

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

25 October 2013

Dear Mr Hoogervorst,

Exposure Draft: Insurance Contracts

We would like to thank the IASB for the significant effort it has taken in developing the revised Exposure Draft – Insurance Contracts (the “Exposure Draft” or “ED”) and welcome the opportunity to comment on the ED. This letter has been drafted by the European Insurance CFO Forum, a body representing the views of 21 of Europe’s largest insurance companies and Insurance Europe, representing 95% of the premium income of the European insurance market. Accordingly it represents the consensus view of a significant element of the European insurance industry.

The development of comprehensive global accounting standards for insurance contracts and related financial instruments is of significant importance to us and hence we see the recent publication of the ED as an important step in the development process towards a finalisation of a high-quality global standard. We strongly encourage the IASB to continue its considerable efforts with the FASB towards converged principle-based standards without delays to the IASB timeframe.

We recognise that the Board has made progress in developing the proposed accounting standards for insurance contracts and related financial instruments. We believe that accounting should reflect the long-term nature of insurance business and address the linkage between assets and liabilities in reporting performance. We do not think that the ED achieves these objectives. Hence, the ED as currently drafted, and its interaction with the proposed IFRS 9 standard, is not appropriate as it will not provide a suitable basis to explain our business performance to our investor community.

The revised proposals in the ED and in the IFRS 9 Classification & Measurement ED are a step towards addressing many of our concerns. We specifically welcome developments such as the recognition of the importance of an appropriate discount rate, the introduction of Other Comprehensive Income (“OCI”) for changes in market interest rates on both insurance liabilities and related assets, the unlocking of the contractual service margin (“CSM”) and the introduction of revised transition principles. However, whilst progress has been made, the current proposals in the ED, when taken together with the proposals for IFRS 9, do not yet adequately achieve their intended purpose and important changes are needed.

Financial reporting should reflect the long-term nature of insurance business and consider the inherent linkage between insurance liabilities and related assets.

Insurers apply asset liability management (“ALM”) strategies in which insurance liabilities and guarantees and their related assets (including derivatives) are managed together according to the insurance contract liability profile to meet obligations to policyholders. Accounting requirements that deal with asset and liability components in isolation, separate from the overall ALM strategy, will result in the inconsistent measurement and presentation of the different components of the overall ALM strategy; this will result in reported earnings that do not reflect the true performance of the insurer.

As a matter of principle, we believe that an insurance contracts accounting standard should recognise the following basic principles:

- where an insurer’s asset and liability cash flows are economically matched, no accounting volatility should be reported in profit or loss nor in OCI;

- when there are cash flow mismatches over the long-term duration of the contracts, short-term market fluctuations in the value of assets and liabilities may be disclosed transparently in the balance sheet, but must not obscure the long-term operating performance in the P&L;
- the profit or loss account should reflect a measure of result that is relevant to the operating performance of the insurer.

We acknowledge the Board's objective to provide a fully transparent current measurement of insurance liabilities in the balance sheet. Such measurement reflects a current view on all relevant assumptions and current interest rates for discounting. However, there remains a series of significant issues with the ED which must be addressed to ensure that the final principles are appropriate for our insurance business:

- **No consistency between measurement of assets and liabilities:** There is a mandatory requirement to reflect all changes in discount rates for liabilities in OCI, whereas IFRS 9 restricts fair value through OCI ("FVOCI")¹ to simple debt securities. There is no ability to apply fair value through P&L ("FVPL")² for liabilities even when that provides better information about performance. OCI must not be mandatory.
- **Participating and unit-linked contracts:** The application of the proposed mechanics of "mirroring" is unclear and highly complex, resulting in bifurcation of cash flows which does not result in an appropriate profit recognition pattern.
- **Unlocking of the CSM:** We welcome the decision to unlock the CSM for changes in estimates relating to future coverage and future services. However, there is limited unlocking of the CSM for participating contracts because the principle has not been fully developed for such contracts. A fully unlocked contractual service margin should be adopted.
- **Treatment of options and guarantees:** The treatment of changes in the value of options and guarantees is unclear in the ED and has not yet been adequately addressed in the proposals as short-term market fluctuations affecting their value are not representative of the long-term operating performance of the insurer.
- **Presentation and disclosure:** Premiums and claims are reported in the P&L on a "notional" earned premium basis which is complex and of little relevance to users of life insurer financial statements. The disclosure requirements are overly burdensome.
- **Reinsurance contractual service margin:** Measurement of the CSM of reinsurance contracts held does not always reflect the economics of the transaction.
- **Some proposals are overly complex:** For example, the bifurcation of cash flows and the requirement to disaggregate investment components will result in significant implementation time, with the cost exceeding the associated benefits.

The interaction between IFRS 4 and IFRS 9 is key for insurers and needs further consideration.

As we have consistently highlighted, the interaction between assets and liabilities is the fundamental core of an insurer's approach to managing its business and reporting its performance. We do not think the approach outlined in the ED sufficiently reflects the linkage between assets and insurance liabilities. Consequently, we believe that the interaction between IFRS 4 and IFRS 9 needs further consideration to take account of the ALM and avoid accounting mismatches. A comprehensive and appropriate approach to FVOCI and FVPL measurement for both assets and insurance liabilities is needed.

The effective dates of IFRS 4 and IFRS 9 should be aligned for insurers so that insurers are not required, but are permitted, to adopt IFRS 9 before the mandatory effective date of IFRS 4. Otherwise it may put into question the usefulness of financial reporting for users in the period between IFRS 9 and IFRS 4 adoption, as users will experience two major changes in insurers' financial statements in short succession. A staggered adoption will not result in improved financial reporting in the period between adoption of the two standards due to the fundamental interaction of financial assets and insurance liabilities for insurers.

¹ "Fair value through OCI" or "FVOCI" means fair value measurement in the balance sheet with unrealised gains reported in OCI for assets; and current fulfilment measurement in the balance sheet with changes in discount rate reported in OCI for insurance liabilities.

² "Fair value through P&L" or "FVPL" means fair value measurement in the balance sheet and unrealised gains reported in P&L for assets; and current fulfilment measurement in the balance sheet with changes in discount rate reported in P&L for insurance liabilities.

We welcome the OCI model, but it must not be mandatory as FVPL application should also be available.

We welcome the Board's decision to introduce an OCI model in IFRS 4 and reintroduce FVOCI 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.

Accounting should reflect the linkage between assets and liabilities and hence the insurance liability accounting model should be suitable for both FVOCI and FVPL applications, depending on the measurement environment for backing assets, so that the resulting performance reporting is useful to users. Consequently, we believe OCI should not be mandatory; insurers should have the ability to present changes in the insurance liability arising from changes in the discount rate in P&L using a current discount rate.

We believe that mandatory OCI, together with the restrictive use of OCI in IFRS 9, would give rise to numerous accounting mismatches and inappropriate performance reporting for certain types of insurance business. For example, accounting mismatches will occur where the insurer holds assets that cannot be measured at FVOCI, such as equities or real estate, where the insurer uses derivatives to mitigate risk in the insurance contracts, or where the insurer does not adopt 'hold to collect and sell' business models for its assets. Whilst we understand the IASB's desire for consistency, the requirement for OCI to be mandatory, in combination with the restrictive use of OCI in IFRS 9, must be reconsidered to ensure meaningful performance reporting. We also refer to our letter to you on the IFRS 9 Classification & Measurement ED dated 28 March 2013.

There is a need for applying both FVOCI and/or FVPL in order to be consistent with the differing types of products, business models and the ALM of insurers. However, the application of FVOCI and FVPL should not be dependent on detailed rules based criteria. Instead we envisage the final standard could include guidance on the types of factors that can be considered in determining the application of FVOCI and/or FVPL, for example, characteristics of the insurance liability/product and the way the corresponding assets and insurance liabilities are managed. The application of either FVOCI or FVPL could be irrevocable in the absence of a significant change in the insurer's business model.

We welcome the unlocking principle for the contractual service margin but believe further changes are essential to improve its relevance.

We support the principle of the CSM to defer profits at inception in order to recognise profit over time as services are provided. We also welcome the introduction of the unlocking principle, which is consistent with the principle that the CSM represents a current estimate of unearned profits to be recognised in future periods. We believe that there should be a single principle of CSM for all insurance contracts.

There are a number of areas where the unlocking principles require revision including the unit of account, the accretion of interest, the treatment of the risk adjustment and the circumstances under which the CSM is rebuilt. Our concerns over the unit of account for the CSM are especially important because setting the unit of account at too granular a level, as suggested in the ED, is inconsistent with the portfolio level applied elsewhere in the ED and will cause greater complexity without significant benefits. As set out below, we have more detailed concerns in relation to the CSM for participating contracts as we do not believe the CSM and unlocking principles have been fully developed in particular for participating type contracts.

Accounting for participating contracts must adequately reflect the nature of these products.

We welcome the introduction of the concept of reflecting the asset dependency in measuring participating contract liabilities, but we oppose the ED's overly complex application mechanics of the 'mirroring' concept. We consider the requirement to bifurcate cash flows to be arbitrary and overly complex. Furthermore, it may result in the inappropriate measurement of the insurance liability and will distort performance reporting. This is a critical issue because participating insurance contracts account for a significant proportion of the contracts written by the European insurance industry.

As an alternative for participating contracts, the industry has developed a proposal for a fully unlocked CSM which would not require bifurcation of cash flows nor a separate exception for mirroring. We believe our

industry proposal would simplify the accounting requirements for participating contracts, be consistent with the overall building block approach and produce a more faithful representation of performance.

We support the use of the discount rate set out in the ED for participating contracts, which helps ensure that the asset dependency is reflected in both the measurement of the liabilities and the interest expense in P&L and we believe this principle should be retained in the final standard.

Our industry proposal uses the existing framework in the ED to create an approach for participating contracts (including contracts for which there is no requirement to hold the underlying items) that is more consistent with the general building block approach as defined in the ED. This ensures that there is a consistent accounting model for all contracts with similar economic characteristics. The application of 'mirroring' in the ED is too restrictive in the types of participating contracts that can use this approach.

