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18.10.2013

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Re: EFRAG Draft Comment Letter on IASB's Revised Exposure Draft, *Insurance Contracts*

Dear Françoise,

We appreciate the opportunity to comment on your draft comment letter pertaining to the IASB's Revised Exposure Draft, *Insurance Contracts* ("Revised ED").

Allianz is one of the largest insurance groups in the world. We anticipate that the new insurance accounting standard will impact all aspects of our financial reporting and, as a result, would like to emphasise the paramount importance to us of developing a high quality financial reporting standard for insurance contracts.

As a member of the European Insurance CFO Forum, we would like to state that we fully support the comment letter submitted by the CFO Forum to EFRAG. This comment letter summarises the position of Allianz in more detail, and gives context to the detailed responses to specific questions posed in the Revised ED, which are set forth in the pages that follow.

Overall, the Revised ED is an improvement compared to the Original Exposure Draft issued in 2010. In particular, we support the following changes:

- The introduction of OCI for the recognition of short-term volatility due to changes in market interest rates on both insurance liabilities and related assets;
- The proposed unlocking of the contractual service margin ("CSM"), allowing offsetting of the impact of changes in assumptions as long as sufficient unearned profit exists;

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- The recognition of the special nature and link between assets and liabilities for participating contracts;
- The recognition of the importance of setting an appropriate discount rate, including the possibility to use a top-down method;
- The retrospective transition guidance.

However, we have significant concerns regarding the proposed accounting for participating insurance contracts. In particular, we reject the bifurcation of cash flow approach and limited unlocking of the CSM, which is inconsistent with current fulfilment value measurement and the definition of the CSM as unearned profit, respectively.

We highly appreciate that EFRAG included a description of the insurance industry's Alternative Approach in Appendix 5 of its draft comment letter and invited constituents to provide feedback on this approach. While we acknowledge that EFRAG has not yet formed a view on the Alternative Approach, we believe this description was very helpful to support a constructive discussion on the important topic of accounting for participating contracts. We strongly recommend supporting the Alternative Approach in EFRAG's final comment letter to the IASB as we believe it provides key advantages over the IASB's proposal:

- The Alternative Approach, which provides a robust solution for all types of participating insurance contracts globally, is building on existing principles of the Revised ED, instead of defining an exception for contracts with a link to underlying items.
- It requires current fulfilment value measurement for all insurance contracts and all components of the liability in the statement of financial position.
- The approach results in more useful and understandable financial information and reflects the long-term nature of business, as it distinguishes between earned returns for services provided (in profit or loss) and changes in the expected future profits (in CSM).
- An asset dependent interest rate to determine interest expense for insurance liabilities in profit or loss avoids accounting mismatches in profit or loss.
- The fully unlocked CSM simplifies retrospective application at transition.
- No bifurcation of cash flows significantly reduces complexity.

With regard to the OCI category for assets, we appreciate that EFRAG recognised the need to develop a solution that avoids accounting mismatches. However, while we acknowledge that EFRAG's proposal to make the OCI approach for insurance liabilities mandatory and measure at FVOCI all assets that relate to the insurance liabilities would achieve this goal, we have several serious concerns regarding this approach:

- We believe it would de facto introduce an industry specific standard, which would contradict fundamental principles of IFRS.
- It would require significant changes to a number of existing standards.
- The approach would be very complex to implement for insurers.
- Conglomerates or non-insurance entities with only a small number of insurance contracts might have serious problems to identify the assets that relate to the insurance liability.

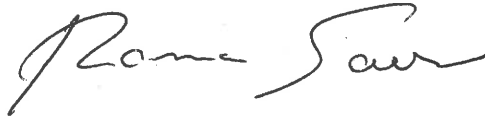
- Finalisation of the insurance contracts project would be delayed by several years.
- In addition, we believe that for some contracts that are managed on a FVTPL basis, recognising the effects from changes in discount rate in OCI would not provide relevant information to users of financial statements.

We believe that an option to recognise the effects from changes in discount rate for insurance liabilities in profit or loss along with the ability to update the discount rate for participating insurance contracts as described in the Alternative Approach provides an alternative solution to avoid accounting mismatches that is easier to implement and more coherent with other standards.

Please refer to our attached responses to the questions raised in EFRAG's draft comment letter for a more comprehensive explanation of our views.

We appreciate the opportunity to share our comments with you. If you have questions or would like to discuss our comments in more detail, please contact us.

Yours sincerely,



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Appendix I: Questions raised in the exposure draft

Adjusting the contractual service margin

Question 1

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if:

a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in Profit or Loss?

Why or why not? If not, what would you recommend and why?

Summary:

Allianz strongly supports the definition of the contractual service margin (CSM) and the respective unlocking principle, which is critical to the overall accounting model for insurance contracts. However, we do not agree with the IASB's limitations on unlocking the CSM, which especially impacts the accounting for participating contracts. We require a fully unlocked CSM that includes:

- **Gains/losses on underlying items, which is inclusive of reinvestment assumptions (for participating contracts);**
- **Changes in time value of options and guarantees ("O&G"); and**
- **Changes in risk adjustment related to future coverage.**

Detailed response:

Allianz supports the definition of the CSM contained in the Revised ED. In particular, we agree that the CSM represents unearned profit from an insurance contract. However, under the IASB's proposal, the CSM does not always represent the unearned profit from the contract. This is caused by the limitations that the IASB puts on what changes may impact the CSM.

If the CSM represents the unearned profit from an insurance contract, external users will be provided with decision-useful information consisting of a current fulfilment value insurance liability on the statement of financial position and profit recognition in profit or loss according to the services provided under the contract. In addition, preparers may not need to use non-GAAP performance reporting measures for life insurance business like embedded value information anymore.

Therefore, Allianz believes that all measurement components should be considered in the subsequent measurement of the CSM, i.e. measurement with completely updated assumptions. Carving out certain measurement components would lead to, from Allianz'

point of view, inconsistent measurement under the building blocks approach and would result in an incomplete implementation of current fulfilment value measurement.

The CSM should be unlocked for gains/losses on underlying items and reinvestment assumptions for participating contracts

The Revised ED indicates in paragraph B68e that "[g]ains and losses on the underlying items do not relate to unearned profit from future services from the insurance contract and are recognised in accordance with the Standards relevant to the underlying items."

We consider this guidance to be inconsistent with the general unlocking of the CSM for changes in expectations of cash flows relating to future coverage or other future services. This guidance also contradicts the definition of the CSM, as unearned profit, in Appendix A of the Revised ED and does not faithfully represent the entity's financial position and performance.

In many cases, the duration of insurance contracts exceeds the duration of the underlying assets (e.g., for a deferred annuity that has a duration of up to 80 years). It is a consequence of the current fulfilment model that cash flow projections for asset dependent cash flows need to be based on reinvestment assumptions for the unmatched part of the contract. If the CSM was not unlocked for changes in these reinvestment assumptions, any change in expected reinvestment assumptions would directly affect net income of the period, which would be inconsistent with the "no gain at inception" principle. In addition, net income would not reflect the economic performance of the period. If, however, the CSM is unlocked for changes in reinvestment assumptions, the change in the expected future profits of shareholders is presented as an adjustment to the CSM and does not affect net income of the period. Changes in reinvestment assumptions are thus not hidden but are fully transparent in the current insurance liability and unlocked CSM.

The CSM should be unlocked for changes in the time value of O&G

Changes in the time value of O&G represent cash flow changes which are included in the current fulfilment value of the insurance contract. However, the Revised ED requires O&G, which are embedded in contracts that specify a link to the returns of underlying items, to be measured separately at current value with changes recorded in profit or loss. This is inconsistent with the treatment of other fulfilment cash flows. Presenting changes in the time value of O&G immediately in profit or loss does not reflect economic performance of the insurer and significantly distorts net income.

The CSM should be unlocked for changes in risk adjustment related to future services

The Revised ED requires that the CSM is not adjusted for changes in the risk adjustment, which instead are recorded directly in profit or loss. This treatment is conceptually inconsistent with the unlocking of the CSM for changes in cash flows relating to future coverage or other future services. As a result, we also believe that the CSM should be unlocked for changes in the risk adjustment that relate to changes in risk for future periods. This is also required to ensure a consistent determination of the CSM at initial recognition

and subsequent measurement dates. We believe that the distinction between changes of the risk adjustment which relate to past and those which relate to future coverage and services is operationally feasible.

Other Aspects of the CSM:

Unit of account

We support the guidance in paragraph B37c, which specifies that the initial measurement of the CSM should be at a portfolio level. This unit of account is consistent with the measurement of the fulfilment cash flows and provides a useful as well as cost effective solution.

