosures specific to insurance contracts in May.

Unit-linked contracts

130. Most insurers agree with the proposals for unit-linked contracts, specifically that:
 - (a) particular assets for which existing requirements result in an accounting mismatch should be recognised and measured at fair value through profit and loss.
 - (b) the guidance is sufficiently comprehensive to establish a clear principle for unit-linked contracts. However, some suggested a need for a broader principle to eliminate all accounting mismatches for unit-linked contracts. More particularly, some noted that the ED proposed that investments of a unit-linked fund in the insurer's own shares should be recognised as assets and they suggested that the same treatment should apply to investments of such a fund in the insurer's own debt, or in debt or equity of other entities within the group.
131. Most also agree that there should be separate presentation of assets and liabilities as well as income and expenses related to unit-linked contracts in the financial statements. Some indicated a lack of clarity about whether the ED intended that fee income and related expense should be included in this line item. (We had not intended that it should.)

132. Some would extend the definition of unit-linked to include indexed-linked contracts.

Unit of account

133. Some observe that the ED specifies a number of different units of account:
- (a) portfolio level in general;
 - (b) cohort level for the residual or composite margin; and
 - (c) contract level for acquisition costs.
134. Some believe that the unit of account should be consistent throughout the standard because they believe that different units of account introduce unnecessary complexity. 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 insurers manage them. Furthermore, some would widen the definition of a portfolio so that all contracts that management prices and controls in the same way are considered to be part of the same portfolio.

Transition

135. Almost all respondents disagree with the proposal in the ED that, on transition, an insurer would measure each portfolio of insurance contracts at the present value of the fulfilment cash flows, without any residual margin. That proposal would result in profit or loss in future periods being lower for contracts in effect at the date of transition than for contracts entered into after the date of transition, for which a residual margin would be recognised. For life contracts, this effect could be significant. The alternatives suggested are:
- (a) Retrospective application except when impracticable, consistent with the general approach in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This would require an alternative approach when retrospective application is impracticable.
 - (b) Permitting or requiring retrospective application in specified circumstances or for only some types of contract. For example, some

suggest that retrospective application might be practicable for insurers producing embedded value information.

- (c) Requiring a limited retrospective application that estimates the residual margin based on a period of between five and ten years before the date of transition.
- (d) Determining a residual margin at the transition date using a proxy. Such a proxy could be:
 - (i) calibrated to the pre-transition carrying amount.
 - (ii) determined in the same manner as for a business combination, namely as the difference between the liability determined using the building block approach and the fair value of the insurance contracts.
 - (iii) determined as the difference between the liability determined using the building block approach and the present value of future cash flows including non-incremental acquisition cost, general and administrative expenses and taxes.
- (e) Requiring a combination of approaches depending on the length of the contracts in force at the date of transition.

136. Some request clarification of the transition for reinsurance assets and for short-duration contracts that would qualify for the modified measurement approach.

137. Some suggest specific arrangements to ease transition to the insurance contracts standard in the context of the new requirements in IFRS 9. These include:

- (a) support for the proposal in the ED to align the effective date of the insurance contracts standard with IFRS 9, even if this were to mean delaying the effective date of IFRS 9 for, say, a year.
- (b) permitting insurers to redesignate financial assets as measured at fair value or at amortised cost if those insurers are required to apply IFRS 9 before the effective date of the insurance contracts standard. Some note that the ED proposed that insurers 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 option should be available for amortised cost.

Implementation period

138. Most insurers recommend that the board should allow between 3 and 5 years after the standard is finalised to permit insurers implement the changes and to educate stakeholders.
139. Some jurisdictions apply a measurement model which updates estimates and assumptions. In those regions, most believe that the proposals could be implemented in around three years.
140. Other jurisdictions will be implementing IFRS for the first time before the IFRS for insurance contracts can be effective. They believe that they will require more time before they can make further changes such as those proposed in the ED, particularly because of the significant systems changes needed to implement the proposals. In those jurisdictions, some state 4-7 years would be necessary.
141. Some jurisdictions believe that the implementation period needed depends on the size of the entity.

Appendix A: Analysis of comment letters by type and region