The key principles of our industry proposal are summarised as follows:

- No exception for the measurement of participating contracts. Instead our industry proposal defines how to apply the general principles of the ED to all contracts with a link to underlying items.
- All insurance contract liabilities would be measured at current fulfilment value on the face of the balance sheet without the 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 is the investment return associated with the contracts.
- Profit would be recognised in accordance with the fulfilment of the contract as services are provided, in accordance with general revenue recognition principles.
- An OCI solution within the ED (in combination with IFRS 9) is needed, but OCI must not be mandatory. We believe there needs to be both FVOCI and FVPL applications available.

We believe the principles of our industry proposal would address our key concerns on the ED. We acknowledge that the application of our industry proposal for participating contracts set out in Appendix 3 will need further development and wider testing on a variety of different insurance products.

The treatment of changes in the value of options and guarantees needs further consideration.

We acknowledge that options and guarantees have to be valued at a current measurement in the balance sheet; however, the definition and treatment of options and guarantees in the ED is unclear. We believe that the treatment of changes in the value of options and guarantees that are closely related to insurance contracts has not yet been adequately addressed in the proposals, as short-term market fluctuations affecting their value are not representative of the long-term operating performance of the insurer.

Under the proposals in the revised ED, all options and guarantees, even those that are not separated, are measured separately at current value through profit or loss. We believe this treatment is inconsistent with the treatment of options and guarantees in financial instruments. We believe that options and guarantees that are not separated should be treated consistently with all other elements of the insurance liability for measurement and presentation as set out in our industry proposal. This means that changes in the value of options and guarantees are recognised based on the nature of the change and the measurement application followed (including the application of OCI and/or FVPL and the CSM) for other elements of the insurance liability and backing assets.

Concern remains on the measurement of the contractual service margin for reinsurance contracts held.

From an economic perspective, a reinsurance contract is highly dependent on the underlying direct insurance contracts and we believe this fact should be taken into consideration for both initial and subsequent measurement of the corresponding reinsurance asset. Consequently, we believe that gains or losses on reinsurance contracts written on an individual loss basis ought to be immediately recognised by the ceding party. We believe that this approach would provide a number of benefits: it provides a transparent presentation

of the terms on which the reinsurance has been agreed and it provides clarity over the extent of reinsurance coverage in the primary statements.

The earned premium revenue presentation for the building block approach will not provide useful information for users of life insurance financial statements and we consider the requirement to disaggregate investment components overly complex and arbitrary.

We believe that the final standard should provide a clear communication tool to investors of our business performance. We do not believe that the proposals in the ED for the presentation of earned premium revenue and expenses under the building block approach will achieve this clear communication. The proposals will also introduce more complexity without providing significant additional benefits.

Whilst the presentation of a premium revenue number is an important metric for non-life insurers, earned premium revenue as set out in the ED is not a relevant measure used by the life insurance industry and as such we believe that insurance analysts and other users of financial statements will neither understand nor rely upon earned premiums as proposed in the ED. Instead, they are likely to continue to request existing volume measures such as gross written premiums and new business premiums. Insurers that only have life insurance products would prefer a summarised margin approach to be available.

We disagree with the requirement to disaggregate ‘non-distinct’ investment components. Disaggregation is conceptually inconsistent with the ED proposal and IFRS 9 requirements not to unbundle these ‘non-distinct’ elements of an insurance contract for classification and measurement purposes. It will also be very costly to implement these requirements and the allocation of components will be unduly arbitrary.

Focus should be given first to revising the proposals in conjunction with less complex guidance; subsequently, extensive testing of the revised proposals is needed.

As described above, we believe that focus is now needed to make sure the proposals in the exposure draft are amended such that they are appropriate for our insurance business. The most critical areas are the interaction between IFRS 4 and IFRS 9 (including the limitation on the application of FVPL and the restrictive use of OCI in IFRS 9), the proposed measurement and presentation of participating contracts and the treatment of options and guarantees. As a next step, efforts are needed to translate these principles into high level and practical guidance, avoiding unnecessary complexity.

Obtaining meaningful results from field testing within the limited time available in the current exposure draft comment period is not possible. The proposals represent a fundamental change in accounting for insurance companies. It is therefore essential that a comprehensive understanding of the proposals is gained, to ensure that they will not have unintended consequences and are workable operationally. Extensive testing is necessary. This should not be confused with either the IASB field testing currently proposed or the three-year period between issuing the standard and its effective date. Testing should only take place once the proposals in IFRS 4 and IFRS 9 have been changed to address the issues presented above. In order to facilitate this testing there should be a review draft setting out the revised proposals.

We would like to thank you for the opportunity to comment on the ED. We would very much like to work in close co-operation with you and the IASB staff through the next deliberation phase. Appendix 1 to this letter sets out our views on the detailed questions posed in the exposure draft. Please feel free to contact us to discuss any matters raised in this letter.

Yours sincerely,



Gerald Harlin
Chair,
European Insurance CFO Forum



Olav Jones
Deputy Director General
Director Economics & Finance, Insurance Europe

APPENDIX 1**Question 1 – Adjusting the contractual service margin**

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows 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?

We support the principle of the CSM to defer profits at inception in order to recognise profit over time as services are provided. We agree with the definition of the CSM in Appendix A of the ED: “A component of the measurement of the insurance contract representing the unearned profit that the entity recognises as it provides services under the insurance contract” which is in line with the principle however, we believe the ED has not sufficiently developed the CSM principle for all types of insurance contracts.

We welcome the decision to unlock the CSM for changes in estimates relating to future coverage and future services and believe that this is a significant improvement on the 2010 ED. Unlocking the CSM is consistent with the principle that the CSM represents future unearned profit and it enables a consistent calibration of the CSM to be maintained between ‘day 1’ and ‘day 2’ accounting.

The principle of the CSM should be the same for all insurance contracts. It has not been fully developed for participating contracts as the CSM does not take account of changes in asset returns that represent income for future services. We have always supported a single measurement model and continue to believe that it can be achieved. A single model ensures consistency between insurance companies and simplifies the application. It also helps users in understanding insurance accounting when one model has been applied in all circumstances. Consequently, fundamental changes are required to the current proposals. We outline our detailed views and our alternative industry proposal for participating contracts in our response to Question 2. We believe our industry proposal for participating contracts utilises consistent principles and is easier for our users (including investors) to understand.

There are a number of other areas where further refinements are required to the CSM which we describe below.

Reinstating the contractual service margin

We have interpreted paragraph 30 and BCA143 as a requirement to track the CSM, even after it has been exhausted, and to reinstate it following a favourable change in the estimates of future cash flows. We are concerned, however, that under paragraph 30 when the CSM is being rebuilt, previous losses that have already been recognised in profit or loss will not be reversed. We believe that a more faithful representation would be achieved by first recognising reversal of past losses within profit or loss until such a time that all prior losses have been fully offset.

Interest accretion

We acknowledge that interest accretion on the CSM is conceptually required to maintain consistency with the revenue recognition proposals. However, we do not consider the requirement to always use the locked-in discount rate at contract inception to accrete interest to be appropriate.

We believe that insurers should accrete interest on the CSM using the discount rate used to unwind the insurance liabilities for P&L purposes. This approach would ensure that interest expense for the time value of money reported in profit or loss would be consistent for both the best estimate cash flows and the CSM. It would also be less complex for insurers using the FVPL application as they will not be required to track the

unlocked CSM by cohort on a year by year basis.

Release of the CSM

We support the requirement for the release of the CSM to be in line with the pattern of services transferred under the contract. We believe that this is consistent with the definition of the CSM as an amount representing the unearned profit under the contract. We are aware that some other constituents may prefer the release pattern to be more prescriptive. We do not believe that this is necessary in a principles-based accounting standard. A more prescriptive approach could result in entities being mandated to use a specific release pattern in all circumstances, such as straight line or the pattern of claims, which may not be a faithful representation of performance of services for all contracts.

Unlocking of the contractual service margin for changes in the risk adjustment

The ED requires that the CSM is not adjusted for changes in the risk adjustment, with such changes taken directly into profit or loss instead. This treatment is conceptually inconsistent with the unlocking of the CSM for changes in the estimates of cash flows relating to future coverage and future services. We believe the requirements should be amended so that the CSM is also unlocked for changes in the risk adjustment that relate to changes in risk for future periods. Our industry proposal for participating contracts of a fully unlocked CSM includes unlocking for changes in the risk adjustment as the proposal applies a full determination of future unearned profit, including changes in risk.

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, which is consistent with the measurement of the fulfilment cash flows. However, as we outline below we think that the definition of a portfolio included in the ED may create too low a level of aggregation. We are also concerned that the ED could be interpreted as suggesting that an even lower level of aggregation is needed in practice.

The definition of a 'portfolio' in Appendix A of the ED is:

"A group of insurance contracts that: (a) provide coverage for similar risks and that are priced similarly relative to the risk taken on; and (b) are managed together as a single pool."

As defined, we are concerned that this is overly restrictive and will create a level of aggregation which is lower than insurers use to manage their business. Setting the unit of account at too low of a level will increase complexity due to the system architecture that will be needed. We propose that the definition of a portfolio should be revised to the following: *"A group of insurance contracts (or a group of components of insurance contracts) that: (a) provide coverage for similar risks; and (b) are managed together as a single pool."*

Whilst the ED itself does not specify a unit of account for subsequently recognising the CSM in P&L, paragraph BCA113 discusses the IASB belief 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 and suggests a low level aggregation that may not be needed in practice in order to meet the principles in the ED. We do not consider it appropriate to subsequently recognise the CSM using a lower unit of account than the portfolio level.

We believe that our concern about the unit of account for the CSM is also relevant for the calculation of the onerous contract test under the PAA approach.

We believe that the standard should specify a principle for how the CSM should be subsequently measured, consistent with paragraph 32 of the ED, and then detailed application guidance would not be necessary. The current inclusion of contradictory wording in the Basis for Conclusions creates confusion in determining how to measure the CSM in practice.

Contractual service margin for reinsurance contracts held

For reinsurance contracts held we are concerned about the determination of the CSM both at inception and in subsequent periods. Our concern relates to the proposed measurement of the reinsurance asset from ceded reinsurance, i.e. the measurement of the CSM within the asset to be recognized from ceded business in the financial statements of a cedant.

For clarity, we confirm that we support the proposed gross presentation of business assumed and ceded (paragraphs 51 and 63) and we do not at all challenge the liability recognition principle that gains at inception of a primary insurance and respectively assumed reinsurance contracts should not be recognised as immediate profits because the insurer or reinsurer should earn the profits resulting from the issued contract during the period of providing its service.