However, we are concerned that the definition of portfolio included in the Revised ED may create too low a level of aggregation. Furthermore, we are concerned that application guidance in the Revised ED could be interpreted as suggesting that an even lower level of aggregation is needed in practice.

In particular, while the Revised ED does not specify a unit of account for subsequently recognising the CSM in profit or loss, paragraph BCA113 states that the level of aggregation in practice will be a lower unit of account than insurers use to manage contracts, referring to contracts with "similar contract inception dates, coverage periods and service profiles" or at "individual contract level". This suggests a very low level of aggregation which will be burdensome to apply in practice due to the complexity of tracking the subsequent measurement of the CSM at that level.

We believe that the standard should specify a principle for how the CSM should be subsequently measured and then detailed application guidance would not be necessary.

Accretion of interest

The Revised ED requires that interest be accreted on the CSM using, in all cases, a locked-in discount rate. We disagree with this guidance. We believe that accretion of interest on the CSM should be based on the discount rate that is used to determine interest expense in profit or loss for the other components of the insurance liability. The use of such a discount rate, which would be unlocked for participating contracts, would allow the CSM to reflect present value of future profit expectations. In summary, the determination of the time value of money should be performed on a consistent basis for all components of the insurance liability including the CSM.

Release of the CSM

The Revised ED requires entities to release the CSM in a systematic way that best reflects the remaining transfer of services that are provided under the contract, and does not prescribe a specific pattern of release. As an insurance contract is a bundle of rights and obligations that are accounted for together, we believe this principles-based guidance is appropriate and support this guidance.

Appendix I: Questions raised in the exposure draft

Re-establishing an exhausted CSM after a favourable change in cash flows

In the event that the CSM is completely exhausted during the coverage period (i.e., CSM<0) and later there is a favourable change in estimated cash flows related to future coverage or other future services creating future expected profits, the CSM should be reinstated immediately to reflect the new estimate of the present value of future profits. This approach maintains a CSM that represents unearned profit. In addition, it ensures that changes in future cash flows do not impact the current period results, except in the case of an onerous contract. Furthermore, it significantly reduces complexity, as a prospective measurement of the CSM could be continued versus preparers being required to store data on the historical development.

Please refer to our response to Question 2 for a complete explanation of how the CSM should work for participating insurance contracts.

Appendix I: Questions raised in the exposure draft

Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

Question 2

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

a) *measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?*

b) *measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (i.e. using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?*

c) *recognises changes in the fulfilment cash flows as follows:*

   i. *changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in Profit or Loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;*

   ii. *changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in Profit or Loss; and*

   iii. *changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in Profit or Loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?*

Why or why not? If not, what would you recommend and why?

Summary:

Allianz appreciates that the Board recognised the need to reflect the linkage between the insurance liability and the underlying items in order to address accounting mismatches for contracts with asset dependent cash flows (i.e., participating contracts). However, we do not believe that the "mirroring" approach proposed in the Revised ED provides relevant information that faithfully represents the entity's financial position and performance. We believe that:

1) **The scope of the approach is defined too narrowly;**
2) **Bifurcation of cash flows is overly complex and would lead to a liability that does not represent the current fulfilment value of the contract; and**

3) **A limited unlocking of the CSM does not fully reflect the economics of participating contracts.**

Below we explain our concerns in more detail and then present an Alternative Approach to account for participating contracts that is less complex, aligned with the general measurement principles of the Revised ED, and does not require a measurement exception for participating contracts.

Detailed response:

The scope of the approach is defined too narrowly

The proposals of the Revised ED can only be applied if the contract requires the entity to hold underlying items or if the underlying item specified in the contract is the assets and liabilities of the entity as a whole and if the contract specifies a link between the payments to the policyholder and the returns on those underlying items. This is a very narrow, legalistic definition that excludes certain contracts for which the entity is not required to hold the underlying items but that are otherwise in substance economically the same.

For instance, there are many contracts for which the cash flows are dependent on asset returns. For some of these contracts, there is a contractual link. Other contracts do not have such a contractual link; and not all these contracts require the entity to hold the underlying items (e.g., life insurance products sold in Belgium). While the legal aspects of the contract may differ, the economic substance of sharing returns with the policyholder is the same. Thus, we believe that the scope that is proposed by the IASB for participating contracts will lead to different accounting for similar insurance contracts.

Instead, there should be no exception for the measurement of participating contracts and the IASB should define how to apply the general principles of the Revised ED to contracts with a link to underlying items.

Bifurcation of cash flows does not provide decision-useful information and is overly complex

The Revised ED would require entities to decompose the cash flows arising from insurance contracts between those that are expected to "vary directly with returns on underlying items" and those that are not. Some parts of the insurance liability would be measured under the general measurement requirements and another part would be measured on a basis which is driven by the basis on which the underlying items are measured. This would result in an insurance liability that does not represent the best estimate of the ultimate probability-weighted expected cash flows and mixes measurement bases for one liability, which would result in a meaningless presentation in statement of financial position.

We believe that for all types of contracts, including contracts with cash flows that are dependent on the returns of underlying items, the present value of the fulfilment cash flows would more faithfully represent the entity's contractual rights and obligations, and convey more useful information about the amounts, timing and uncertainty of the cash flows generated by those rights and obligations.

In addition, bifurcation of cash flows adds significant complexity to the measurement of the insurance contract liability. It is artificial and arbitrary and for many insurance contracts operationally infeasible:

- In some cases policyholder participation is not based on investment income but on the entire earnings of the entity or the net result of a portfolio of assets and liabilities.
- In many jurisdictions, bonuses are declared to individual policyholders each year and are guaranteed after the declaration. Increases in guarantee either from profit allocation but also from additional premium payments force a new decomposition of the cash flows between those that "vary directly with returns on underlying items" and those that do not during subsequent measurement. This not only introduces operational complexity that is not manageable, but also has an impact on earnings since the cash flows are measured using different measurement bases.

During the limited field testing we conducted during the comment period, we tried to model certain portfolios of participating contracts. However, even with simplified assumptions we failed to apply the requirements of the Revised ED for participating contracts. Please refer to our separate response to the field testing questionnaire for more details on these concerns.

Limited unlocking of the CSM does not fully reflect the economics of participating contracts

As expressed in our response to Question 1, we believe all measurement components should be considered in the subsequent measurement of the CSM, i.e. measurement with completely updated assumptions. Carving out certain measurement components would lead to inconsistent measurement and result in an incomplete implementation of the fulfilment value model. We thus believe that participating insurance contracts require a fully unlocked CSM that includes:

- Gains/losses on underlying items, which is inclusive of reinvestment assumptions;
- Changes in time value of O&G; and
- Changes in risk adjustment related to future coverage.

We believe that the CSM should be considered as unearned profit and consistently presented at day one and in all subsequent reporting periods. As long as the margin is not completely unlocked, it is not fully aligned with its definition of unearned profit and lacks relevancy to users of our financial statements. Please refer to our response to Question 1 for further details.

We recommend the global insurance industry's Alternative Approach to accounting for participating insurance contracts

The approach proposed in the Revised ED for participating contracts (bifurcation of cash flows and limited unlocking of CSM) is seen by many constituents as the key concern. The insurance industry has developed an Alternative Approach using the existing framework in the Revised ED to create an approach for participating insurance contracts that is more

consistent with the general building blocks approach as defined in the Revised ED. Its principles can be summarised as follows:

- The measurement of insurance liabilities for participating insurance contracts should follow the general principles and measurement model of the Revised ED.
- All insurance liabilities would be measured at current fulfilment value in the statement of financial position without bifurcation of cash flows.
- The CSM should always reflect the unearned profit arising from the insurance contracts and be determined on a fully unlocked basis. For participating contracts an intrinsic element of the unearned profit are the investment returns arising from the contract.
- Profit for all contracts would be recognised in accordance with the fulfilment of the contract as services are provided, in accordance with general revenue recognition principles.

These principles will apply uniformly. However, consistent with the differing types of products and the business model for asset-liability management, the practical application of the principles can be conducted under both a "current value through OCI" and a "current value through profit or loss" environment.

