IAIS

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

21 October 2013

Ref: 13/98

Mr Hans Hoogervorst
Chairman
IFRS Foundation
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Exposure Draft ED/2013/7 Insurance Contracts

Dear Mr Hoogervorst:

The International Association of Insurance Supervisors (IAIS) welcomes the opportunity to comment on the International Accounting Standard Board (IASB)'s exposure draft *Insurance Contracts* (the ED).

We acknowledge the considerable efforts of the IASB and its staff in developing its insurance contracts accounting proposals, and we support the IASB's and Financial Accounting Standards Board (FASB)'s efforts to produce a converged approach to both financial instrument and insurance accounting, in so far as is possible. Convergence remains a key objective. We encourage the Boards to consider the feedback that they receive on the insurance contract accounting proposals and to work together to close the gaps. As ever, in the event that the Boards cannot reach a converged position, we encourage them to ensure that any resulting differences are both identifiable by, and understandable to, users of financial statements.

A significant concern for IAIS members is the level of complexity arising from the proposals. While the IASB has revised its proposals in respect of insurance accounting to reflect the needs and views of stakeholders, almost all of the changes add to the complexity of the standard both in terms of implementation of the requirements and of the information to be presented. Complexity increases the operational risks and costs to regulated entities, and those additional costs may be passed on to policyholders. In some cases complexity may compromise the quality of information provided to users. We refer the IASB to the comments included in this letter in response to the specific questions asked in the ED, but also emphasize to the IASB the importance of considering the effect of all changes together in

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order to determine whether the objective of improving the financial reporting information provided by insurers is achieved.

We also reiterate the point made in our response to the IASB's recent exposure draft on Expected Credit Losses that it is important that insurers are able to apply the requirements of both IFRS 9 and the expected insurance contracts standard at the same time. If the effective dates of these two standards cannot be aligned, we encourage the IASB to consider introducing an exception for insurers so as to enable implementation of IFRS 9 and IFRS 4 phase II concurrently. Moreover it is important that the IASB allow sufficient time for implementation of both standards.

The appendix to this letter provides more detailed responses to the questions set out in the ED.

If you have questions regarding this letter, please contact Aina Liepins at the IAIS Secretariat (tel: +41 61 280 8199; email: aina.liepins@bis.org) or Markus Grund, Chair of the IAIS Accounting and Auditing Issues Subcommittee (tel: +49 228 4108 3671; email: markus.grund@bafin.de).

Yours sincerely,

Peter Braumüller
Chair, Executive Committee

Michael McRaith
Chair, Technical Committee

IAIS

Appendix

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?

In the July 2010 Insurance Contracts Exposure Draft (2010 ED) the IASB proposed that the residual margin, as it was then called, should be locked in and released in a systematic way over the contract period. This had the effect of prohibiting the recognition of a gain at initial recognition and then requiring subsequent changes in estimates to be recognised fully in profit or loss. Many respondents argued that it would be inconsistent to prohibit the recognition of an estimated gain at inception, but then to require the subsequent recognition of gains on the basis of changes in estimates made after initial recognition. In the Basis for Conclusions the IASB explains that it was persuaded by this argument.

While not all IAIS members agree that the contractual service margin and risk adjustment approach is preferable to the alternative solution proposed by FASB, all members are supportive of the comments below.

The origin of the contractual service margin (CSM) is an estimate at inception of the future profit related to coverage and services on the contracts. We accept the IASB's view that the margin should be adjusted when, on a later reporting date, the estimates determining the liability related to the remaining part of the contract have changed. In such cases re-measuring the CSM should provide a current representation of the expected profitability from future coverage and services.

Even though we agree with the principle behind adjusting the CSM, we retain some concerns about how the adjustment should be calculated and in respect of its application. Moreover, this change to the model considerably increases the complexity of the model, bringing with it both an operational concern and a question as to how insurers might adequately communicate the resulting information in a meaningful manner to users of financial statements. It is important that the IASB considers and addresses such challenges, particularly in light of the additional complexity introduced by other changes to the model arising from the ED.

We have set out below some suggestions for amending how the adjustment should be calculated and expressed other concerns regarding the application.