We agree with paragraph BCA143 that the CSM for business assumed (i.e. for insurance liabilities) is different to that for business ceded (i.e. for reinsurance assets). While the CSM on the liability side of the balance sheet (i.e. for insurance and reinsurance business assumed) defers expected profits not yet earned, the deferral of expected future results is not the purpose of the CSM on the asset side (i.e. within the reinsurance asset for reinsurance contracts held). Rather the CSM of reinsurance contracts held needs to be determined in such a manner that the reinsurance asset reflects the effects generated by the release from risk provided under a reinsurance contract.

When ceding risks to a reinsurer, the cedant replaces uncertain future results with certain future results. Consequently, the cedant is not subject to the risks covered under the reinsurance contract³. This should be reflected in a strong link between the CSM of the reinsurance contract held and that of the underlying original insurance contract. The current wording in paragraphs 41c and 41d can lead to significant divergence between those margins and can create the following issues for individual underlying insurance contracts:

- As the CSM of reinsurance contracts held is neither at inception nor subsequently linked to that of the underlying insurance business, this would not provide relevant financial information. The calibration of the CSM to the reinsurance premium as proposed in the ED would not allow for proper measurement and presentation of non-performance risk from reinsurance contracts on individual loss basis as explained further below.
- The core function of reinsurance to mitigate losses from insurance risk is not reflected appropriately in the ED for the subsequent measurement of the CSM. In a situation where unfavourable changes in the future cash flows of the underlying insurance contracts exceed the CSM on the liability side, the cedant would suffer a loss from the incoming business. Although covered by a reinsurance contract held, this loss cannot be compensated by a respective change of the reinsurance asset. This effect is caused by requiring a reduction in the CSM for a reinsurance contract held and even allowing for a negative CSM.

For the recognition of reinsurance contracts held, a differentiation is made in paragraph 41a between:

- reinsurance contracts providing coverage for the aggregate losses of a portfolio of underlying contracts (here referred to as ‘reinsurance contracts on aggregate loss basis’); and
- all other reinsurance contracts (i.e. reinsurance contracts providing coverage for the loss of individual underlying insurance contracts, here referred to as ‘reinsurance contracts on individual loss basis’).

Given the above, we support the Board’s approach in paragraph 41a for recognition of reinsurance contracts held and propose to follow this approach for the measurement as well: For reinsurance contracts on aggregate loss basis, we support the Board’s proposal outlined in paragraph 41c(i) because those contracts transfer a risk defined based on a portfolio of underlying insurance contracts from the cedant to the reinsurer. For those contracts the CSM of the reinsurance asset should be solely based on the reinsurance contract which implies a calibration of the CSM to the reinsurance premium at inception as proposed in the ED.

³ Of course, the non-performance risk of the reinsurer needs to be taken into consideration which would generally be achieved in applying paragraph 41 (b) (iii) of the ED.

Reinsurance contracts on individual loss basis, however, should not be measured as proposed in the ED. As outlined in BCA 128 and paragraph 41b the cash flows of a reinsurance contract held depend on the cash flows of the contracts they cover. In particular, from an economic perspective, reinsurance contracts on individual loss basis fully depend on the underlying direct insurance contract(s). The “Follow-The-Fortunes”⁴ principle is an essential feature of such contracts and should be reflected in accounting. Based on this, the CSM of the reinsurance asset should reflect the reinsurer’s share in the risk of the underlying business. We therefore propose to calculate the CSM resulting from these contracts in accordance to the proportion of the risk adjustment of the reinsurance asset in relation to the risk adjustment of the liability of underlying contracts. Consequently, we consider the assumption in paragraph 41c(i) that *“the entity shall recognise any net cost or net gain on purchasing the reinsurance contract as a contractual service margin”* as being not appropriate for reinsurance contracts on individual loss basis. Based on the above considerations for such contracts we propose that the gains or losses, dependent on the respective terms and conditions from buying the reinsurance, be recognised at inception of the contract because we believe that this appropriately reflects the economics of these contracts.

Under our approach non-performance risk is reflected appropriately as well when applying paragraph 41b(iii): The CSM within the reinsurance asset would not be calibrated to the reinsurance premium which means that the impact of non-performance risk on the fulfilment cash flows is not “artificially” offset by an increase in the CSM due to calibration rules. Rather, the impact of non-performance risk becomes transparently visible under our approach. By contrast, under the ED proposals the CSM would be calibrated to the reinsurance premium. Therefore, non-performance risk would not result in any impact on the total reinsurance asset (i. e. the sum of the fulfilment cash flows and the CSM) and we believe that this results in inappropriate information.

In the subsequent measurement, the CSM of the reinsurance asset should be amortised based on the same pattern as the amortisation of the CSM of the liability, however restricted so that it not becomes negative. There is one exception to this as follows: In the case of a reinsurance contract on aggregate loss basis where the CSM at initial recognition is negative, the subsequent CSM should not be less than the CSM at initial recognition including interest accreted on the CSM.

This proposed approach has the following advantages:

- Any differentiation between prospective and retroactive contracts is not needed because such a distinction does not appear appropriate from an economic viewpoint, since it would imply a different treatment of the ceded liability for incurred claims depending on the nature of the reinsurance contract (i.e. prospective or retroactive).
- Non-performance risk is appropriately reflected when applying paragraph 41b(iii).
- The approach is easy to apply in practice and easy to understand.
- Our approach for reinsurance contracts on individual loss basis enables users to identify the reinsurer’s share in the underlying business both at initial recognition and subsequently.
- Users can identify more or less favourable reinsurance conditions.
- Overall, our approach leads to a faithful representation and provides relevant financial information.

Recognition of (re)insurance liabilities

For certain types of contracts, such as those that provide insurance cover for a number of similar or identical risks, the number of these insured risks is unknown at the beginning of the coverage period of these insurance contracts and the insurance premiums are directly linked to the number of underlying insurance risks which are finally covered. This is common for certain types of reinsurance contracts, which are typically on an individual risk basis, and for primary group insurance contracts, such as the insurance of a fleet of cars of a leasing company. For these types of contract, the initial measurement of both the fulfilment cash flows and the CSM would be based on an estimate of underlying insurance risks that are expected to be concluded in future. In

⁴ “Follow-The-Fortunes” is a reinsurance concept that exemplifies the significant dependency between a reinsurance contract and the underlying direct insurance business. This fundamental doctrine provides generally that a reinsurer, in its services under the reinsurance contract, must follow the underwriting fortunes of its cedant and, therefore, is bound by the claims-handling decisions of its cedant.

subsequent periods the fulfilment cash flows are adjusted to reflect the actual business volume. The CSM is adjusted for changes in estimated cash flows resulting from changes in business volume, but changes in the risk adjustment resulting from changes in business volume are recognised in the income statement. Consequently, changes in business volume have an artificial impact on profit or loss. That means the economics of such insurance contracts are not reflected appropriately but lead to counterintuitive effects.

For recognition of reinsurance contracts held, a differentiation is made between 'reinsurance contracts on aggregate loss basis' and all other reinsurance contracts (i.e. 'reinsurance contracts on individual loss basis'). For the measurement of an insurance contract which itself covers one or more underlying insurance risks an entity shall take into account cash flows resulting from underlying insurance risks at the same time when the underlying insurance risks (i.e. the individual underlying insurance contracts) are recognised. For 'reinsurance contracts on individual loss basis' this would be consistent with recognition requirements for reinsurance contracts held. Alternatively, counterintuitive effects could be avoided by adjusting the CSM for changes in the risk adjustment relating to future periods.

Question 2 - Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

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?

Measurement and presentation of participating contracts

We believe that accounting for participating contracts must adequately reflect the nature of the products. There are several aspects in the measurement model for participating contracts in the ED that we support, such as the introduction of the concept to reflect the asset dependent nature of the contracts. However, we believe the proposed requirements are too complex and do not provide an appropriate basis for reporting performance from these contracts.

The CSM is defined in the ED to be the unearned profit that the entity recognises as it provides services under the contract. For many participating products, the asset return forms part of the fee for the services provided. As such, we believe that, in order to consistently measure the CSM for participating contracts between contract inception and subsequent measurement and with other types of insurance contracts, the CSM should take into account changes in the sharing of such returns that represent income for future services.

Our industry proposal of a 'fully unlocked contractual service margin'

As an alternative for participating contracts, the industry has developed a proposal for a fully unlocked CSM which would not require bifurcation of cash flows nor a separate exception for mirroring. Our industry proposal is set out in Appendix 3. Our industry proposal was formerly described as utilising a "Floating Residual Margin" but can also be described as utilising a "fully unlocked contractual service margin".

We believe our industry proposal would simplify the accounting requirements for participating contracts, be consistent with the overall building block approach and produce a more faithful representation of our performance. Our industry proposal would also apply to insurance contracts for which there is no requirement to hold the underlying items. This ensures that there is a consistent accounting model for all participating contracts with similar economic characteristics.

We believe the principles in the proposal would address our key concerns on the ED. We acknowledge that the application of our industry proposal in the context of participating contracts in Appendix 3 will need further development and wider testing on a variety of different insurance products.

Scope of the mirroring approach

Our industry proposal would not be restricted to insurance contracts under the mirroring approach. Consequently, the exception to the building block approach for the mirroring approach in the ED would no longer be required. Using a single measurement model offers significant benefits, notably in terms of reducing complexity, increasing consistency and hence aiding comparability, which will help both the users and preparers of financial statements.

The criteria for the mirroring approach in paragraph 33 of the ED, which “requires the entity to hold underlying items” and “specifies a link between the payments to the policyholder and the returns on those underlying items”, is too narrowly defined to capture a significant number of participating contracts. For example, we are aware of some types of unit-linked contracts that fail these criteria. It is unclear whether it was the intention of the IASB to define the mirroring approach so narrowly.

We believe that a consistent principle should be applicable to all types of participating and unit-linked contracts given that the economic characteristics of these contracts are similar. Under our industry proposal no scope criteria are needed as it applies a single measurement model to all contracts.