Key advantages of the Alternative Approach include a more faithful presentation of performance, better comparability and reduced complexity

- The approach builds on existing principles of the Revised ED instead of defining an exception for contracts with a link to underlying items.
- It requires current fulfilment value measurement for all insurance contracts and all components of the liability in the statement of financial position.
- The potential impact of changes in reinvestment assumptions would be fully transparent.
- The income statement would reflect the long-term nature of business. The approach distinguishes between earned returns for services provided (in profit or loss) and changes in expected future profits (in CSM).
- An asset dependent interest rate to determine interest expense for insurance liabilities in profit or loss avoids accounting mismatches in profit or loss.
- The fully unlocked CSM simplifies retrospective application at transition.
- No bifurcation of cash flows significantly reduces complexity.

Appendix I: Questions raised in the exposure draft

Description of key aspects of the Alternative Approach

Below is our description of key aspects of the Alternative Approach that will be further described in an appendix to the European Insurance CFO Forum comment letter:

Scope

Economically similar contracts are measured in a consistent way under the Alternative Approach, including all contractual and discretionary expected future cash flows. Contrary to paragraphs 33 and 34 of the Revised ED, the Alternative Approach would not establish an exception for the measurement of participating contracts but proposes a fully prospective current fulfilment value for all insurance contracts in accordance with the general building blocks approach as defined in the Revised ED. Paragraphs 33, 34 and 66 could potentially be removed.

The Alternative Approach can be applied to all contracts whose cash flows significantly depend on asset returns. Examples of these contracts include European 90/10 participating contracts, universal life type contracts, and equity-indexed annuity contracts. Instead of a scope definition, the alternative approach uses the criteria established in the Revised ED for the general building block approach for treatment of asset dependent cash flows and the determination of the discount rate for asset dependent cash flows in paragraphs 26a and 60h.

We believe that existing insurance products can be clearly divided into contracts whose cash flows significantly depend on asset returns and contracts with no or only insignificant asset dependency. Thus, we believe that a principles-based guidance referring to "significant asset dependence" would work very well in practice.

A similar scope question exists for the classification of a contract as insurance contract. Under the current IFRS 4, the entity needs to evaluate if the contract contains "significant insurance risk". This principles-based guidance, which has been carried forward to the Revised ED, proved to be effective in practice and did not cause many controversial discussions about whether a contract qualifies for classification of a contract as insurance contract or not.

Measurement and presentation

As noted, the Alternative Approach does not introduce an exception for the measurement of participating contracts. Instead, it defines how to apply the general principles of the Revised ED to contracts with a link to underlying items. The four building blocks of the general measurement requirements would be determined as follows:

1. Future cash flows

Under the Alternative Approach, all insurance liabilities are measured at current fulfilment value in the statement of financial position to ensure a consistent measurement basis. There is no bifurcation or separation of asset dependent and non-asset dependent cash flows within a contract.

For participating contracts whose cash flows significantly depend on asset returns, asset management services are an explicit service under the insurance contract. The expected cash in- and outflows under these contracts depend on the investment returns from the underlying items. Thus, for participating contracts all cash flows from returns on underlying items relate to services provided under the contract and thus need to be considered for initial and subsequent measurement of the fulfilment cash flows and the CSM.

Accordingly, all cash flows arising from contractual or discretionary participation features should be reflected in the fulfilment cash flows. Entities should consider all expected cash flows including:

i. Expected cash flows from existing assets, which would be reflected in the expected cash flows of the insurance liability; and

ii. Expected cash flows from future reinvestments, which would be considered in the measurement of the liability using a discount rate curve that is consistent with how asset returns are reported in profit or loss, including adjustments for expected reinvestment rates.

Using expected reinvestment rates does not preclude that existing market information based on the target asset allocation (i.e., forward rates) is used. Incorporating reinvestment assumptions into valuation of the liability is consistent with estimating a current liability and the use of market-consistent information.

An insurance contract is a bundle of rights and obligations that should be accounted for together (after separating investment components, embedded derivatives and performance obligations in accordance with paragraphs 9 to 11 of the Revised ED). Thus, O&G embedded in insurance contracts that are not separately accounted for as derivatives when applying the financial instrument requirements are part of the fulfilment cash flows. As a consequence, the time value of O&G should be determined considering the effect of the possible outcomes (e.g., by using stochastic scenarios) and treated consistently with the Revised ED's general requirements for fulfilment cash flows. O&G should be measured within the overall insurance contract obligation, using a current value approach. They should not be separated and measured independently, as they are an integrated embedded component of probability-weighted cash flows.

2. *Time value of money*

For purposes of balance sheet measurement of the insurance contract liability, the valuation basis is the current fulfilment value, as proposed in the general measurement requirements of the Revised ED. All cash flows under a contract are treated consistently without bifurcation as proposed in the Revised ED. These cash flows are discounted with a current discount rate which would be consistent with the rate used for non-participating contracts to ensure a comparable measurement of all insurance contracts in the statement of financial position.

For purposes of unwinding the current insurance liabilities to recognise interest expense in profit or loss, entities would unlock this discount rate to a rate that reflects the dependence of the liability cash flows on the returns of assets. Please refer to our response to Question 4 for more details on the discount rate used to determine interest expense in profit or loss.

3. *Risk adjustment*

The general requirements of the Revised ED apply.

4. *Contractual Service Margin*

Under the Alternative Approach, the CSM reflects consistently the unearned profit of the shareholders arising from the insurance contract at inception and in all subsequent periods over the life of the contract. Determination of the CSM is consistent with the measurement of the other building blocks and aligned with the principles of the revenue recognition project. This requires that all assumptions underlying its calculation are updated.

A prospective measurement of the CSM can also be expressed by a full unlocking of the CSM, accretion of interest using the interest rate applied to determine interest expense in profit or loss and a release of the CSM based on changes of the present value of expected future profits; there should be no differences between a prospective calculation and a determination of the CSM based on these principles proposed by the Alternative Approach.

Unlocking of the CSM

For participating contracts, asset management activities, including crediting asset returns to the policyholder, are explicit services under the insurance contract. The difference between the expected investment returns and the amount credited to the policyholder is part of the compensation in exchange for the asset management services provided by the insurer. Thus, changes in the expected investment returns and changes in the expected crediting rate affect the unearned future profit from the contract.

The CSM should be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services. This would mean that regarding changes in expected asset returns including reinvestment assumptions, the CSM would be unlocked for changes in the expected amount retained by the insurer (e.g., as a result of a change in the proportions of asset returns shared between the policyholders and the insurer).

This treatment would be consistent with the treatment of contracts that contain an explicit asset management fee (e.g., unit linked contracts). For such contracts, the CSM would be unlocked for changes in the estimates of future fees in accordance with paragraph B68e of the Revised ED.

As the CSM shall be unlocked for changes in cash flows relating to future coverage or other future services, recognising changes of the time value of O&G immediately in profit or loss is inconsistent with the treatment of other fulfilment cash flows. The Alternative Approach effectively treats the change in the time value of O&G as an adjustment of the CSM. As noted by the IASB Staff in Agenda Paper 2B for the December 2012 Board meeting, this is consistent with how the margin is estimated on day one and with the idea that the O&G, services, and insurance coverage are interrelated and with the general principle to unlock the CSM for changes in cash flows relating to future coverage or other future services. Therefore, the CSM represents the unearned profit from the entire contract, consistently at inception and afterwards. If the contract becomes onerous, the CSM disappears and all

changes in the time value of O&G go directly through profit or loss, without requiring a separate premium deficiency test. To ensure transparency, a requirement could be included in the standard to disclose in the notes the time value of O&G.

As explained in our response to Question 1, treatment of risk adjustment should be consistent with other fulfilment cash flows (i.e., the CSM should be adjusted for changes in the risk adjustment related to future coverage or other future services).

Accretion of interest

The Alternative Approach would imply accretion of interest on the CSM based on the discount rate that is used to determine interest expense in profit or loss for the other components of the insurance liability. The use of such an unlocked discount rate would allow the CSM to reflect future profit expectations, as those expectations are calculated based on the present value of future profits considering returns from both existing investments and projected reinvestments.

Release of the CSM

The Revised ED establishes principles-based guidance only, as it requires entities to release the CSM in a systematic way that best reflects the remaining transfer of services that are provided under the contract, and does not prescribe a specific pattern of release. We support this guidance and believe that a meaningful pattern for the allocation of the margin considers the provision of services as satisfied over the life of the contract, and is based on the insurer's expectations of total unearned profit and allocates that unearned profit in a reasonable, systematic way.

