Financial Reporting Council

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

25 October 2013

Dear Hans

ED/2013/7 Exposure Draft "Insurance Contracts"

The FRC is pleased to have the opportunity to comment on the IASB's Exposure Draft ED/2013/7 "Insurance Contracts" (2013 ED).

We commend IASB and its staff for their efforts in bringing to bear principles for accounting for insurance contracts that are consistent with IFRS as a whole. We also endorse their continued efforts in addressing constituents' concerns with the proposals in the July 2010 ED "Insurance Contracts". As a result of this work, we believe that the proposals in the 2013 ED go a long way to addressing those concerns. However, we believe that certain aspects of the proposals need further work before the standard can be finalised. Our overall view is set out below (summarised in paragraph 16) and detailed responses to the ED questions are addressed in the Appendix to this letter.

1. Early results from the field testing exercise we are co-ordinating with EFRAG and IASB, indicate that the ED's insurance accounting model is difficult to implement for preparers and the results for life insurance business, in particular, are complex to understand. A significant amount of this complexity arises due to the issues set out below – the mandatory use of OCI, the "mirroring approach", whether, and to what extent, the CSM should be unlocked and the interest accretion methodology. We do not believe that a solution for accounting for insurance contracts can be finalised before these issues are addressed. In particular, we would not recommend that the current complexity in reporting of insurance contracts is replaced by proposals that create new and additional complexity in reporting.

2. We believe that a narrowing down of options for accounting for insurance contract liabilities will constitute a significant step forward in terms of bringing consistency to reporting of insurance contracts under IFRS. As such, we would not recommend that the IASB look for a single perfect solution but instead allow a small range of approaches. We also believe that the IASB should work to finalise the standard on insurance contracts so that it focuses on reflecting the business model and the risks in that model in both the statements of financial position and performance.

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Mandatory use of OCI

3. We believe that real volatility arising from the business model and the risks in that model should be reported in the financial statements. By contrast, accounting classification of economically matched assets and liabilities should not lead to volatility on such items being reported in different performance statements. IASB's discussion paper on its conceptual framework project is currently looking at making the business model a key to financial reporting by entities. We believe that this is a significant concept for reporting of asset and liability measurement by entities such as insurance companies which often manage, and/or are required by regulators to manage, the risks in the business on a matched basis- as explained further below.

4. We are concerned that the introduction of the requirement in the 2013 ED to measure and present insurance liabilities in the Other Comprehensive Income (OCI) will have implications for current business practices and reporting by the insurance industry. The business model for many insurers is to hold financial assets that match the value and incidence of cash flows arising from their insurance liabilities. The classification and measurement requirements in IFRS 9, not only take the nature of the financial instrument into account but also, require a consideration of the entity's business model for holding the financial asset. We therefore agree with Stephen Cooper's alternative view that the ED's proposals requiring that insurance liabilities are recognised and presented in OCI will create extensive accounting mismatches where economically matched assets are classified differently (e.g. at Fair value through Profit or Loss (FV-PL) or at amortised cost). We believe the ED proposal will lead to an asset liability measurement mismatch being hardcoded into accounting for insurance contracts and result in increased complexity in the financial statements rendering them less understandable for the users. For example, where an insurance liability is economically hedged using a derivative the ED would force the reporting entity to report the gains and losses on the liability through OCI whilst those for the asset will be reported through the income statement under IFRS 9.

5. We are also concerned that the implication of this accounting mismatch is to incentivise insurers to only hold assets that can be held at FV-OCI (e.g. corporate debt) rather than those compulsorily required to be FV-PL (e.g. equities). We recommend that IASB should make the requirements for classification and measurement of insurance contracts consistent with those for financial assets or at least permit an option where matching is core to the risk management principles of the business. In our view, this would entail requiring insurance liabilities to be classified as FV-PL with an option to recognise and present them in OCI based on business model and nature of the liability. We believe this approach will be consistent with that applied by other financial institutions, e.g. banks.