Bifurcation of cash flows

We believe the requirement to bifurcate the cash flows must be removed from the final standard. These requirements are unclear and highly complex. We believe there should be no requirement to bifurcate cash flows for either measurement or presentation purposes because an insurance contract should be recognised as a whole, rather than as component pieces, reflecting the basis on which the company manages it. We fully support not requiring the bifurcation of cash flows as set out in our industry proposal, which also benefits from the use of a standard single measurement model. Whilst we welcome the introduction of the concept to reflect the asset dependency of participating contracts, we consider the requirement to bifurcate cash flows to be arbitrary and overly complex.

Even for a simple insurance contract, there are a number of interpretations as to how the cash flows could be bifurcated, with each interpretation resulting in a different measurement of the insurance contract liability. The IASB has mandated one interpretation for the bifurcation of cash flows, but the example in paragraph B86 is not an insurance contract, as it does not take into account cash flows arising from guarantees on death. There are no examples of bifurcation of cash flows with an insured event and hence the example oversimplifies the application of the requirement. It is unclear how insurers would apply paragraph B86 in practice to the wide variety of insurance contracts that exist.

The bifurcation will also create distorted performance reporting. Our investors will find this difficult to understand, particularly with regards to what has changed and where that change has been recorded.

Discount rate

We support the use of the discount rate set out in the ED for participating contracts, which helps ensure that the asset dependency is reflected in both the measurement of the liabilities and the interest expense in P&L. We also believe that discount rate should apply to all cash flows arising under the contract, not just to certain bifurcated components. This approach better aligns the consistent measurement of assets and liabilities. We provide further comments on interest expense in profit or loss in our response to Question 4.

Treatment of changes in the value of options and guarantees

We believe that the treatment of changes in the value of options and guarantees that are closely related to insurance contracts has not yet been adequately addressed in the proposals as short-term market fluctuations affecting their value are not representative of the long-term operating performance of the insurer.

Under the proposals in the revised ED, all options and guarantees, even those that are not separated, are measured separately at current value through profit or loss. We believe this treatment is inconsistent with the

treatment of options and guarantees in financial instruments. We believe that options and guarantees that are not separated should be treated consistently with all other elements of the insurance liability for measurement and presentation as set out in our industry proposal. This means that changes in the value of options and guarantees are recognised based on the nature of the change and the measurement application followed (including the application of OCI and/or FVPL and the CSM) for other elements of the insurance liability and backing assets.

Question 3 - Presentation of insurance contract revenue and expenses

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?

Earned premium revenue

We believe that the final standard should provide a clear communication tool to investors of our business performance. We do not believe that the proposals in the ED for the presentation of revenue and expenses will achieve this and believe the proposals will introduce more complexity without providing significant additional benefits.

The presentation of a premium revenue number is an important metric for non-life insurers. However, the earned premium revenue as set out in the ED will not provide decision useful information for life insurance investors. It is not a relevant measure used by the life insurance industry and as such we believe that insurance analysts and other users of financial statements will neither understand nor rely upon earned premiums as proposed in the ED. Instead, they are likely to continue to request existing volume measures such as gross written premiums and new business premiums. Insurers that only have life insurance products would prefer a summarised margin approach to be available.

Earned premium revenue may also create an inconsistency with the overall model as it uses expected claims as the main driver of premium revenue. This may not be in line with the transfer of services as claims are not always the main service provided by the insurer, even for non-life insurers. This may also result in an inconsistency with the premium allocation approach, which correctly uses transfer of services as the driver for premium revenue.

Disaggregation of premiums and claims

Paragraph 58 of the ED requires amounts relating to investment components that are not separated to be disaggregated from the revenue and incurred claims presented in profit or loss. We disagree with the requirement to disaggregate 'non-distinct' investment components from premiums and claims. Conceptually, this is inconsistent with the ED's proposal not to unbundle 'non-distinct' elements of an insurance contract.

We have two key concerns in relation to this requirement. Firstly, we are concerned that the requirement to disaggregate 'non-distinct' investment components from the earned premium revenue number will be unduly costly to implement as the data required is not readily available and is inherently difficult to obtain. Allocation of some of these components would be unduly arbitrary and would not provide comparable information. As such the costs of this disaggregation would outweigh the benefits from presenting a revenue measure.

Secondly, we are concerned about the definition of an investment component, which is very broadly defined in Appendix A of the ED. We believe the definition will capture a wide range of insurance contracts and their components. For example, surrender values, sliding commissions and no-claims bonuses might be classified as investment components and require disaggregation. Furthermore, life contingent annuity contracts sometimes have a minimum pay-out if a death occurs in the initial years of the contract. We believe the disaggregation requirements will be more complex than the IASB may have envisaged.

Question 4 - Interest expense in profit or loss

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?

OCI model and FVPL application

We welcome the Board's decision to introduce an OCI model in IFRS 4 and reintroduce FVOCI 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 do not believe OCI should be mandatory and believe insurers should have the ability to present changes in the insurance liability arising from changes in the discount rate in P&L using a current discount rate.

There should be one accounting model that applies to all insurance contracts and all insurance businesses, which adequately addresses accounting in both FVOCI and FVPL applications. As we have continuously expressed in the context of the discussions on both accounting for insurance contracts and accounting for financial instruments, there are circumstances where FVPL best reflects the management and performance measurement of certain insurance portfolios. The ability to apply current measurement in the P&L or in OCI should be available in those circumstances when that provides the most relevant information to users.

The OCI model as currently proposed in the ED, together with the restrictive use of OCI in IFRS 9, will result in many possible accounting mismatches. For example, accounting mismatches will occur where the insurer holds assets that cannot be measured at FVOCI, such as equities or real estate, where the insurer uses derivatives to mitigate risk in the insurance contracts or where the insurer does not adopt 'hold to collect and sell' business model for its assets.

Whilst we understand the IASB's desire for consistency, the requirement for OCI to be mandatory, in combination with the restrictive use of OCI in IFRS 9, must be reconsidered to ensure meaningful performance reporting. We also refer to our letter to you on the IFRS 9 Classification & Measurement ED dated 28 March 2013.

There is a need for applying both FVOCI and/or FVPL in order to be consistent with the differing types of products, business models and the ALM of insurers, however, the application of FVOCI and FVPL should not be dependent on detailed rules based criteria. Instead we envisage the final standard could include guidance on the types of factors that can be considered in determining the application of FVOCI and/or FVPL, for example, characteristics of the insurance liability/product and the way the corresponding assets and insurance liabilities are managed. The application of either FVOCI or FVPL could be irrevocable in the absence of a significant change in the insurer's business model.

Discount rate

We support the use of an updated discount rate for all cash flows on asset-dependent contracts so that a single rate applies to each contract. The same principle applies for FVOCI application.

Premium allocation approach

When an insurer applies a locked-in discount rate under the premium allocation approach, we believe it could be overly restrictive to always apply the locked-in discount rate from contract inception. Many non-life insurers do not currently retain information in their claims system about underwriting year discount rates. Requiring insurers to use a locked-in discount rate from inception to report interest expense under the premium allocation approach will result in costs to implement the system capabilities. Furthermore, we believe that it is also equally important that insurers applying the premium allocation approach have the ability to report interest expense in profit or loss using a current discount rate.

Question 5 - Effective date and transition

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?

Effective date

The effective date of IFRS 4 and IFRS 9 should be aligned so that insurers are not required, but are permitted, to adopt IFRS 9 before the mandatory effective date of IFRS 4. Otherwise it may put into question the usefulness of financial reporting for users in the period between IFRS 9 and IFRS 4 adoption, as users will experience two major changes in an insurer's financial statements in short succession. A staggered adoption will not result in improved financial reporting for insurers in the period between adoption of the two standards due to the fundamental interaction of financial assets and insurance liabilities.

In setting the effective date, it is important that the proposed three-year implementation period that has been discussed previously by the IASB is given. The standard will introduce fundamental changes to insurance accounting which have far reaching operational challenges. In particular, whilst we agree to the retrospective application approach for transition, it will be an extensive and time consuming exercise for life insurers. This means the two years usually applied to new standards will not be sufficient for insurers and at least a three-year period is needed.

Extensive work to test the proposals is needed

We do not believe it is possible to obtain meaningful results from the IASB's current field testing within the limited time available in the current exposure draft comment period. The proposals represent a fundamental change in accounting for insurance companies. It is therefore essential that a comprehensive understanding of the proposals is gained, to ensure that they will not have unintended consequences and are workable operationally. Extensive testing, beyond that currently proposed, is necessary. This should not be confused with either the IASB field testing currently proposed or the three-year period between issuing the standard and its effective date.

This testing can only take place once the proposals in IFRS 4 and IFRS 9 have been changed to address the issues presented above. In order to facilitate the testing there should be a review draft setting out the proposals.

Approach to transition

We strongly support the IASB's decision to introduce a retrospective application of the insurance contracts standard. We believe the most appropriate conceptual approach to transition is to require the determination of a CSM on transition even where it requires insurers to employ estimation techniques.

Whilst we acknowledge that a retrospective application is more complicated to apply in practice, the benefits of this approach far outweigh the costs of implementation. Without retrospective application, an inconsistent accounting basis would be created between existing contracts and any new business issued after the transition date.

We believe the simplifications introduced by the IASB in the transitional requirements achieve a good balance between reducing complexity and also ensuring that the valuation of the insurance contract liability on transition is appropriate.

Question 6 – The likely effects of a Standard for insurance contracts

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.*

The final standard will undoubtedly be costly to implement. We believe such costs can be justified provided that the final standard provides a basis of financial reporting that reflects the long-term nature of insurance business and considers the inherent linkage between insurance liabilities and related assets so that the resulting performance reporting is useful to users. We recognise that the Board has made progress in developing the proposed accounting standards for insurance contracts and related financial instruments. We believe that accounting should reflect the long-term nature of insurance business and address the linkage between assets and liabilities in reporting performance. We do not think that the ED achieves these objectives. Hence, the ED as currently drafted, and its interaction with the proposed IFRS 9 standard, is not appropriate as it will not provide a suitable basis to explain our business performance to our investor community.