Illustrative example 13 for ED/2011/6, *Revenue from Contracts with Customers* states that performance-based incentive fees for asset management services should only be recognised if the entity is reasonably assured to be entitled to the fee. Although the constraint on recognising revenue proposed in the revenue recognition project does not apply to the allocation of the CSM for insurance contracts, a consistent view should be taken for asset management services provided under a participating insurance contract and for asset management services accounted for under the revenue recognition standard. All other things being equal, the profit recognition pattern on a contract where the insurer receives an asset management fee should be the same as one in which the insurer receives an identical amount through a combination of lower fees with a share of returns on an asset pool.

The share of asset and other returns not credited to the policyholder can be considered as remuneration in exchange for the asset management services provided under the contract, similar to a performance-based fee. For certain types of contracts, the amount of asset and other returns credited to the policyholder could serve as a good approximation for the main services provided in that period. However, this depends on the nature of the product and the mechanics of the allocation mechanism. As a result, the CSM would be determined prospectively based on the projected future allocations of asset returns to shareholders, consistent with the underlying contractual or regulatory participating mechanism. If other services are provided in addition, they should be taken into account when defining the change in CSM as well.

Appendix I: Questions raised in the exposure draft

Presentation requirements for unit liked contracts

ED/2010/8, *Insurance Contracts* contained specific guidance that the pool of assets underlying unit linked contracts and the portion of the liabilities from unit linked contracts should be presented as a separate line item. The FASB ED *Insurance Contracts (Topic 834)* includes comparable guidance.

Similar requirements were also included in the ED/2010/8, *Insurance Contracts.* However, this guidance is no longer included in the Revised ED. We encourage the IASB to reconsider this issue, for the reasons stated by FASB and in order to avoid conflicts that may rise from different interpretation of the requirement to consolidate investment funds under IFRS 10.

Appendix I: Questions raised in the exposure draft

Presentation of insurance contract revenue and expense

Question 3

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in Profit or Loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

Summary

We are not convinced that the IASB's presentation proposal meets the objective to provide relevant information that faithfully represents the entity's financial performance. We believe the IASB should reconsider the summarised margin approach.

Detailed response:

We believe that the IASB's proposal to present "insurance contract revenue" (i.e., change in CSM +/- change in risk adjustment +/- expected claims) for long duration contracts measured using the building blocks model does not provide relevant information that faithfully represents the entity's financial performance.

Furthermore, we are concerned about the proposal to exclude receipts and payments of investment components from premiums, claims and benefits presented in profit or loss, which is of questionable value and adds unnecessary complexity for both preparers and users. Thus, we do not support the IASB's proposal regarding presentation of revenue and expenses in profit or loss.

We believe that the Board should reconsider the summarised margin approach that was originally proposed in the ED/2010/8, *Insurance Contracts*. The summarised margin approach enables a more flexible approach for all insurance products. While no top line revenue is presented in profit or loss, volume information can be provided via the segment disclosures on the same basis as is used internally for performance evaluation and resource allocation, which we believe is the most relevant information for users. We elaborate on our key arguments below.

Revenue/expense presentation proposal does not provide useful information

We do not believe that insurance contract revenue as defined in the Revised ED provides relevant information. In particular, it is derived artificially from the changes in the building blocks. Thus, it is not capable of making a difference in investor decisions – it provides no additional information of predictive or confirmatory value that could otherwise be obtained from the summarised margin.

Also, we do not believe that insurance contract revenue provides a faithful representation of the revenue that is earned. In particular, it is not complete, i.e. is not linked to the premium

paid by the policyholder to the entity. The premium is a significant fact that is absent from the proposed approach.

Furthermore, the information provided needs to be accepted and used by analysts and investors to justify the costs to produce it. During discussions with Allianz' top analysts, we heard significant concerns regarding the presentation proposal for long duration contracts measured using the building blocks approach. More specifically they questioned whether the revenue number proposed provides information they can use for their analysis in a reasonable way and that the information provides additional insights. They emphasised that they will use additional volume information provided by the companies.

We would also point out that insurance revenue for a conglomerate insurance company with asset management or banking business is not a useful piece of information. The nature of revenue and profitability varies significantly depending on the product. Therefore, there is no "one-size-fits-all solution".

Based on these points, we conclude that the insurance contract revenue approach does not provide useful financial information.

The presentation proposal increases complexity for preparers and users

The Revised ED proposes that premiums, claims and benefits presented in profit or loss should exclude receipts and payments of investment components, where investment components are defined as the amount that the insurer is obligated to pay to policyholders or to their beneficiaries regardless of whether an insured event occurs (Note: This is different from current practice, which defines as deposit element the premium received). The purpose of this guidance is to separate the deposit element of the insurance contract. However, we have the following concerns:

- This adjustment to reported revenue, claims and benefits further complicates the profit or loss presentation for the users.
- Separation of the investment component for presentation is not aligned with unbundling guidance, which requires separation of investment components that are "distinct". This results in the exclusion of revenue and expenses for presentation but not in measurement. We do not see an argument which justifies this inconsistent treatment. Furthermore, while we acknowledge that a deposit element is not revenue, the investment component as defined in the Revised ED is interrelated with other cash flows and this is why it is not separated under paragraphs 9 to 11 of the Revised ED. Also, the result of separating the investment component from revenue and expense in this manner is not meaningful, and the calculation would be operationally complex or even infeasible.
- The investment component is not linked to the actual customer consideration that is received.

Determining the amount that the insurer is obligated to pay to policyholders or to their beneficiaries regardless of whether an insured event occurs, adds additional complexity in transition and ongoing reporting. Since existing systems are not able to provide this

information, system changes would also be required, and we do not believe that the benefits of this information exceed the costs of producing it.

Thus, we do not support the proposal and ask the Board to reconsider the summarised margin approach that was originally contained in the ED/2010/8, *Insurance Contracts*.

Appendix I: Questions raised in the exposure draft

Interest expense in profit or loss

Question 4

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

a) recognising, in Profit or Loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

b) recognising, in other comprehensive income, the difference between:

i. the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and

ii. the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

Summary:

We strongly support the introduction of an OCI model in IFRS 4 and the related FVOCI category in IFRS 9. However, the use of OCI must not be mandatory and locking-in the interest rate for the liability for incurred claims under the simplified approach at inception of the contract is not feasible. The OCI model proposed in the Revised ED is fully consistent with the industry's Alternative Approach.

Detailed response:

We strongly support the use of OCI for insurance contracts. However, OCI must not be mandatory

Under the OCI model, insurers are able to report a statement of financial position measured at current fulfilment value while preserving a decision-useful income statement that reflects the long-term nature of the insurer's business. This model provides more relevant information to users of our financial statements, avoiding the issue of short-term market movements that do not impact the policyholder or shareholder distorting the insurer's earnings.

From a technical perspective, the OCI component represents a "bridging item" as defined in DP/2013/1, *A Review of the Conceptual Framework for Financial Reporting*. It contains the effect from applying two different discount rates for the statement of financial position and

profit or loss – a current discount rate for the statement of financial position and a locked-in discount rate (or an unlocked asset-based rate for participating contracts) for profit or loss.

However, we are very concerned that for some contracts, the mandatory application of the OCI solution would not provide meaningful information to users. Insurance liabilities and the related assets should be measured and presented in a consistent way, reflecting their interaction. Despite the introduction of a FVOCI category for simple debt instruments in IFRS 9, measurement at FVOCI is not applicable for all asset categories. Thus, we are very concerned that the mandatory application of the OCI approach would create an accounting mismatch if a large share of the assets backing an insurance liability is not eligible for measurement at FVOCI.

In addition, some contracts, such as unit linked or variable annuity contracts, are managed on a FVTPL basis. For these contracts, recognising the effects from changes in discount rate in OCI would not provide relevant information to users of financial statements.

As a result, we strongly believe that the standard should contain an option to present effects from changes in discount rate for insurance liabilities directly in profit or loss.

We support the use of an unlocked discount rate for the determination of interest expense in profit or loss for participating contracts

We agree that the discount rate for determination of interest expense in profit or loss under the OCI model should be the discount rate determined at inception of the contract, as stated in paragraph 60h of the Revised ED. This discount rate should be unlocked when changes in underlying items change the expected future cash flows under the contract, in line with paragraph 60h of the Revised ED.

We noted that the Revised ED does not explicitly state to which new rate the discount rate should be updated. To adequately reflect the nature of participating contracts, it is key that the change in discount rate reflects the change of the expected cash flows under the insurance contract. Thus, the discount rate should be based on how returns of the existing assets backing the insurance contract are recognised in profit or loss in the matched period and the expected yield for reinvestment in the unmatched period. This ensures that the discount rate changes to the extent the expected cash flows are changing as well.