Firstly, we note a lack of clarity in the ED in respect of the discount rate used to determine the amount that adjusts the CSM at the end of the reporting period. Our understanding from

discussions with IASB staff is that paragraphs 29 and 30 as drafted in the ED were intended to result in an adjustment to the CSM that is based on the locked-in discount rate at inception of the contract. IAIS members have differing views as to whether this is the most appropriate basis (the alternative being an adjustment based on cash flows discounted at the current rate) but nevertheless believe that it is important that the IASB clarify the measurement basis applied to the adjustment to CSM. It would also be beneficial if the IASB provide an explanation of the reasons for adjustment measurement based on either a locked-in or current discount rate so that the rationale behind the IASB's decision is clear. The suggestion does not deal with the question whether the effect of change in the discount rate should be recorded in profit or loss (P&L) or in other comprehensive income (OCI) which is discussed under Q4.

Secondly, we note that strong arguments can be made as to whether changes in the part of the risk adjustment related to future coverage in principle should be added to the amount that adjusts the CSM. Those in favour of splitting the risk adjustment argue that it is conceptually appropriate to do so, and that existing practice in certain jurisdictions indicates implementing such an approach is not difficult. Those opposed question whether the split is indeed straight-forward when the risk adjustment methodology is not prescribed and so may vary, and also question whether the additional complexity is merited when it is not clear whether or not the effect (the impact on P&L) will be material. They also acknowledge the arguments set out by the IASB in the Basis for Conclusions to the ED and the conclusion that all changes in the risk adjustment should be recognised immediately in P&L (BC36-BC37).

As such, we recommend that the IASB reconsider this issue and, where possible, seek further evidence (for example, through field-testing) of the potential impact that this alternative approach might have, before finally concluding on the structure of the adjustment to CSM.

We acknowledge the intention of the IASB behind the separate identification of the CSM and risk adjustment but note a concern as to whether the distinction between these items is robust enough to ensure a consistent approach by entities. The IASB's decision to leave the risk margin approach to entities to decide gives rise to a risk that entities may choose to adopt an approach that minimises the risk adjustment in order to maximise the CSM, and thereby make room for larger deferrals of any future deteriorations. Such a practice seems possible by claiming that the entity requires little or no 'compensation for bearing the uncertainty' while it is expecting a huge profit represented by a big CSM. We do not believe that this was the intention of the IASB and consequently request the IASB to reconsider whether the new definition of the risk adjustment is too subjective and gives rise to an unnecessary risk of divergent practices in this area. Further consideration of this issue is included in our response to question 6 below.

Compared to the locked-in approach in the 2010 ED, the new proposal will result in deferral of the expected gains and losses related to changing expectations about the number and size of future claims on existing contracts. It is therefore important that there is clear disclosure of the extent to which changes in judgments about covered future insurance events are reflected in the CSM. We request the IASB to consider whether the proposed disclosure requirements, including those in respect of significant judgements, will fulfil this need adequately. In essence, the problem is whether changes in judgments that will have a material effect on future profitability but not necessarily on current profits are captured by the disclosure requirement. The IASB may wish to consider whether there should be a specific requirement to disclose the origins of the changes in the CSM, new contracts, run off, changes in estimates etc.

We have considered whether the settlement period should be included in the period over which the CSM is released and IAIS members' views vary. Release of a margin over the

settlement period would undoubtedly introduce additional complexity but might be appropriate if the services to which CSM refers include the settlement of claims. The term 'services' has been used in the ED without a proper definition and this has served to confuse matters. If the objective of the CSM is to reflect reward over time for 'services' provided it becomes critical that the IASB provide a precise definition of that term. This, combined with a clear principle, might help to resolve the confusion to which the change of terminology describing the fourth building block has led.

We also note that a number of uncertainties around the requirements exist. One significant issue is that of 'loss reversals'. Where an increase in expected cash flows relating to future coverage and future services has eliminated the CSM and led to the recognition of a loss in the P&L it is our understanding that the prospective nature of the CSM measurement approach will lead to an asymmetric approach in the event that such an increase reversed. Rather than resulting in a reversal of the loss recorded in P&L and re-establishment of CSM at its original zero-point, instead the model will require a CSM to be reinstated at the point the loss reverses. We believe that this asymmetric approach will distort both liability valuations and profit reporting and as such a symmetric approach should be required. While this will require entities to track historical CSM and loss recognition information, we do not believe that it will be overly burdensome and we believe it will result in more meaningful information.

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?

While members are generally supportive of the objective of the IASB in this area, namely that it is appropriate to try to find a way to eliminate accounting mismatches, IAIS members have differing views as to whether the approach specifically proposed by the IASB is reasonable. At present there are concerns about the practical application of the requirements and the lack of a common understanding of how the requirements would be applied.