We share the IASB's objective for the final standard to be of a high quality and based on strong principles. We believe that the insurance contracts standard must clearly reflect the insurance business model and the performance of insurance businesses, including for participating contracts. A standard that would improve the transparency and comparability of financial statements across the industry and thereby help our users to better understand our performance would be worth the cost of implementing. Although there has been progress towards the goal of adequately reflecting the insurance business model, this goal has not yet been achieved. There are a number of critical areas that need further development. Without these improvements to the proposals, the costs of implementing the standard cannot be justified:

- **No consistency between measurement of assets and liabilities:** There is a mandatory requirement to reflect all changes in discount rates for liabilities in OCI, whereas IFRS 9 restricts FVOCI to simple debt securities. There is no ability to apply fair value through P&L for liabilities even when that provides better information about performance. OCI must not be mandatory.
- **Participating and unit-linked contracts:** The application of the proposed mechanics of “mirroring” is unclear and highly complex, resulting in bifurcation of cash flows which does not result in an appropriate profit recognition pattern.
- **Unlocking of the CSM:** We welcome the decision to unlock the CSM for changes in estimates relating to future coverage and future services. However, there is limited unlocking of the CSM for participating contracts because the principle has not been fully developed for such contracts. A fully unlocked contractual service margin should be adopted.
- **Treatment of options and guarantees:** The treatment of changes in the value of options and guarantees is unclear in the ED and has not yet been adequately addressed in the proposals as short-term market fluctuations affecting their value are not representative of the long-term operating performance of the insurer.
- **Presentation and disclosure:** Premiums and claims are reported in the P&L on a “notional” earned premium basis which is complex and of little relevance to users of life insurer financial statements. The disclosure requirements are overly burdensome.
- **Reinsurance contractual service margin:** Measurement of the CSM of reinsurance contracts held does not always reflect the economics of the transaction.
- **Some proposals are overly complex:** For example, the bifurcation of cash flows and the requirement to disaggregate investment components will result in significant implementation time, with the cost exceeding the associated benefits.

The cost of implementation can also be reduced through simplifications to the requirements to remove unnecessarily complexity. In particular, in our responses to Questions 2 and 3 above we have highlighted the complexities associated with:

- the different treatment of participating contracts depending on the characteristics of the link between assets and liabilities;
- the bifurcation of cash flows;
- the disaggregation requirements in the presentation of revenue; and
- the importance of ensuring the unit of account is appropriate.

These complexities arise notably from the detailed level of prescription in the ED. Furthermore, it is likely that smaller companies and mutuals are likely to find these complexities especially onerous given their more limited resources. We believe that our industry proposal for a fully unlocked contractual service margin would not only reduce the amount of complexity in the modelling of participating contracts and therefore the costs to comply for all companies, but also make the standard easier to understand for both the insurers and our users. We have also recommended reducing complexity by removing the disaggregation requirements and maintaining a principles-based approach for the unit of account.

In our response to Question 5 we highlighted that obtaining meaningful results from IASB's current field testing within the limited time available in the current exposure draft comment period is not possible. There should be more extensive testing of the proposals to ensure that they will not have unintended consequences and are operationally workable. This testing should only take place once the proposals in IFRS 4 and IFRS 9 have been changed to address the issues presented above. In order to facilitate the testing there should be a review draft setting out the proposals.

Question 7 – Clarity of drafting

*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?*

In this response letter we have raised a number of significant conceptual issues with the underlying principles in the standard which need to be addressed. The current proposals in the ED do not yet adequately achieve their intended purpose in significant areas and important changes are needed. We believe focus should be given first to developing principles to be appropriate for insurance business before finalising the detailed wording and application guidance. Consequently, we feel it is premature to comment on detailed wording. We note, however, that the current draft wording can be unclear, confusing and even potentially contradictory at times.

In this response letter we have raised some comments on the wording and application guidance where we believe there is a lack of clarity or the words can be interpreted differently to how the IASB intended. Matters noted in relation to the following topics are set out in Appendix 2 to this letter:

- Discount rate;
- The treatment of acquisition costs in the earned premium approach;
- Fulfilment cash flows;
- Unbundling;
- Combination of insurance contracts; and
- Recognition point.

APPENDIX 2

We understand that the IASB has not actively sought comments on the exposure draft outside of the areas covered by the ED questions. Given the importance of this standard, we would like to take this opportunity to comment on other elements in the ED which interact with the areas of the ED questions.

Definition

We support the definition of insurance risk in the ED and welcome the fact that it is unchanged from both existing IFRS 4 Phase I and the 2010 Exposure Draft. As expressed previously, from our perspective the existing definition has worked very effectively across all territories that have implemented IFRS to date. Retaining the existing definition removes the requirement to undergo a product reclassification exercise upon the introduction of Phase II.

Scope

We support the scope of the standard. More significantly, as outlined in the exposure draft, it is very important that financial instruments with discretionary participation features (“investment DPF contracts”) are included within the scope of the standard and hence accounted for on a consistent basis to insurance contracts. This reflects the fact that the contracts are economically similar and using consistent accounting will provide more useful information to users, particularly as the financial instruments accounting is not designed to specifically consider these types of contract.

We note that paragraphs 17e and 33-34 of the ED may create a contradiction for investment contracts with discretionary participation features. Paragraph 17 specifies the use of the standard building block approach as set out in paragraphs 18-32 for such contracts. However, the contract may also meet the criteria set out in paragraph 33, suggesting the mirroring approach ought to be followed. We believe our industry proposal for participating contracts described in Appendix 3 should equally apply to these types of contracts.

Combination of insurance contracts

We appreciate that the term “otherwise interdependent” has been replaced by a more detailed description in the ED by referring to the wording of ED/2011/6.

In accordance with paragraph 8a two contracts have to be combined whenever they are “negotiated as a package with a single commercial objective”. For insurance contracts the concept of a “single commercial objective” is quite ambiguous since any contract has the objective to compensate the policyholder if an insured event adversely affects the policyholder. Hence, in a broad interpretation, any two insurance contracts have the same commercial objective. On the other hand, the “single commercial objective” is present if protection is provided against the same insured event, i.e. the contracts “relate to the same insurance risk” which is already covered by paragraph 8c.

We suggest clarifying this by either deleting paragraph 8a or by specifying under which circumstances not covered by paragraphs 8b and 8c a combination of insurance contracts which are “negotiated as a package” is required.

Paragraph 8 seems to indicate that insurance contracts shall also be combined for recognition and measurement. We also suggest clarifying that paragraph 8 needs to be applied when assessing the significance of insurance risk rather than when recognising or measuring an insurance contract.

Unbundling

As outlined in our response to the 2010 exposure draft, we believe that unbundling should not be required because a contract should be recognised as a whole, rather than as component pieces, and that the existing definition of insurance works well to determine what the measurement and boundaries should be. We believe

the revised unbundling requirements for investment components based on a principle of being “distinct” is clearer than the 2010 ED in identifying the limited scenarios where this will apply.

However, we have concerns with the treatment of goods and services based on the requirements in the ED. We believe asset management services should only be separated in very limited circumstances, such as when the investment component is separated. The ED Illustrative Example 1 demonstrates a scenario where the asset management services are considered a distinct service and are separated, even though there is no distinct investment component. This example suggests a more frequent separation of asset management services, which we oppose. This example should be removed from the final standard and the guidance clarified to make clear that separation of asset management services should only be in limited circumstances (i.e. where the asset management service is genuinely distinct from other components of the contract).

In addition, as outlined in our response to Question 3 we do not support the requirement that investment components that are not separated be disaggregated from revenue and incurred claims presented in profit or loss. It will be unduly costly to implement as the data required is not readily available and is inherently difficult to obtain. This is also inconsistent with the treatment of an insurance contract which is not separated.

Recognition point

We support the IASB’s decision to amend the recognition point to when the coverage begins. However, we reiterate our concern as outlined in response to Question 1 on the artificial impact on profit or loss the recognition point will have for certain types of reinsurance contracts. We believe the CSM should be adjusted for such impacts.

Fulfilment cash flows

We support the principles and guidance in the ED on fulfilment cash flows.

We have noted a drafting issue with paragraph B66k which states “payments arising from existing contracts that provide policyholders with a share in the returns on underlying items (see paragraph 33), regardless of whether those payments are made to current or future policyholders.” We believe this sentence should say payments arising from “existing and prior contracts”. This wording has been redrafted since the 2010 exposure draft and the current wording could limit the inclusion of any bonus payment to policyholders of amounts arising from prior contracts (such as amounts included in the estate of with-profits funds that will ultimately be paid to policyholders rather than shareholders). We believe it was the intention of the IASB to include such amounts in the cash flows and hence the wording should be amended.

We welcome the introduction of paragraph B66i which allows the fulfilment cash flows to include payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder and related receipts. However, we are concerned that the intent of the Board in this area remains unclear. There are certain taxation regimes, such as in the UK, where tax is payable on investment returns that are entirely for the benefit of the policyholder (e.g. tax payable on the returns in a unit-linked or with-profits fund where policyholder balances are adjusted to allow for the payment of such tax). To include the gross return, without the tax that will be suffered by the policyholder, will overstate the policyholder liability. However, as these payments are all made by the same legal entity, some may argue this scenario is not captured within the paragraph above. We would suggest that adding a clarification on this topic in the final standard may help explain the Board’s intent in this area and confirm that such scenarios are captured.

Acquisition costs

We support the inclusion of acquisition costs in the fulfilment cash flows as pricing of insurance contracts takes into account acquisition costs. Hence, such costs must be taken into account in determining the CSM. We appreciate the changes the IASB has made to the 2010 ED for the fulfilment cash flows to now include directly attributable acquisition costs incurred at the portfolio level. The portfolio level is more in line with how insurers

price and manage insurance business.

We would not support the IASB aligning with the FASB proposal in this area to limit acquisition costs to those associated with successful selling efforts as this is inconsistent with how insurers manage insurance business at the portfolio level.

Discount rate

Discount rate principle

We support the principle in the ED that the discount rate used to adjust the fulfilment cash flows for the time value of money should reflect the characteristics of those cash flows and be consistent with observable current market prices.

We strongly support the ability to use either bottom-up or top-down methodologies to determine the discount rate.

As outlined earlier in our letter in relation to participating contracts, we support the principle in the ED that the discount rate for participating cash flows should reflect asset dependency. This is an important principle to ensure appropriate accounting where the insurance contract liability has a dependence on asset returns as insurers employ assets liability matching practices.