As the liability cash flow projections include reinvestment assumptions (based on current market rates where available) for the period beyond the duration where underlying items exist, cash flows might change as a result of changes in the expected reinvestment rates. Thus, the unlocking of the discount rate reflects such changes as well. In addition, when measuring contracts for durations beyond the point for which sufficient market data is observable, entities should be permitted to use their estimate of long-term returns, consistent with current fulfilment valuation.

Overall, the discount rate would "mirror" the presentation of the assets in profit or loss:

i. Where the insurer applies "current value through OCI", the discount rate would reflect the measurement of the underlying assets (e.g., for FVOCI assets the discount rate would be an amortised cost based rate which is unlocked when changes in the

underlying items change the expected future cash flows under the contract, including a change in reinvestment assumptions).

ii. Where the insurer applies "current value through profit or loss", the discount rate would be a current rate.

We strongly support the creation of the FVOCI category for assets under IFRS 9

As stated in our IFRS 9 comment letter to the IASB, we strongly support the reintroduction of FVOCI for simple debt instruments in IFRS 9, as we see OCI as a vital element to adequately reflect the performance of certain insurance products in a current measurement environment. However, we would reiterate some concerns with the IFRS 9 proposal and its interaction with the new insurance accounting proposal. In particular, we support an unconditional option to use FVOCI or amortised cost for simple debt instruments. In addition, we propose that the "eligible" debt instrument definition should be broadened and oppose no recycling of OCI amounts for equity instruments.

Some constituents brought up suggestions to define an own measurement category at FVOCI of assets backing insurance liabilities. We do not support this idea as we believe that the adjustments to IFRS 9 (mentioned above) together with the required changes in the Revised ED on insurance contracts, specifically on participating contracts, would provide an acceptable solution for insurance companies and reduce accounting mismatches in most cases. In addition we believe that these changes can be implemented in a relatively short period of time, whereas creating a separate measurement category for assets backing insurance liabilities would require significant changes in a number of standards, causing a significant delay in finalising the insurance contracts project.

The OCI Model is fully consistent with the Alternative Approach

The Alternative Approach described in our response to Question 2 is fully consistent with the OCI model introduced in the Revised ED. It is also consistent with the bridging item concept as defined in DP/2013/1, *A Review of the Conceptual Framework for Financial Reporting*, and it is consistent with the FVOCI category for simple debt instruments introduced in IFRS 9 that would apply for a large part of the assets held by an insurance company.

The Alternative Approach implicitly distinguishes between the asset-liability matched and unmatched part of the contract. For the matched part (the duration where existing investments provide cash inflows which match expected cash outflows), changes in discount rate do not change the expected cash inflows and outflows under the contract. Due to discounting, however, an interest rate change impacts the current value of the insurance liability. This effect reflects short-term movements that reverse automatically over the life of the contract. Insurers would use OCI to report these changes in the insurance liability arising from changes in the current discount rate in the period in which the duration of the insurance liabilities and related assets are matched.

For the unmatched part, the insurer is exposed to reinvestment risk. A change in discount rate changes the expected investment returns and the expected crediting rate, and thus changes the expected cash inflows and outflows under the contract. These changes relate

to future asset management services and affect the unearned future profit from the contract. As described in our response to Question 2, the CSM would thus be unlocked for changes in reinvestment assumptions relating to the unmatched part, consistent with its definition as unearned future profit from the contract.

OCI would be the difference between:

i. The carrying amount of the liability measured using the current rate; and

ii. The carrying amount of the liability measured using the discount rate for determination of interest expense in profit or loss.

As a change in discount rate equally affects both the current rate and the discount rate to determine the interest expense in profit or loss (via current reinvestment assumptions), there would be no OCI effect from the unmatched part.

The proposed alternative supports a clear and economically based separation between CSM and OCI:

- The CSM reflects consistently the unearned profit of the shareholders arising from the insurance contract at inception and in all subsequent periods over the life of the contract.
- The purpose of OCI is to capture the short-term market movements in assets and liabilities that do not impact the policyholder or shareholder during the period in which assets and liabilities are matched.

Hedging solutions for insurance liabilities need to be developed as part of the IFRS 9 macro hedging project

Current measurement under future accounting rules combined with the low interest rate environment will increase insurers' needs for hedging. The primary driver is the insurer's desire to avoid accounting mismatches. Macro hedging should enable insurers to reflect asset-liability management and asset portfolio hedging strategies. Therefore, we believe that solutions need to be developed and strongly recommend the Board to include insurance liabilities in the scope of the macro hedge project.

Simplified approach

For most property-casualty business, locking-in the interest rate for the liability for incurred claims under the simplified approach at inception of the contract is not feasible for two reasons:

1) Property-casualty contracts are not modelled at a contract level but rather at a portfolio level.
2) Depending on the nature of the underlying business, the way in which an insurer models a portfolio of contracts differs. Three common approaches include accident period (period in which claim is incurred), underwriting period and report period. Accident period is typically used for direct insurance business (coverage on occurrence basis), underwriting period when modelling reinsurance contracts on risk attaching

basis and report period for certain claims made policies (e.g., medical malpractice business).

Under the simplified approach, only claims reserves are subject to discounting and hence the lock-in of the discount rate only applies to unpaid claims, not all provisions since inception of a policy. As the discount would be calculated on cash flows from claims projections, it is necessary to apply the lock-in at the same level as the discounting itself, i.e. by development period (typically annually) and separately for each origin period (accident, report or underwriting period depending on how a reserve class is practically calculated). As property-casualty contracts are not modelled at a contract level but rather at a portfolio level, the lock-in needs to be done at a portfolio level as well.

Appendix I: Questions raised in the exposure draft

Effective date and transition

Question 5

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

Summary

We support the decision to require retrospective application of the new standard which is key to enable a comparable and decision-useful reporting of the performance of insurers. The effective date of the new standard for insurance contracts must be aligned with the mandatory first application of the revised IFRS 9.

Detailed response:

Effective date of IFRS 9 and IFRS 4 need to be aligned for insurers

We strongly believe that insurers should not be required to adopt IFRS 9 before the effective date of the new IFRS 4. Insurers would have to implement two significant accounting changes in short succession, which would be operationally burdensome and distort the informative value of insurers' financial statements for users over several periods. Effective dates of IFRS 9 and IFRS 4 should be aligned so that for entities conducting insurance business the mandatory application of both standards coincides.

Should application dates of IFRS 9 and IFRS 4 differ, it is requested that IFRS 4 provides a fully unconstrained re-designation option for all assets under IFRS 9 at the date of first application of the new IFRS 4.

We generally agree with the proposed approach for transition

We strongly support the proposal to require retrospective application of the new standard. The proposed approach to transition maximises the comparability between contracts in-force at the date of transition with those issued after transition while using objective information to the largest extent possible. In particular, the transition proposal provides for the estimation of the remaining CSM at the date of transition, which is necessary to attain comparability in accounting between in-force contracts and new business.

We do acknowledge that retrospective application increases complexity upon transition, but we believe that the benefits of retrospective application (i.e., consistent accounting for in-force and new business) clearly outweigh the costs. Furthermore, we believe that the introduction of simplifications and several practical expedients by the IASB mitigate the complexity issue.

Appendix I: Questions raised in the exposure draft

The CSM should be determined on a fully unlocked or prospective basis

That said, we have identified significant problems with transitioning based on the current measurement guidance for participating contracts. In particular, the measurement approach introduced in the Revised ED causes significant operational complexity for retrospective application.

Since the CSM is not fully unlocked and thus cannot be measured independently of prior period data, the remaining margin at the date of the earliest period presented needs to be determined by estimating the required building blocks and changes for the period between initial recognition of the respective portfolio of insurance contracts and the beginning of the earliest period presented.

This complexity could be significantly avoided or at least reduced if the measurement concept for the CSM is changed to a fully unlocked margin, as proposed in our responses to Questions 1 and 2. A fully unlocked CSM would eliminate the need to recalculate prior period building blocks values upon transition to the new standard.

Appendix I: Questions raised in the exposure draft

The likely effect of a standard for insurance contracts

Question 6

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5?

How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:

a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and

b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

Summary

The proposals of the Revised ED add complexity and will cause significant costs and efforts for us and for all our stakeholders. However, we believe the new standard will be a good investment if it improves the transparency and comparability of financial statements across the industry and provides decision-useful information to our stakeholders. Several issues need further development to adequately reflect the economics of the long-term insurance business model and make the costs of implementing the standard justifiable.