Mirroring Approach

6. The ED proposes a mirroring approach for measurement of liabilities where the contract specifies a link to returns on underlying items. Although, in theory, this exception to the overall measurement requirements for insurance contracts is addressing the concern from insurers about contracts where payments to policyholder are linked to returns on assets, we believe that these proposals are likely to be complicated to apply and understand in practice. Problems are likely to arise from the mandatory requirements: for there to be a contractually specified link between the assets and payments to policyholders; for a decomposition and separate measurement of cash flows between those that vary with the underlying

assets and those that do not; and likely arbitrary presentation of those "decomposed" cash flows in the statement of financial position and the returns on them in the income statement. For example, some UK constituents tell us that the mirroring approach is impractical even for unit-linked business.

Reflecting the nature of insurance business

7. Constituents, including users, have highlighted to us that the ED does not consider presentational and disclosure issues of relevance to the long term and regulated nature of much insurance business. Returns to shareholders are impacted by these factors and so there is a reasonable expectation that such relevant information should be presented. In particular, we recommend that a reconciliation between the accounting capital and the capital required under the relevant regulatory regime should be included as a separate disclosure requirement. We note that the EDTF has also included a similar disclosure in the recommended disclosures list for banks.

8. There is concern in connection with participating contracts that fluctuations in investment values will be recognised and reported which will not be relevant to amounts paid to policyholders and shareholders which are based on longer term values. Some insurers are developing a proposal to amend the presentation of short term investment through the contractual service margin (the floating CSM). Conceptually the issue is potentially no different to the recognition of unrealised gains and losses in other businesses however in the case of insurers the period over which returns emerge is longer. Accordingly consideration should be given to disclosing the timing of such returns.

Accretion of Interest

9. We are unclear as to the rationale for the requirement in the ED to accrete interest on the contractual service margin at locked-in rates. We believe that there is little merit in accreting interest on the contractual service margin at a locked-in rate when all other elements of the cash flows from the insurance liabilities will be discounted using current rates.

10. We are also aware of our constituents' concerns that maintenance and tracking of cohorts for this purpose is resource intensive and will require implementation of new systems that currently do not exist. We encourage IASB to carefully consider the potential cost benefit analysis of the proposals for accreting interest on the contractual service margin against alternatives before finalising the standard.

Implementation issues

11. We highlight the need to consider the interaction of the insurance standard with the implementation of IFRS 9. As noted above, due to the nature of insurance companies' business (and often regulatory requirements) there is significant interaction between the requirements in IFRS 9 and those proposed in this ED.

12. We note that insurers are concerned about the implementation costs and the need for some companies to implement entirely new models and IT systems. We also note that the proposals in this ED will bring significant changes to the reporting of insurance contract accounting which will most likely impact entities where provision of insurance contracts is the main business activity. As a result, we would recommend that IASB permit sufficient implementation time after the publication of

the final standard. However, early adoption of the standard should be permitted for entities that find themselves able to change systems quickly.

13. As mentioned above, in our view the proposals in the ED require further work. If the IASB does not intend to issue further EDs on this topic, we suggest that it places a review draft on its website for a time period to allow implementation issues to be ironed out prior to finalisation of the standard. We believe such an approach would reduce the need for significant changes to the standard after its publication and any post-implementation IFRIC interpretations.

14. Failing the above, we believe there is merit in conducting more field-testing once the proposals are finalised. Another way in which the IASB can smooth the transition to the new standard may be to set up an Expert Advisory Group that works through any implementation issues with a view to finding agreed upon solutions.

15. During our outreach with UK constituents, we have become aware of a distinct lack of engagement with the ED's proposals by the wider financial reporting user community. We have been told by users that they are not intending to respond to the IASB on the ED's proposals as they find them complex and have difficulty understanding how they will change reporting by insurance companies. We understand that the IASB has developed some examples of the impact of the standard's implementation on insurer financial statements. We would recommend that the IASB discuss these examples with as wide a range of the users as possible to ensure that user views on the proposals are understood and their concerns addressed prior to the finalisation of the standard.