Application guidance on determining the discount rate

We have noted corrections needed to the drafting of the application guidance for determining the discount rate, which we outline below:

- Paragraph B74 is new guidance added since the version of the staff draft published in October 2011. We believe paragraph B74a is conceptually incorrect and it is unclear what is meant by the “market premium for liquidity”. It is also inconsistent with the second half of paragraph B70a(iii) which suggests certain liquidity differences are not adjusted. We believe paragraph B74 should be updated to remove this language.
- We believe paragraph B72 is unhelpful and should be deleted. It suggests there is only one type of liquidity for all types of insurance contracts, which is conceptually incorrect.

We are also concerned about the overall process followed in this area as the wording and application guidance included in the ED has been substantially re-written since the staff draft of the wording that was provided on the IASB website for comment. We are concerned that the continued re-drafting of this wording, without formal consultation, could result in unintended consequences that have material implications given the significance of the discount rate to earnings and the measurement of the insurance liability.

Risk adjustment

Risk adjustment techniques

We agree that it would not be consistent with a principles-based standard to limit the techniques that can be applied in practice to determine the risk adjustment. We therefore think that the ED provides sufficient guidance in explaining how the risk adjustment is determined in practice.

Unlocking the CSM for changes in the risk adjustment

As outlined in our response to Question 1 on the CSM, we believe that the CSM should also be unlocked for changes in the risk adjustment that relate to future services or future coverage, which is more conceptually consistent with the overall unlocking principle.

Confidence level disclosure

We note that the requirement to disclose the confidence level where an insurer uses a technique other than

confidence level to determine the risk adjustment has been retained in the ED. We do not agree that the insurer should disclose the confidence level as we do not believe it will provide useful information to users and will be burdensome to apply in practice. We understand that the IASB's objective for this disclosure requirement is to allow users of financial statements to understand the entity-specific assessment of risk aversion; however, we believe that this can be adequately achieved through disclosures about the risk adjustment technique adopted by the entity.

Unit of account

We support the overall unit of account principle in the ED that the insurance contract liability is determined at the portfolio level as this is consistent with the manner in which insurance companies manage insurance risk. However, as outlined in our response to Question 1 we are concerned about the current definition of a portfolio, which will set the level of aggregation too low. Instead, we propose that the definition of a portfolio should be revised to the following: *“A group of insurance contracts (or a group of components of insurance contracts) that: (a) provide coverage for similar risks; and (b) are managed together as a single pool.”*

Diversification of the risk adjustment

We support the IASB's decision not to restrict the diversification benefit for the risk adjustment to within a portfolio. It is appropriate to allow further diversification of risk up to a group level as the benefits of diversification between lines of business are an integral part of an insurer's business model and therefore it is appropriate that accounting reflects these benefits in the valuation of the insurance contract liability.

Contractual service margin

We note that whilst the ED itself does not specify a unit of account for subsequently recognising the CSM in P&L, paragraph BCA113 in the Basis for Conclusions discusses the IASB belief 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, and suggests a low level aggregation that may not be needed in practice in order to meet the principles in the ED.

The current inclusion of contradictory wording in the Basis for Conclusions creates confusion in determining how to measure the CSM in practice.

Premium Allocation Approach

We support the inclusion of the premium allocation approach in the standard as a proxy model which approximates the full building block approach. Whilst we strongly support a single measurement model for all insurance contracts, we believe that under a principles-based standard, it is appropriate to introduce a simplification that is materially consistent with the full model. Consequently, we also agree that insurers should be permitted, rather than required, to apply the premium allocation approach, as this is consistent with the development of a simplified proxy model.

We support the changes that the IASB has made to the premium allocation approach to make the approach more straightforward to apply in practice. We agree with the practical expedients that have been included in the ED, specifically the ability to expense acquisition costs, not to discount the liability for remaining coverage and incurred claims in the circumstances where discounting is immaterial or the period of time is one year or less.

Portfolio transfers and business combinations

Paragraph C2 suggests that there is a need to revisit the acquisition accounting of historic business combinations. This would override the IFRS 1 exemption, which many took advantage of when converting to IFRS from local GAAP, which allowed first time adopters to elect not to apply IFRS 3 retrospectively to past business combinations. We believe more thought is required in this area to balance the complexities of

revisiting historic transactions (where the data may not exist to comply with the ED), with a need to ensure there is a sensible profit recognition pattern for business that has been previously acquired.

Disclosures

Volume of disclosure requirements

In response to the 2010 ED, we had said that we did not support the proposed disclosure requirements as we felt they should be principles-based and we were concerned about the volume and level of detailed prescriptive requirements. We do not believe these concerns have been addressed in the revised ED, which not only contains the previously proposed large volume of detailed prescriptive requirements but new additional detailed prescriptive disclosure requirements that have been added through the re-deliberation process.

Whilst we understand that disclosure has not been identified by the IASB as a re-exposure topic, we believe that further consideration of the disclosure model is needed in order to simplify the requirements, ensure the objective for disclosure is principles-based and ensure each required disclosure provides useful information to users and is needed.

Confidence level disclosure

We strongly disagree with the requirement to disclose the confidence level to which the risk adjustment corresponds if a different method is used. We do not believe that the disclosure of a confidence level will provide useful decision making information to users. It may also be misleading as it would not provide a consistent comparison between companies. This requirement should be removed from the final standard as the IASB's objective of providing information about the risk adjustment can be addressed through quantitative and qualitative disclosures about the risk adjustment technique applied.

APPENDIX 3 – INDUSTRY PROPOSAL

Alternative approach proposed for participating contracts by the insurance industry

Executive Summary

The approach proposed in the ED for participating contracts (bifurcation of cash flows and limited unlocking of contractual service margin (“CSM”)) is seen by constituents as a key concern. The insurance industry has developed an alternative approach using the existing framework in the ED to create an approach for participating insurance contracts that is more consistent with the general building block approach as defined in the 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 on the face of the balance sheet 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 and liability management, the practical application of the principles will vary and can therefore be conducted under both a ‘Current Value through OCI’ and a ‘Current Value through P&L’ applications with the fulfilment cash flows, risk adjustment, CSM, and shareholders’ equity reflecting the attributes of the contracts.

Key advantages:

- Builds on existing principles of the ED instead of defining an exception for contracts with a link to underlying items.
- Current fulfilment value measurement for all insurance contracts and all components of the liability in the balance sheet.
- Full transparency of potential impact of changes in reinvestment assumptions.
- P&L reflects long-term nature of business: distinguish between earned returns for services provided (P&L) and changes in the expected future profits (CSM).
- Asset dependent P&L discount rate for insurance liability avoids accounting mismatches in P&L.
- Reflects the asset / liability linkage for participating contracts.
- Fully unlocked measurement of the CSM simplifies retrospective application at transition and also modifications made to insurance contracts.
- No bifurcation of cash flows and use of a single yield curve for measurement of the whole contract, which removes undue complexity and is in line with the integrated nature of the products.

→ *Faithful presentation of performance, better comparability & reduced complexity*

A. Background and purpose of paper

- (1) The IASB’s June 2013 exposure draft (the “ED”) includes requirements attached to its “mirroring” principles that have the effects of:
 - (a) Requiring overly complex bifurcation of cash flows into different elements for measurement and presentation purposes.

The requirement to bifurcate is arbitrary and complex. The costs of the IASB's requirements very significantly outweigh any benefits. Through the order in which companies undergo the separate calculations there is a high likelihood that the measurement will be subjective and inconsistent even if the same base assumptions are applied.

(b) Inappropriate and inconsistent measurement of the CSM.

The ED defines the CSM as representing the unearned profit that the entity recognises as it provides services under the insurance contract. The CSM principle has not been fully developed for participating contracts as the ED imposes artificial constraints to exclude asset returns that are earned over the contract in line with the provision of services. This creates inconsistent measurement of the CSM for participating contracts with this feature compared to unit linked contracts where the CSM is recalibrated for the impact of changes in projected future fees due to volatility in market values of assets held to back the contracts.

For unit linked business, the services are asset management, protection and administration and these are provided over the coverage period. Changes in the value of underlying items and changes in reinvestment assumptions result in changes in estimates of future cash flows. In accordance with the ED, the CSM is unlocked for these changes and is recognised over the coverage period in line with the provision of services.

For other participating business, services also include asset management, protection and administration and these services are similarly provided over the coverage period. For these contracts, under the ED changes in estimates of future cash flows resulting from changes in the value of underlying items and changes in reinvestment assumptions are taken to the P&L. This is not consistent with unit linked business and is not consistent with the broader principles of the ED as these changes in estimates are not recognised in line with the provision of services.

This results in an inconsistency in the financial statements for contracts that have substantially similar contractual features.

- (2) This paper explains the principles of the proposed alternative approach. The proposal develops the existing IASB building block approach in order to apply a consistent basis for all insurance business and takes account of the particular features of participating contracts.

B. Underlying principle

- (3) We believe that accounting should reflect the long-term nature of insurance business and address the linkage between assets and liabilities in reporting performance. Insurers apply asset liability management strategies in which insurance liabilities and guarantees and their related assets (including derivatives) are managed together according to the insurance contract liability profile to meet obligations to policyholders.
- (4) The IASB proposal for participating contracts in the ED does not meet these objectives. Therefore the insurance industry has developed an alternative approach which is described in this document.

C. Scope

- (5) The ED includes a measurement and presentation exemption for a narrowly defined group of participating contracts. The alternative approach proposes a current fulfilment value in accordance with the general building block approach as defined in the ED. We suggest that all cash flows of a contract are valued in a single calculation (or a single calculation per scenario where a stochastic model is used), consistent with the building block approach, with the investment return and discount rate assumptions reflecting the returns on underlying assets.
- (6) It aims to measure economically similar contracts in a consistent way, including those where all or a significant part of the cash flows are dependent on returns from underlying items. This is in contrast to the IASB's proposed 'mirroring approach', which applies only to contracts that require the entity to hold the underlying items and specify a link to returns on those underlying items.

- (7) Our principles based approach provides a solution for a wide range of contracts from different jurisdictions, which have different participating mechanisms and are subject to different legal and regulatory frameworks.
- (8) The proposal works equally for contracts which are reported under a 'current value through P&L' or a 'current value through OCI' application. While presenting the same current value on face of the balance sheet, both a P&L and an OCI treatment needs to be available for performance reporting to best reflect the different asset liability management approaches which exist as a result of different product characteristics.