Detailed response:

The new standard will impact all aspects of our insurance accounting

Insurance accounting today is to a large extent based upon rules-based guidance that reflects regulatory requirements for insurance companies and insurance contracts, resulting in poor comparability of financial statements across jurisdictions. We believe that the IASB's approach to develop a principles-based standard is the only approach possible to reach consistent accounting treatment across jurisdictions.

The implementation of such a new standard will impact all aspects of our insurance accounting and thus, will cause significant costs and efforts for us and for all our stakeholders, including analysts and regulators. However, we believe the new standard will be a good investment if it improves the transparency and comparability of financial statements across the industry and provides decision-useful information to our stakeholders. In addition, it could be used for internal steering and management purposes and some non-GAAP measures that are currently used for internal and external communication would become redundant.

This, however, requires that the new standard adequately reflects the economics of the long-term insurance business model. Although there has been substantial progress compared to the ED/2010/8, *Insurance Contracts*, several issues need further development to make the costs of implementing the standard justifiable, in particular with the regard to the treatment of participating contracts.

The Revised ED increases complexity

Compared to the ED/2010/8, *Insurance Contracts*, some proposals add some complexity (e.g., presenting effects from changes in discount rate in OCI and the unlocking of the CSM), which we believe is necessary to appropriately reflect the insurance business model, that is very complex, and the performance of insurance businesses. However, we believe that some of the IASB's proposals in the Revised ED do not create benefits that outweigh the complexity that they introduce. In particular:

- We believe that the mirroring approach for participating contracts including bifurcation of cash flows is overly complex and does not provide decision-useful information. The Alternative Approach for participating contracts that will be further described in an appendix to the European Insurance CFO Forum comment letter would reduce complexity and increase understandability for our stakeholders.
- The limited unlocking of the CSM for participating contracts as proposed in the Revised ED makes a prospective measurement of the CSM impossible and adds significant complexity for transition and every subsequent measurement, as historical information is needed to re-measure the CSM.
- We understand that the rationale behind the insurance contract revenue proposal is to make insurance business comparable with other industries. However, we agree with specialist users who think that the summarised margin information is most relevant, in particular for a conglomerate insurance company. In our opinion, the unique nature of insurance business justifies a different presentation.
- Locking-in the discount rate at contract inception on an individual contract basis for the liability for incurred claims under the simplified approach would not be possible using generally accepted property-casualty reserving techniques as this is inconsistent with how the data is aggregated and modelled. As the discount effect for the liability for incurred claims would be calculated on cash flows from claims projections, it is necessary to apply the lock-in at the same level as the discounting itself, i.e. by development period (typically annually) and separately for each origin period (accident, report or underwriting period depending on how a reserve class is practically calculated).
- We are concerned that the guidance on the unit of account for the CSM results in a very low level of aggregation which would be burdensome to apply in practice.

The likely effect of a standard for insurance contracts

Question 7

Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB?

If not, please describe any proposal that is not clear. How would you clarify it?

We believe that significant changes to the Revised ED are required before we can comment on the clarity of the drafted proposal.

Appendix II: Questions to constituents

Adjusting the contractual service margin

14	*Do you believe that the distinction between changes in estimates relating to future coverage or other future services and experience adjustments would involve a significant amount of judgement? If so, do you believe that the proposed guidance provides sufficient explanation on how entities make this distinction?*

No, we do not believe that the distinction between changes in estimates relating to future coverage or other future services and experience adjustments would involve a significant amount of judgement.

We believe that this distinction is conceptually right and operationally feasible also for risk adjustment.

Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

56 *Do you believe the alternative approach described in Appendix 5 will lead to financial statements that provide relevant information that faithfully represent the entity's financial position and performance for contracts with asset dependent cash flows? Why or why not? If not, what would you recommend and why? Please consider whether the alternative approach eliminates or reduces accounting mismatches while reporting consistently contracts with similar economic features (i.e. contracts with asset dependent cash flows). Do you support the alternative approach wholly or partly? Please explain, which parts you support and which you do not?*

Yes, we believe that the Alternative Approach described in Appendix 5 of EFRAG's draft comment letter will lead to financial statements that provide relevant information that faithfully represents the entity's financial position and performance for contracts with asset dependent cash flows.

The Alternative Approach applies existing principles of the Revised ED to contracts with asset dependent cash flows instead of defining an exception for such contracts. The statement of financial position would be measured at current fulfilment value. The income statement would reflect the long-term nature of business. The approach distinguishes between earned returns for services provided in profit or loss and changes in the expected future profits from the contract in the CSM that includes the projected future allocations of asset returns to shareholders based on the underlying contractual or regulatory participating mechanism.

Under this approach, there would be no accounting mismatch in profit or loss because determination of interest expense in profit or loss reflects the asset dependence of the liability. To avoid an accounting mismatch also for non-participating contracts where a large share of assets is not eligible for measurement at FVOCI, an option to recognise the effects from changes in discount rate for insurance liabilities immediately in profit or loss is required (Please refer to our comments on Question 108 for further details).

57 *Do you believe that for contracts with asset dependent cash flows, the effect of changes in financial assumptions should be accounted for in the contractual service margin resulting in a fully prospective contractual service margin? If so, why and how this should be done?*

We agree that for contracts with asset dependent cash flows, the effects of changes in financial assumptions should be accounted for in the CSM.

Asset management activities, including crediting asset returns to the policyholder, are explicit services under the insurance contract. The difference between the expected investment returns and the amount credited to the policyholder is part of the compensation in exchange for the asset management services provided by the insurer. Thus, changes in the expected

investment returns and changes in the expected crediting rate affect the unearned future profit from the contract. The CSM should be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services. This would mean that for changes in expected asset returns including reinvestment assumptions, the CSM would be unlocked for changes in the expected amount retained by the insurer (e.g., as a result of a change in the proportions of asset returns shared between the policyholders and the insurer).

In many cases, the duration of insurance contracts exceeds the duration of the underlying assets (e.g., for a deferred annuity that has a duration of up to 80 years). It is a consequence of the current fulfilment model that cash flow projections for asset dependent cash flows need to be based on reinvestment assumptions for the unmatched part of the contract. If the CSM was not unlocked for changes in these reinvestment assumptions, any change in expected reinvestment assumptions would directly affect net income of the period. If, however, the CSM is unlocked for changes in reinvestment assumptions, the change in the expected future profits of shareholders is presented as an adjustment to the CSM and does not affect net income of the period. Changes in reinvestment assumptions are thus fully transparent in the current insurance liability and unlocked CSM.

As the CSM shall be unlocked for changes in cash flows relating to future coverage or other future services, recognising changes of the time value of options and guarantees ("O&G") immediately in profit or loss is inconsistent with the treatment of other fulfilment cash flows. The Alternative Approach effectively treats the change in the time value of O&G as an adjustment to the CSM. This is consistent with how the margin is estimated on day one. In addition, it is consistent with the idea that O&G, services, and insurance coverage are interrelated and with the general principle to unlock the CSM for changes in cash flows relating to future coverage or other future services. Therefore, the CSM represents the unearned profit from the entire contract, consistent at inception and afterwards. If the contract becomes onerous, the CSM disappears and all changes in the time value of O&G go directly through profit or loss, without requiring a separate premium deficiency test.

58	*Do you agree that interest expense should be recognised in Profit or Loss based on a yield as proposed in the alternative approach (please refer to paragraphs 21 – 25 of Appendix 5 for a description of the yield curve under the alternative approach)? Why or why not?*

We agree that interest expense should be recognised in profit or loss as proposed in the Alternative Approach. The use of such an unlocked discount rate would allow the CSM to reflect future profit expectations, as those expectations are calculated based on the present value of future profits considering reinvestment assumptions, and thus be consistent with the underlying cash flow projections. In addition, the reference of the discount rate to the profit or loss discount rate of the underlying assets effectively mitigates any accounting mismatch even with a mixed measurement model for the underlying assets.

Appendix II: Questions to constituents

59	*What should be the pattern of release of the contractual service margin for contracts with asset dependent cash flows?*

The Revised ED requires entities to release the CSM in a systematic way that best reflects the remaining transfer of services that are provided under the contract, and does not prescribe a specific pattern of release. As an insurance contract is a bundle of rights and obligations that are accounted for together, we believe this principles-based guidance is appropriate and support this guidance.

The share of asset and other returns not credited to the policyholder can be considered as consideration in exchange for the asset management services provided under the contract. For certain types of contracts, the amount of asset and other returns credited to the policyholder could serve as a good approximation for the main services provided in that period. However, this depends on the nature of the product and the mechanics of the allocation mechanism. As a result, the CSM would be determined prospectively based on the projected future allocations of asset returns to shareholders, consistent with the underlying contractual or regulatory participating mechanism. If other services are provided in addition, they should be taken into account when defining the change in CSM as well.