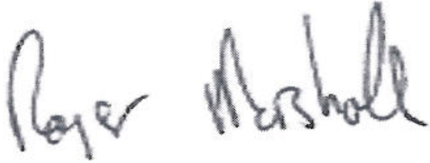
Summary

16. In summary, we encourage the IASB to conclude its project on insurance accounting promptly seeking to narrow the range of accounting practice but recognising that a one size fits all approach is not likely to prove timely or pragmatic. In doing so we recommend that the IASB should:

    a. focus on ensuring that the nature of the business and how its risks are managed is appropriately reported. Meet the needs of users by including reporting of the matching of assets and liabilities; disclosure of regulatory capital requirements; and disclosure of the likely timing of returns to shareholders;
    b. in that context, require insurance liabilities to be reported at FV-PL with an option to recognise and present them in OCI based on the business model;
    c. ensure that the accounting for participatory contracts reflects economic not just legal reality;
    d. ensure that the nature of the insurance business is reflected in the financial reporting by entities conducting such business i.e. through the presentation requirements and relevant disclosures;
    e. endeavour to strike a balance between the cost of implementation and any complexity introduced by the new standard; and
    f. field test and /or set up implementation advisory groups

Should you have any queries about the comments in this letter please do not hesitate to contact either me or Seema Jamil-O'Neill at 020 7492 2422 or s.jamiloneill@frc.org.uk.

Yours sincerely



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Appendix – Responses to questions in the ED

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: (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?

Adjusting the contractual service margin

1. In its response to the IASB's 2010 ED, the Accounting Council's predecessor (the ASB) highlighted the need for clarification of the impact on the residual margin in the event that an insurance contract becomes materially less profitable or even loss making subsequent to inception. In that letter the ASB highlighted that some constituents wanted to see a recalibration of the residual margin on subsequent re-measurement with any changes in the underlying assumptions to be taken through OCI.

2. We are therefore pleased to see that the ED clarifies this issue and feel that the nature of the contractual service margin (previously denoted the residual margin) is now clearly linked to the future coverage and services provided on the insurance contracts.

3. Further, although the separation between the changes in cash flows relating to future coverage and services, and those relating to other changes may appear to create some logistical difficulty for preparers, we understand that this information is obtainable currently. As a result, we do not believe these proposals should create a significant additional burden.

Accreting interest at locked-in interest rates

4. We note that the ASB's response to the 2010 ED set out its opposition to the accretion of interest on the residual margin. This was on the basis that it represented no more than deferred profit and the ASB did not believe that accreting interest on it was conceptually valid since it merely grosses up two items in the income statement, and did not provide meaningful information to the user.

5. We believe that the proposed contractual service margin represents more than just a plug number so we agree that accreting interest on it makes conceptual sense.

However, we are unclear as to the rationale for the requirement in the ED to accrete interest on the contractual service margin *at locked-in* rates and believe that there is little merit in accreting interest on the contractual service margin at a locked-in rate when all other elements of the cash flows from the insurance liabilities will be discounted using current rates.

6. We are also aware of concerns that maintenance and tracking of cohorts for this purpose is resource intensive and will require implementation of new systems that currently do not exist. This is an area where the IASB needs to carefully consider the potential cost benefit analysis of these proposals against those for any alternatives before finalising the standard.

7. We recommend that an alternative is to require interest accretion on the contractual service margin at the current market rates, making it more consistent with the other proposals in the ED.

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 (ie 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?

8. In principle we agree that financial statements would provide relevant information if an entity 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 (the so called "mirroring approach").

9. Although, in theory, this exception to the overall measurement requirements for insurance contracts is addressing the concern from insurers about contracts where payments to policyholders are linked to returns on assets, we believe that these proposals are likely to be complicated for preparers to apply and users to understand in practice. Problems are likely to arise from the mandatory requirements:

    a. for there to be a contractually specified link between the assets and insurance liabilities;
    b. for a decomposition and separate measurement of cash flows between those that vary with the underlying assets and those that do not; and
    c. the resulting presentation of those "decomposed" cash flows in the statement of financial position and the returns on them in the income statement is likely to be arbitrary.

10. Although a number of insurance contracts specify a link between the underlying asset and the insurance liability, for some other contracts such links are less specific. As a result of the pre-conditions to the mirroring approach it is likely that economically similar transactions will be treated differently depending on whether a link is specified in the contract.