D. Key measurement principles

- (9) Under the alternative approach, all insurance liabilities are measured at current fulfilment value on the face of the balance sheet to ensure a consistent measurement basis.
- (10) The insurance liabilities and the related assets are measured and presented in a consistent way, reflecting their interaction. The insurance liability is calculated under the general building block approach and includes all contractual and discretionary expected future cash flows. When the policyholder participates in the investment returns of underlying items, entities consider both (i) expected cash flows from existing assets, which are reflected in the expected cash flows of the insurance liability, and (ii) expected cash flows from future reinvestments, which are considered in the measurement of the liability using current reinvestment assumptions.
- (11) The starting point for the valuation of insurance liabilities is the current fulfilment cash flows. All cash flows under a contract are treated consistently without bifurcation as proposed by the ED.
- (12) Options and guarantees embedded in the insurance contracts which are not separated are reflected at current value determined under a set of stochastic scenarios, in order to reflect the potential effects on the liability. This is in line with the IASB's general measurement requirements, which apply to all cash flows arising from insurance contracts without distinguishing the cash flows that specifically arise from options and guarantees.
- (13) The CSM always reflects the unearned profit of shareholders arising from the insurance contracts and is determined on a fully unlocked basis without the artificial restrictions for unlocking imposed by the ED. Changes in future gross profit expectations are deferred through the CSM.
- (14) In contrast to the ED, the CSM is also adjusted for changes in financial assumption for participating contracts whose cash flows significantly depend on the asset returns, including changes in the value of underlying items and changes in reinvestment assumptions.
- (15) The release of the CSM 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. As a result, profit is recognised in accordance with general revenue principles. The profit drivers will reflect the services provided which, as for non-participating business, will vary depending upon the nature of the contract.
- (16) In summary, the measurement of the expected present value of future cash flows in the balance sheet under the alternative approach does not differ from the general building block model proposed in the ED. However, the ED proposes to not apply this model but requires to bifurcate the cash flows for certain types of participating insurance contracts according to paragraphs 33 and 34, and a measurement in accordance with the asset measurement. This would lead to a different measurement basis compared to the alternative model. In addition, compared to the ED proposals, under the alternative model the CSM will be recalibrated to incorporate unearned profit so that the substance of the contractual arrangements is properly reflected for all types of participating business.

E. Adjusting the contractual service margin

- (17) The ED defines the CSM as unearned profit that the entity recognises as it provides services under the insurance contract. For the subsequent measurement, paragraph 30 of the ED requires an adjustment to the remaining amount of the CSM for a difference between the current and previous estimates of the

present value of future cash flows that relate to future coverage and other future services. The alternative approach builds on the definition of the CSM as unearned profit and the unlocking principles of paragraph 30 of the ED.

- (18) Under the alternative approach, the CSM is adjusted each reporting period to represent the whole of the remaining unearned profit arising from the insurance contract. This requires that all assumptions underlying the calculation of the CSM as the present value of future profits are updated. As a result, the CSM under the alternative approach is defined consistently at initial recognition and for subsequent measurement, as it is calculated on a fully unlocked basis, consistent with the other building blocks.
- (19) The alternative approach takes the view that asset management activities, i.e. crediting asset returns to the policyholder, are explicit services under the insurance contracts. The level of these services changes over time because expectations of future asset returns which impact the liability cash flows are changing with the change of the investment portfolio and with the changes in reinvestment assumptions in case of an asset-liability mismatch. Therefore, the CSM is adjusted for such changes in the profitability of the contract as required by paragraph 30 of the ED.
- (20) However, the ED contains guidance, which could lead to an interpretation that unlocking the CSM is not allowed for changes in the estimates relating to the returns of assets backing insurance contracts (BC41). This is only appropriate for contracts where cash flows do not vary with the changes in the underlying items.
- (21) Under the view that the CSM represents the remaining unearned profit at each reporting date, entities release this margin and recognise profits as services are provided. The services provided to the policyholder throughout the contract period include insurance cover, investment management services and provision of an increasing level of guaranteed bonuses as the period the contract is in force increases. The amount of asset returns credited to the policyholders could serve as a proxy for the services provided in that period, because asset management services are often the main service provided under a participating contract.
- (22) Regarding this pattern of release, it should be noted that the IASB's ED provides principles based guidance only, as it requires entities to release the CSM in the 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.
- (23) Under the alternative approach, entities indirectly accrete interest on the CSM consistently with how interest expense is recognised in profit or loss for the other components of the insurance liability.
- (24) As the CSM represents the value of future profits it includes the projected future allocations of asset returns to shareholders based on the underlying contractual or regulatory participating mechanism (i.e. fair value through OCI, fair value through P&L, amortised cost or a mixture of those). The asset base used consists of all assets backing the liability currently allocated to policyholders.
- (25) In contrast, the IASB's proposals would accrete interest on the CSM based on the locked-in discount rate determined at inception which is in contrast to the fully unlocked nature of the CSM. This results in a different profit recognition pattern compared with the alternative approach.
- (26) To be able to present the CSM on an unlocked basis with the same definition at initial recognition and at every subsequent reporting date, under the alternative approach the CSM is also adjusted for changes in the risk adjustment related to future coverage as well. The ED does not allow this.
- (27) In summary, the CSM under the alternative approach reflects the remaining unearned profit of the insurance contract, and this profit would be earned as it emerges over time, consistently at inception of the contract and for subsequent measurement. In contrast, the CSM under the IASB's approach represents the unearned profit arising from the insurance contract as estimated at the inception of the contract, subsequently only partially updated and reflecting locked in assumptions. Thus, at subsequent measurement dates it does not represent unearned profit anymore.

F. Presenting changes of insurance liabilities

- (28) For the purposes of unwinding the current insurance liabilities to recognise interest expense in profit or loss, entities would use a discount rate. That includes the reflection of the dependence of the liability cash flows on the returns of assets, which the ED has defined in paragraph 26(a). A single yield curve is used for discounting all fulfilment cash flows under the contract and measuring the unearned profit in CSM.
- (29) The discount rate would “mirror” the presentation of the assets in the statement of profit or loss:
- i. Where the insurer applies FVOCI 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 FVPL the discount rate would be a current period rate.
- (30) As a result, the discount rate used for the alternative approach is in line with the requirements of the ED.
- (31) Changes in the value of options and guarantees are treated consistently with all other elements of the insurance liability. This means that changes in the value of options and guarantees are recognised based on the nature of the change and the measurement application followed (including the application of OCI and/or FVPL and the CSM) for other elements of the insurance liability and backing assets.

Illustrations of the alternative approach under FVOCI

- (32) In this illustration, assets purchased at inception are measured at fair value through OCI. Consistently, entities would use OCI to report changes in the insurance liability arising from changes in the current discount rate from these assets. Accordingly, the amounts reported in OCI would reflect short-term movements in the discount rates that reverse automatically over time and that do not affect the performance of the period.
- (33) However, interest rate movements will impact the performance of future periods if the entity is exposed to reinvestment risk. In that case, the present value of the future profits will change and entities would adjust the CSM to reflect a higher or lower expected reinvestment yield in the gross profits arising from the portfolio. The reinvestment yield would be measured based on market assumptions.
- (34) For the purposes of unwinding the current insurance liabilities to recognise interest expense in profit or loss:
- For the existing assets, the yield of the assets, adjusted for expected defaults that back the insurance contract should be used; where fair value through OCI is used for assets, such yield reflects an amortised cost based yield.
 - For reinvestments the expected reinvestment yield based on current market rates and the existing asset allocation should be used.
- (35) Illustrating example European 90/10 participating life contract:
- 20 year liability duration
 - Single premium of CU 1,000
 - Premiums are invested in FVOCI bonds with a 15 year duration at a 5% coupon
 - Market interest rates at inception $t=0$: 5%
 - Market interest rates at $t=1-20$: 4%
 - Guaranteed return of 3%, annual crediting of asset returns
 - Value of options and guarantees: put on 90% assets
 - For simplicity it has been assumed: no death benefit, no acquisition cost, no risk adjustments, no surrenders

- A duration mismatch exists, the insurer bears the reinvestment risk and in year 1 the current interest rate drops from 5% to 4%. -> Lower profit expectation from year 15 onwards.
- The difference in expected profit due to the drop in interest rates goes to the fully unlocked CSM.
- The main profit driver of the CSM is the book return from the asset side.
- The change in reinvestment rates after year 15 goes to the CSM, all other changes in interest rates go to OCI.
- The CSM takes reinvestment assumptions into account, it shows ALM and an economic result, without the need for cash flow bifurcation.
- The fully unlocked CSM would also provide users with a meaningful figure as it reflects the estimated unearned profit of the contract.
- In this particular example any change in the value of options and guarantees are unlocked in the CSM as it should be treated consistently with all other elements of the insurance liability for measurement and presentation. Reporting the change in the time value of options and guarantees in OCI and P&L would also be an appropriate application under the alternative approach.