Generally, a prospective measurement of the CSM can also be expressed by a full unlocking of the CSM, accretion of interest using the interest rate applied to determine interest expense in profit or loss and a release of the CSM based on changes of the present value of expected future profits. There should be no differences between a prospective calculation and a determination based on these principles proposed by the Alternative Approach.

60	*Do you believe the alternative approach is operationally more or less complex than the IASB's 'mirroring approach'?*

We believe that the Alternative Approach as defined in Appendix 5 of EFRAG's draft comment letter significantly reduces complexity compared to the IASB's "mirroring approach". It builds on existing principles of the Revised ED instead of defining an exception for contracts with a link to underlying items. There is no need for bifurcation of cash flows and the use of a single discount rate for the whole contract significantly reduces complexity.

In addition, the fully prospective measurement of the CSM enables simple and high quality retrospective application that is far less complex than what otherwise would be required.

61	*Do you believe that the alternative approach, or a variant thereof, would be conducive to understandable and useful information for investors and their advisors?*

As stated in our response to Question 56, we believe the Alternative Approach described in Appendix 5 will lead to financial statements that provide relevant information that faithfully represents the entity's financial position and performance for contracts with asset dependent

cash flows. We are thus convinced that it would be conducive to understandable and useful information to users of financial statements.

Appendix II: Questions to constituents

Presentation of insurance contract revenue and expense

87	*Do you believe that the investment component amounts would be difficult and costly to compute because they are not distinct and are highly interrelated with the insurance component with the insurance component?*

The investment component does not refer to an explicit account balance or deposit component. It has to be computed for claims only. For many products, it would be difficult to determine if the contract contains an investment component and what the amount would be, because the investment component would be highly interrelated with the insurance component. Currently, we do not have all information that is required to compute the investment component available in our systems.

88	*Do you believe that additional application guidance is necessary to determine these amounts on a portfolio level?*

We are not aware of additional guidance required to determine the investment component on a portfolio level. However, we generally believe the investment component is difficult and costly to obtain and we do not believe that a determination on portfolio level would provide any relief.

89	*Do you believe that preparing and presenting revenue under the ED proposals would be difficult and costly?*

Generally, we believe that the computation of revenue and expense would not require big changes in the accounting and actuarial systems. However, we do not have the information that is required to compute the investment component available in our systems. Implementing this could create costs and complexity in transition and ongoing reporting. Overall, we do not believe that the benefits of revenue information exceed the costs of producing it.

Appendix II: Questions to constituents

Interest expense in profit or loss

> 103 *Under the IASB's proposals, the difference to be reported in OCI is determined by comparing the discount rate to measure the liabilities and, depending on the type of cash flows, the locked-in discount rate at inception of the insurance contract or an updated rate. Under IAS 19 Employee Benefits, the difference is determined by comparing the discount rate at the beginning of the reporting period and the rate at the end of the reporting period. Some, including IASB Board member Stephen Cooper, hold the view that only the latter difference (i.e. the effect of changes in discount rates in the period of the change) provides relevant information (as is described in paragraphs AV5 and AV6 of the Basis for Conclusions), and that, therefore, only this difference should be reported in OCI.*
>
> 104 *Do you support the approach in the ED or should the interest expense recognised in profit and loss be based on a current discount rate for all type of cash flows? If so, should the discount rate be the rate at the beginning of the period, as in IAS 19, or that at the closing date?*

We support the proposal in the Revised ED that the difference to be reported in OCI is determined by comparing the discount rate to measure the liabilities and the discount rate used to determine interest expense in profit or loss.

The OCI component represents a "bridging item" as defined in the Discussion Paper DP/2013/1, *A Review of the Conceptual Framework for Financial Reporting*.

Under this model, insurers are able to report a statement of financial position measured at current fulfilment value while preserving a decision-useful income statement that reflects the long-term nature of the insurer's business.

> 108 *Do you believe the suggested approach described above will lead to financial statements that provide relevant information that faithfully represent the entity's financial position and performance for contracts? Please consider whether the suggested approach eliminates or reduces accounting mismatches in Profit or Loss and OCI.*

We share EFRAG's view that presenting changes in the insurance liabilities consistently with how changes in the related assets are reported is necessary to convey relevant information about the insurance performance.

Despite the introduction of a FVOCI category for simple debt instruments in IFRS 9, measurement at FVOCI is not applicable for all asset categories. Thus, the mandatory application of the OCI approach for insurance liabilities in combination with IFRS 9 could create an accounting mismatch if a large share of the assets backing an insurance liability is not eligible for measurement at FVOCI.

To avoid this accounting mismatch, the EFRAG draft comment letter proposes to make the OCI approach for insurance liabilities mandatory and measure at FVOCI all assets that relate to the insurance liabilities, presenting in profit or loss their primary performance indicators and other gains and losses in OCI. We acknowledge that this approach would (by definition) avoid any accounting mismatches. However, we have several serious concerns regarding this approach:

1) We understand that EFRAG broadly links the requirement to measure all assets backing insurance liabilities at FVOCI to a business model that is based on active asset-liability management strategies. Still, the proposal would de facto create an industry specific standard, which contradicts a basic principle of IFRS.
2) Both projects, IFRS 9 and IFRS 4 Phase II, are in a final or close-to-final stage. The EFRAG proposal would require intense and controversial discussions (e.g., about what the primary performance indicators would be for different asset classes or if additional impairment models are required), which would delay these projects for several years.
3) The proposal would go beyond the IFRS 9 scope, which would require significant changes in other standards (e.g., IAS 16 and IAS 40). We do not believe that such a fundamental change should be proposed given the many open projects the IASB already has on its agenda.
4) The proposal would be very complex to implement, since an exact allocation of assets to insurance liabilities would be necessary. In addition, a "regrouping" of assets from those backing insurance liabilities to those not backing insurance liabilities would be required for specific assets from period to period, resulting in different measurement bases for these assets. The impact of these regroupings would be hard to explain.
5) Conglomerates or non-insurance entities with only a small number of insurance contracts might have serious problems to identify the assets that relate to the insurance liability.
6) Some contracts, such as unit linked or variable annuity contracts, are managed on a FVTPL basis. In particular, policyholder participation for these contracts is based on the fair value of the underlying items. For such contracts, recognising the effects from changes in discount rate in OCI would not provide relevant information to users of financial statements.

We believe that for most cases the FVOCI category in IFRS 9 combined with recognising the effects from changes in discount rate for insurance liabilities in OCI would result only in a small and acceptable accounting mismatch and provide relevant and meaningful information to users of financial statements.

For those cases where a large share of the assets backing an insurance liability is not eligible for measurement at FVOCI, we strongly recommend an alternative solution that is easier to implement and more coherent with other standards:

1) An option to present the effects from changes in discount rate for insurance liabilities in profit or loss should be included in IFRS 4. This option makes it possible to avoid accounting mismatches also under the mixed measurement approach in IFRS 9.

2) In addition, the Alternative Approach for participating contracts, which we fully support, would capture the profit or loss measurement basis of the assets in the discount rate used to determine interest expense in profit or loss for insurance liabilities. This would effectively avoid an accounting mismatch in the income statement, even if some assets are measured at FVTPL.
3) Macro hedging should enable insurers to reflect asset-liability management and asset portfolio hedging strategies. Therefore, we believe that solutions should be further developed. In particular, insurance liabilities should be included in the scope of the macro hedge project.

109	*Are you aware of any circumstances in which, from your point of view, measurement of both insurance liabilities and the related financial assets at FV-PL might be needed instead of, or combined with, measurement at FV-OCI? If so, please provide a description of the portfolios of insurance contracts concerned and how the asset-liability management strategy differs from other portfolios.*

Under the OCI proposal of the Revised ED, insurers are able to report a statement of financial position measured at current fulfilment value while preserving a decision-useful income statement that reflects the long-term nature of the insurer's business. We believe that for most insurance contracts this model provides more relevant information to users of our financial statements, avoiding short-term market movements that do not impact the policyholder or shareholder and otherwise would distort the insurer's earnings.

However, some contracts, such as unit linked or variable annuity contracts, are managed on a FVTPL basis. In particular, policyholder participation for these contracts is based on the fair value of the underlying items. For such contracts, recognising the effects from changes in discount rate in OCI would not provide relevant information to users of financial statements.