11. The ED requires cash flows to be decomposed between those that vary with the underlying assets and those that do not, and requires them to be measured separately. However, the ED criteria in paragraph B85 underlying this split of cash flows are vague and are likely to be difficult to apply and explain in practice. As a result, we believe that the resulting presentation in the statement of financial position and income statement is likely to be arbitrary and misleading for the users of the financial statements.

12. Constituents, including users, have highlighted to us that the ED does not consider presentational and disclosure issues of relevance to the long term and regulated nature of much insurance business. Returns to shareholders are impacted by these factors and so there is a reasonable expectation that such relevant information should be presented. In particular, we recommend that a reconciliation between the accounting capital and the capital required under the relevant regulatory regime should be included as a separate disclosure requirement. We note that the EDTF has also included a similar disclosure in the recommended disclosures list for banks.

13. There is concern in connection with participating contracts that fluctuations in investment values will be recognised and reported which will not be relevant to amounts paid to policyholders and shareholders which are based on longer term values. Some insurers are developing a proposal to amend the presentation of short

term investment through the contractual service margin (the floating CSM). Conceptually the issue is potentially no different to the recognition of unrealised gains and losses in other businesses however in the case of insurers the period over which returns emerge is longer. Accordingly, consideration should be given to disclosing the timing of such returns. Aspects of this alternative proposal are still unresolved, and in particular we do not believe there is clarity around the following: what constitutes "service" in the Contractual Service Margin (CSM), are investment returns part of asset or liability valuation, how options and guarantees should be valued in a model that espouses measurement at fulfilment value for insurance liabilities, and what do the changes in risk adjustment represent. Without clarification on the above issues we are unable to conclude on the conceptual merits of this industry proposal.

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?

14. We agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity presents all its insurance contract revenue and expenses in profit or loss rather than presenting information about the changes in the components of the insurance contracts.

15. This approach is consistent with the presentation of revenue and expenses for other long-term contracts under IFRS and would help improve the comparability of financial reporting by insurance companies, both within the industry as well as with other types of entities.

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?

16. While we recognise that sometimes it can be useful to segregate underwriting performance from market movements, a common business model for insurers is to match the asset and liability cash flows by value and duration so as to limit volatility. This would mean that any residual volatility, perhaps caused by changes in credit risk, is of value to users.

17. We agree with the proposals in the ED that specify that the effect on the insurance contract liability of changes in the discount rates during the period should be reported separately. We believe that gains or losses arising from changes in discount rates are meaningful to the user of financial statements and should be reported separately (whether through OCI or PL) from underwriting performance.

18. However, we disagree with the ED proposal that these changes should be reported in OCI. We think that by taking this approach the IASB has stipulated that entities would report volatility in their insurance liabilities through OCI. However, corresponding changes in value on the relevant assets may be reported in the PL, OCI or not at all depending on whether those assets are categorised as at FV-PL, FV-OCI or at amortised cost. We believe that accounting for insurance contracts in accordance with the ED proposals will not reflect the underlying economics leading to unnecessary accounting mismatches in the financial statements.

19. We are concerned that the introduction of the requirement in the 2013 ED to measure and present insurance liabilities in the Other Comprehensive Income (OCI) will have implications for current business practices and reporting by the insurance industry. The business model for many insurers is to hold financial assets that match the value and incidence of cash flows arising from their insurance liabilities. The classification and measurement requirements in IFRS 9, not only take the nature of the financial instrument into account but also, require a consideration of the entity's business model for holding the financial asset. We therefore agree with Stephen Cooper's alternative view that the ED's proposals requiring that insurance liabilities are recognised and presented in OCI will create extensive accounting mismatches where economically matched assets are classified differently (e.g. at Fair value through Profit or Loss (FV-PL) or at amortised cost). We believe the ED proposal will lead to an asset liability measurement mismatch being hardcoded into accounting for insurance contracts and result in increased complexity in the financial statements rendering them less understandable for the users. For example, where an insurance liability is economically hedged using a derivative the ED would force the reporting entity to report the gains and losses on the liability through OCI whilst those for the asset will be reported through the income statement under IFRS 9.