	Year				
	0	1	2	3	20
Current interest rate	5,0%	4,0%	4,0%	4,0%	4,0%
Book yield		5,0%	5,0%	5,0%	4,0%
Investment amortized cost	1.000,0	1.050,0	1.102,5	1.157,6	2.529,3
Investment fair value	1.000,0	1.200,5	1.248,6	1.298,5	2.529,3
Best Estimate Liability amort. cost	940,1	991,4	1.040,4	1.091,7	2.376,4

Balance Sheet

	0	1	2	3	20
ASSETS	1.000,0	1.200,5	1.248,6	1.298,5	2.529,3
BEL current	940,1	1.132,9	1.177,6	1.224,1	2.376,4
Contractual Service Margin	59,9	53,6	51,9	50,1	0,0
INSURANCE LIABILITIES	1.000,0	1.186,4	1.229,5	1.274,2	2.376,4
Retained Earnings	0,0	5,0	10,3	15,8	152,9
OCI from Assets	0,0	150,5	146,1	140,9	0,0
OCI from Liabilities	0,0	141,4	137,2	132,4	0,0
OCI	0,0	9,1	8,8	8,5	0,0
EQUITY	0,0	14,1	19,1	24,3	152,9

Income Statement

	0	1	2	3	20
Investment Income		50,0	52,5	55,1	97,3
CSM amortization		6,3	1,7	1,8	3,8
BEL unwinding		-51,3	-48,9	-51,4	-91,4
NET INCOME		5,0	5,3	5,5	9,7
Assets		150,5	-4,5	-5,2	0,0
Liabilities		-141,4	4,2	4,9	0,0
OCI		9,1	-0,3	-0,3	0,0
TCI		14,1	5,0	5,2	9,7

Illustrations of the alternative approach under FVPL

- (36) For the types of business for which this approach is applicable the shareholder profit represents fees earned over the duration of the contract for the provision of services for investment management and policyholder benefits. However, unlike the products for which FVOCI application may be appropriate, the distinction between realised and unrealised gains and losses on the assets backing the contract is not relevant and to do so for accounting purposes would be inappropriate. Instead the policyholder receives, over the duration of the contract, the surplus earned by the fund from investment return (including realised and unrealised gains and losses) and other surpluses through, for example, sharing of the surpluses from providing insurance coverage, net of the fee earned by the shareholder. This type of business may be attractive to policyholders as they are sold as long duration (e.g. 20-25 years) with the backing assets deliberately spread across a wide range of asset categories such as equities, investment properties, debt securities. By deliberately investing in a wide range the aim is to provide the policyholder benefits that are attractive partly by reference to the total return on the assets, including unrealised gains and losses. To reflect the underlying commercial substance therefore the value movements on the investment assets and policyholder liabilities are recorded solely in profit or loss.
- (37) Under the FVPL basis the effect of the change in the discount rate will be booked in profit or loss together with the effect of changes to fulfilment cash flows (incl. risk adjustment) arising from changes to expected future cash flows. In addition the unwind of discount booked in the income statement is at the current rate. The treatment reflects:
- i. the broad based nature of the investments backing the contracts (equities, investment properties, bonds, and other investments);
 - ii. the fact that the assets and policyholder liabilities are managed on a fair value basis; and
 - iii. pay-outs to policyholders reflect returns on a fair value basis
- (38) Similarly to unit linked business, the release from the CSM reflects the fees earned in the period for provision of investment management and policyholder benefits. In the balance sheet the CSM alters for the release to profit or loss for the fees earned and also as the fair values on the investments arising from the contractual cash flows fluctuate for market movements to the extent that they are not reflected in changes to projected policyholder benefits. These amounts represent changes to projected future fees. This is no different in substance from the fluctuating value of future fees on unit linked contracts which are unlocked in the CSM under the ED. Accordingly, and as for the OCI approach, the CSM is recalibrated for changes in future cash flows.
- (39) For these contracts profit or loss will incorporate the asset returns (including realised and unrealised gains and losses (distinction between these components is not relevant) for the fund as a whole, of which the majority will be allocated to policyholder liabilities. Mechanically the allocation can be represented as an unwind of insurance liability discount at current period rates (rather than historic book yields which are not relevant to this type of contract) and the excess or deficit of the additional investment return.
- (40) Setting aside changes to the risk adjustment and other incidental changes of operating assumptions and experience variances, the main movement in profit or loss is that the returns arising in the year which have yet to be earned (because the services have not been provided to policyholders) are allocated as a charge for an increase in the CSM. As services are provided to the policyholder amounts are released to profit or loss.
- (41) A simple illustration of these features is shown below.

- This illustration shows how investment variances would be accounted for using a fully unlocked CSM for entities using FVPL.
- For illustration purposes, it is assumed that the excess investment return is allocated 90:10 between policyholders and shareholders.
- For simplicity, the cost of guarantees is not considered, it is assumed that there is no change to the discount rate and the risk adjustment is assumed not to depend on investment return.
- The fulfillment cash flows (including risk adjustment) are increased by the policyholders' share of the excess investment return.
- The CSM is increased by the shareholders' share of the excess investment return.
- The net profit or loss reflects the release from the CSM in line with the pattern of transfer of services (such as asset management, protection and administration).

	Year 1
Investment return	
- Expected return	200
- Excess (unexpected return)	1,000
Total investment return	1,200
Change in fulfilment cash flows	
- Unwind of discount rate	(200)
- Change in cash flow estimates	(900)
Total change in fulfilment cash flows	(1,100)
Change in risk adjustment	-
Change in CSM	
- Accretion of interest	(10)
- Amortisation	50
- Change in cash flow estimates	(100)
Total change in CSM	(60)
Total profit or loss	40
Other comprehensive income	-
Total comprehensive income	40

Comparison with the IASB's proposals

(42) The tables below compare the alternative approach proposed by the industry with the IASB's general requirements and the measurement and presentation exception proposed in the ED for contracts that require the entity to hold the underlying items and specify a link to the returns on those underlying items (the 'mirroring approach').

(43) Scope & Initial measurement

Initial measurement	IASB's mirroring approach	IASB's general requirements	Alternative approach with FVOCI	Alternative approach with FVPL
Scope	<ul style="list-style-type: none"> Contracts which require an entity to hold underlying items and specify a link between the payments to the policyholder and the returns on those underlying items. 	<ul style="list-style-type: none"> All insurance contracts. 	<ul style="list-style-type: none"> No specific scope definition needed, as general building block model applied with reflection of asset dependency in determination of fulfilment cash flows and discount rate. 	<ul style="list-style-type: none"> Same as FVOCI.
Insurance liability (excluding contractual service margin)	<ul style="list-style-type: none"> Bifurcation of cash flows. Cash flows that vary directly with returns on underlying items are measured by reference to the carrying amount of the underlying items. Other cash flows are measured at current fulfilment value. Options and guarantees are bifurcated. 	<ul style="list-style-type: none"> Measured at current fulfilment value. Treatment of options and guarantees unclear. 	<ul style="list-style-type: none"> Same as IASB's general requirements. The cash flows arising from options and guarantees are treated in the same way as any other expected cash flows. 	<ul style="list-style-type: none"> Same as FVOCI.
Contractual service margin (CSM)	<ul style="list-style-type: none"> No differences for determination of the CSM. Represents expected unearned future profit. 			

(44) Subsequent measurement

Subsequent measurement	IASB's mirroring approach	IASB's general requirements	Alternative approach FVOCI	Alternative approach FVPL
Interest expense presented in profit or loss / OCI	<ul style="list-style-type: none"> Changes in cash flows that vary directly with returns on underlying items are presented on the same basis as the recognition of changes in the value of the underlying items. For fixed cash flows, determined using locked-in discount rate, with difference reported in OCI. Option components that are not separately accounted for as derivatives are measured at current value through P&L. 	<ul style="list-style-type: none"> Unwinding of the insurance liability based on locked-in discount rate at inception and updated discount rate for cash flows that are expected to vary directly with returns on underlying items. Amount stored in OCI equals the difference between the carrying amount of the insurance contract measured using the current rate and the carrying amount of the insurance contract measured using the discount rate for determination of interest expense in profit or loss. All other changes in insurance liabilities presented in P&L 	<ul style="list-style-type: none"> Unwinding of the insurance liability for P&L purposes based on the P&L return of the existing assets backing the contract and the expected yield for reinvested assets. When assets reported under FVOCI, this represents an amortised cost based rate. See IASB's general requirements for basic mechanics. 	<ul style="list-style-type: none"> Unwinding of the insurance liability for P&L purposes based on a current market based rate. Effectively, all changes of insurance liability presented in P&L and no amounts reported in OCI.

Subsequent measurement	IASB's mirroring approach	IASB's general requirements	Alternative approach FVOCI	Alternative approach FVPL
Contractual service margin (CSM)	<ul style="list-style-type: none"> • Adjust CSM for changes in estimates of the present value of future cash flows that relate to future coverage and other future services: <ul style="list-style-type: none"> ○ Gains and losses on underlying items do not relate to unearned profit from future services from the insurance contract. ○ No unlocking for changes in the value of options and guarantees. ○ No unlocking for changes in risk adjustment. • Accretion of interest using locked-in discount rate. • Release CSM as service is provided. 	<ul style="list-style-type: none"> • See IASB's mirroring approach. 	<ul style="list-style-type: none"> • The CSM is measured on a fully unlocked basis and represents the unearned profit of the contract at each reporting date consistent with initial measurement at day one, based on updated financial and non-financial assumptions which impact performance. • This is in line with adjusting of the CSM for all changes in estimates of future cash flows that relate to future coverage and other future services. • This results in adjusting the CSM for changes <ul style="list-style-type: none"> ○ in reinvestment assumptions and changes in underlying items related to future coverage and services; ○ in risk adjustment related to future coverage and services; ○ Implicit accretion of interest with the interest rate applied to determine interest expense in P&L. • Release of CSM based on changes of the present value of expected future profits. 	<ul style="list-style-type: none"> • Same as FVOCI.

- (45) The alternative approach would require a disclosure of the changes in the CSM in the reporting period. This would show a reconciliation of the unearned profit of the insurer due to changes in financial assumptions (reinvestment assumptions) and changes in non-financial assumptions. In this way, all changes are clearly and transparently disclosed to the users of financial statements.
- (46) Comparison of alternative approach with ED principles:
- a) “Introduce a comprehensive, coherent framework for all insurance contracts that provides information that reflects the many different ways in which entities make money from insurance contracts, whether through fees from asset management services, investment income from a spread business or underwriting profit from a protection business” (Basis for Conclusions, EA12).
-> *One consistent measurement model for all insurance contracts.*
 - b) Measure an insurance contract an entity issues “using a current value approach” (ED.2). “Including all the cash flows that arise from insurance contracts is consistent with the IASB’s principle that the measurement of an insurance contract should treat all cash flows that arise from the contract in the same way” (Basis for Conclusions, BCA59).
-> *No exception for participating contracts – apply building block model.*
 - c) Adjust “the estimates of future cash flows for the time value of money, using discount rates that reflect the characteristics of those cash flows” (ED.25).
-> *Asset dependency is reflected consistently in cash flow projection and discount rate.*
 - d) Contractual Service Margin: “Representing the unearned profit that the entity recognises as it provides services under the insurance contract” (Appendix A).
-> *Fully unlocked measurement of CSM based on updated assumptions. Apply the same rationale at inception and for subsequent measurement (i.e., deferral of future gains).*
 - e) Adjust the remaining amount of the CSM for a difference between the current and previous estimates of the cash flows that relate to future coverage and other future services (ED.30).
-> *Changes in financial assumptions change level of future service and thus should unlock the CSM.*