Summing up our comments on Questions 108 and 109, we strongly believe that the standard should contain an option to present effects from changes in discount rate directly in profit or loss if:

1) An accounting mismatch would be avoided (because a large share of the assets backing an insurance liability is not eligible for measurement at FVOCI); or
2) The contracts are managed on a FVTPL basis and thus recognising the effects from changes in discount rate in OCI would not provide relevant information to users of financial statements.

As the above indicators might be difficult to operationalise, we believe that the standard should not put any constraints on using a profit or loss treatment, but that the selection should be irrevocable as long as the underlying business model does not change significantly which would require a re-designation (rare cases only).

Appendix II: Questions to constituents

> *110 Do you believe that EFRAG should suggest how the assets related to insurance liabilities should be identified? If so, what would you recommend and why?*

As noted in our response to question 108, the required allocation would be very complex to implement. The allocation of assets to liabilities depends on regulatory requirements that vary between jurisdictions. In addition, a "regrouping" of assets from those backing insurance liabilities to those not backing insurance liabilities might be required for specific assets from period to period, resulting in different measurement bases for these assets. The impact of these changes would be difficult to explain.

> *111 Do you believe that derivatives should also be accounted for using OCI? If so, how could objective evidence be gathered in respect of derivatives that only play a role in matching insurance liabilities?*

No. We do not support FVOCI classification and measurement under IFRS 9 for derivatives. In the case of derivatives that are used to match insurance liabilities, we believe that solutions need to be developed via the macro hedge project.

Please note that for participating contracts under the alternative approach, the asset dependent cash flows and the discount rate used to determine interest expense in profit or loss (asset dependent unlocked discount rate) would take into account the impact of derivatives which are part of the underlying assets. This would effectively avoid an accounting mismatch, as the profit or loss treatment of derivatives would be reflected in the measurement of the liability.

> *112 Do you believe that EFRAG should suggest how the assets related to insurance liabilities should be identified? If so, what would you recommend and why?*

We do not support the expansion of FVOCI beyond simple debt instruments. However, we do believe that the FVOCI category for simple debt instruments should be broadened within IFRS 9. As noted in our comment letter to EFRAG on the ED/2012/4, *Classification and Measurement: Limited Amendments to IFRS 9* from 18.03.2013, we believe the "eligible" debt definition ("contractual cash flow characteristics test") is too narrow as it too often triggers FVTPL classification.

Regarding property, DP/2013/1, *A Review of the Conceptual Framework for Financial Reporting* states that the revaluation of property, plant and equipment as currently required under IFRS does not meet the definition of a bridging item, because in accordance with IAS 16, depreciation amounts recognised in profit or loss are determined using revalued carrying amounts. Consequently, cost less accumulated depreciation would not be a meaningful, understandable and clearly describable measure. In addition, the standard does not permit recycling. We agree with this analysis and with the conclusion that the IASB may at some point wish to consider whether to amend the revaluation model in IAS 16 to make it

consistent with the bridging item concept. However, this should not be part of the discussion of the insurance contracts project.

113 Do you agree that following EFRAG's approach, the IASB would need to develop an impairment model for debt instruments that do not meet the contractual cash flow characteristics assessment and investments in equities that would be measured at FV-OCI and potentially other assets? If so, what impairment model would you recommend and why?

We believe that for some assets new impairment models would be required which would cause controversial discussions and take a lot of time. This is one of the reasons why we do not support EFRAG's proposal.

114 Do you see any problems in recycling realised gains and loss on investments related to contracts with asset-dependent cash flows (that are not under the scope of the IASB's measurement and presentation exception as discussed in Question 2)? If so, what solutions would you recommend? Please explain your answer.

Consistent with your view, we are concerned about no recycling of OCI for equity instruments under IFRS 9. This restriction causes the treatment of equities to be inconsistent with the accounting for an insurer's corresponding liabilities. This is particularly so for participating contracts, where the investment returns (including gains and losses) are ultimately passed to the policyholder. We believe a transfer of the amounts from OCI to profit or loss should be possible if a sale of an equity instrument occurs.

115 Where should changes in the time value of options and guarantees not separated from insurance liabilities be recognised? Please explain your answer.

An insurance contract is a bundle of rights and obligations that should be accounted for together (after separating investment components, embedded derivatives and performance obligations in accordance with paragraphs 9 to 11 of the Revised ED). Thus, O&G embedded in insurance contracts that are not separately accounted for as derivatives when applying the financial instrument requirements are part of the fulfilment cash flows. Therefore, the time value of O&G should be determined considering the effect of the possible outcomes (e.g., by using stochastic scenarios) and be treated consistently with the standard's general requirements for fulfilment cash flows. O&G should be measured within the overall insurance contract obligation, using a current value approach.

Consequently, consistent with the unlocking of the CSM for changes in cash flows relating to future coverage or other future services, changes in the time value of O&G should be treated as an adjustment to the CSM. This is consistent with how the margin is estimated on day

one. In addition, it is consistent with the idea that O&G, services, and insurance coverage are interrelated and with the general principle to unlock the CSM for changes in cash flows relating to future coverage or other future services. Therefore, the CSM represents the unearned profit from the entire contract, consistent at inception and afterwards. If the contract becomes onerous, the CSM disappears and all changes in the time value of O&G are recorded directly in profit or loss, without requiring a separate premium deficiency test. Recognising these changes immediately in profit or loss is inconsistent with the treatment of other fulfilment cash flows. In addition, this does not reflect economic performance of the insurer and significantly distorts net income.

Appendix II: Questions to constituents

Effective date and transition

> 135 *Considering EFRAG's recommendation for entities where insurance forms a significant part of their activities (i.e. the effective date of IFRS 9 should be deferred until the effective date of the new insurance contracts standard), do you believe that:*
>
> *a) Those entities should always be required to apply the impairment proposals earlier than the other parts of IFRS 9; or*
>
> *b) Those entities should be allowed early implementation of the impairment proposals compared to the other parts of IFRS 9.*

We fully support EFRAG's recommendation that for entities where insurance forms a significant part of their activities the effective date of IFRS 9 should be deferred until the effective date of the new insurance contracts standard. This includes all three stages of the IFRS 9 project (i.e., classification and measurement, impairment and hedge accounting).

> 136 *Do you believe the scope of the redesignations and reclassifications when the new insurance contracts standard is applied for the first time by entities for whom insurance forms a significant part of their activities, should be extended beyond IFRS 9 (e.g. investment properties)? If yes, please explain what items should be within that scope?*

If effective dates of IFRS 9 and the new IFRS 4 were not aligned, a fully unconstrained re-designation option for all assets under IFRS 9 at the date of first application of the new IFRS 4 would mitigate reporting and operational issues to some extent. However, this would only be a second best solution for us.

We do not believe that the scope of redesignations and reclassifications when the new insurance contracts standard is applied for the first time should be extended beyond IFRS 9.

The likely effect of a standard for insurance contracts

139 Do you believe that the IASB's response to the comments on the 2010 Exposure Draft balance the costs of applying these proposals with the benefits of the resulting information provided?

Compared to the ED/2010/8, *Insurance Contracts*, some proposals clearly add complexity (e.g., presenting effects from changes in discount rate in OCI and the unlocking of the CSM). We believe that this is necessary to appropriately reflect the insurance business model and that thus the additional benefits of these proposals outweigh their costs.

However, a number of IASB responses – such as bifurcation of cash flows and disaggregation of investment components – create high complexity and costs without resulting in significant benefits.

Appendix II: Questions to constituents

The likely effect of a standard for insurance contracts

141 Do you agree with the areas/paragraphs identified by EFRAG in Appendix 4?
142 Have you identified any other areas/paragraphs that need clarification? Please explain.

As stated in our response to Question 7 of Appendix I, we believe that significant changes to the Revised ED are required before we comment on the clarity of the drafted proposal.

Additional Comments:

17 *Do you agree with EFRAG's conclusion that day one gains and losses on buying reinsurance should be recognised over the coverage period? If not, please explain how those should be accounted for and what the supporting arguments for a different accounting treatment are.*

No. We believe that gains and losses on reinsurance contracts written on an individual loss basis should be immediately recognised by the ceding party in profit or loss. This approach has the following advantages: it prevents accounting arbitrage and transparently presents the terms and extent of reinsurance coverage in the primary insurer's financial statements.

23 *Do you agree with EFRAG's recommendation that the requirement to disclose information about the effects of each regulatory framework in which entities operate should be deleted in the final standard? Please explain your answer.*

We agree with EFRAG's recommendation and rationale to remove the requirement to disclose information about the effects of each regulatory framework in which entities operate.