20. We are also concerned that the implication of this accounting mismatch is to incentivise insurers to only hold assets that can be held at FV-OCI (e.g. corporate debt) rather than those compulsorily required to be FV-PL (e.g. equities). We recommend that IASB should make the requirements for classification and measurement of insurance contracts consistent with those for financial assets or at least permit an option where matching is core to the risk management principles of the business. In our view, this would entail requiring insurance liabilities to be classified as FV-PL with an option to recognise and present them in OCI based on business model and nature of the liability. We believe this approach will be consistent with that applied by other financial institutions, e.g. banks.

21. We also believe that there is merit in including additional disclosure requirements dealing with aspects of the asset liability matching that cannot be captured on the face of the financial statements e.g. cash flow/maturity mismatches.

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?

22. We believe that the transitional provisions in the ED are an improvement on the 2010 proposals. The transitional provisions should permit companies with large number of insurance contracts to swiftly transition onto the requirements of the new standard.

23. We note that insurers are concerned about the implementation costs and the need for some companies to implement entirely new models and IT systems. We also note that the proposals in this ED will bring significant changes to the reporting of insurance contract accounting which will most likely impact entities where provision of insurance contracts is the main business activity. As a result, we would recommend that IASB permit sufficient implementation time after the publication of the final standard. However, early adoption of the standard should be permitted for entities that find themselves able to change systems quickly.

24. We highlight the need to consider the interaction of the insurance standard with the implementation of IFRS 9. As noted above, due to the nature of insurance companies' business (and often regulatory requirements) there is significant interaction between the requirements in IFRS 9 and those proposed in this ED.

25. Early results from the field testing exercise that we are co-ordinating with EFRAG and IASB, indicate that the ED's insurance accounting model is difficult to implement and the results for life insurance business, in particular, are complex to understand. A significant amount of this complexity arises due to the issues raised above – the mandatory use of OCI, the "mirroring approach" and whether, and to what extent, the CSM should be unlocked. We do not believe that, a solution for accounting for insurance contracts can be finalised before these issues are addressed.

26. In our view, the changes proposed in the ED require further work. If the IASB does not intend to issue further EDs on this topic, we suggest that it places a review draft on its website for a time period to allow implementation issues to be ironed out prior to finalisation of the standard. We believe such an approach would reduce the need for significant changes to the standard after its publication and any post-implementation IFRIC interpretations.

27. Failing the above, we believe there is merit in conducting more field-testing once the proposals are finalised. Another way in which the IASB can smooth the transition to the new standard may be to set up an Expert Advisory Group that works through any implementation issues with a view to finding agreed upon solutions.

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.

28. We believe that the proposals in the ED are likely to be beneficial for users of financial statements by providing comparability between insurance entities and other financial institutions as well as non-financial institutions with long-term contracts.

29. However, we recognise that there are likely to be significant implementation costs associated for insurers as they will feel the impact of changes in accounting standards on both sides of the statement of financial position. We believe that a narrowing down of options for accounting for insurance contract liabilities will constitute a significant step forward in terms of bringing consistency to reporting of insurance contracts under IFRS. As such, we would not recommend that the IASB look for a perfect solution but instead allow us more range of approaches. We also believe that the IASB should work to finalise the standard on insurance accounting so that it focuses on reflecting the business model and the risks in that model in both the statements of financial position and performance.

30. We are currently conducting a field-test exercise in conjunction with EFRAG and the IASB. That field-test should provide more information on the likely effects and associated costs of implementation of the requirements in the ED. We expect to publish the results of that Europe-wide exercise in conjunction with EFRAG later in the year.

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?

31. As part of our outreach, it has become clear that significant aspects of the proposals in the ED are unclear to preparers. Some that we are aware of include:

    a. requirements for the "mirroring exception" proposed in the ED are unclear and interpreted differently depending on the constituent we speak with;
    b. paragraph B68 d) and e) appear to contradict each other;
    c. there is no definition of what constitutes "service" in a CSM; and
    d. the ED proposal does not deal with how options and guarantees which form part of an insurance contract should be measured under a fulfilment basis of measurement.