However, there is general agreement that the proposal creates real complexity. For example, the necessity to decompose cash flows may create an excessive operational burden, with the requirements appearing as somewhat arbitrary. This creates an obvious cost for both preparers in preparing the information and users in interpreting it and it is not yet clear to us that the expected benefits from the approach outweigh this cost.

The IASB is faced with an obvious dilemma here, as there is a choice between a measurement outcome that will be consistent with other insurance contracts (i.e. in line with the building block model) and one that is instead consistent with the assets from which the obligations to the policyholder arise. It is difficult to comment on the proposals as they stand given the uncertainties and complexities of the model as it has so far been described in the ED and accompanying document. In principle, the best outcome would be a solution to the accounting mismatch issue and reflective of the economic interdependencies between insurers' assets and liabilities that is not an exception to, but is instead consistent with, the building block model and capable of consistent application.

We encourage the IASB to reconsider the appropriateness of the model proposed in the ED, and to examine whether the detailed requirements should be revised so as to make the approach clearly understood, meaningful in outcome, and capable of consistent application. We acknowledge the IASB's desire for feedback on the model as proposed and comment specifically thereon below.

A particular concern to us is that interested stakeholders have expressed many differing interpretations of how the requirements would be applied in practice, and have noted that it results in an artificial and confusing deconstruction of the insurance liability cash flows. Clearly, at present there is not enough guidance and examples to enable a proper assessment of the proposals.

Furthermore, it is not clear that the IASB's objective has truly been fulfilled. For example, it can be argued that:

- The valuation resulting from the approach is 'arbitrary' as it may not be reflective of actual fulfilment cash flows. As such, the measurement of some insurance liabilities will be at an amount that does not reflect what the entity expects to pay to fulfil the contract and, indeed, would vary depending on the measurement approach adopted for the valuation of the underlying assets.
- Artificial volatility is created by the requirements that changes in cash flows that vary indirectly with underlying items (such as those relating to certain embedded options) go to P&L.
- The scope of the cash flows covered by the mirroring approach is unclear. In the Basis for Conclusions the IASB acknowledges that cash flows may be decomposed in a number of ways even for a relatively simple example.
- The scope may be too wide, for example in not requiring a clearer or tighter link to the pass-through of returns to the policyholder.

Given the various concerns and lack of clarity as to how the approach will be consistently applied, it is not clear to us that the approach, as currently expressed, will provide users with understandable and faithful information. Members are generally of the view that the example and guidance in the ED are not sufficient.

Examples of areas where clarifications from the IASB are necessary include:

- Whether the timing of the passing through of the return to the policyholder affects if the approach can be applied. For example, can the mirroring approach apply where discretion exists over the timing of the distribution of profits on participating contracts to policyholders?
- Whether charges levied based on amounts attributable to the policyholder are included or excluded from the 'mirrored' cash flows (i.e. whether the approach is applied to gross or net cash flows attributable to policyholders).

We reiterate IAIS members' views that the issues of economic interdependence and accounting mismatches need to be addressed in a way that is in principle consistent with the building blocks approach, and where appropriate, IFRS 9.

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?

In our comments on the 2010 ED, we noted that that most members would not regard the summarised margin presentation as useful for portfolios measured using the premium allocation approach (PAA), and that the presentation method outlined in paragraph 75[1] of that ED should be used for these contracts. We also noted that the IAIS believes that the summarised margin approach would provide useful information for portfolios that are not measured using the PAA. We continue to hold these views. The presentation proposals in the current ED for the PAA remain appropriate.

We understand the IASB's desire to have a revenue presentation that is consistent with the principles set out in the 2011 Exposure Draft *Revenue from Contracts with Customers* and we also appreciate the IASB's efforts to present volume information in the Statement of Comprehensive Income.

[1] 75 For some short-duration contracts, the pre-claims liability is measured in accordance with paragraphs 56–60. For those contracts, an insurer shall, in addition to the applicable line items in paragraph 72, include in its statement of comprehensive income line items that present the following amounts from insurance contracts for the period:
(a) the underwriting margin, disaggregated either in the statement of comprehensive income or in the notes into:
(i) premium revenue, determined as the gross release of the pre-claims obligation (ie grossed-up for the amortisation of incremental acquisition costs, see paragraph 57(a)).
(ii) claims incurred.
(iii) expenses incurred.
(iv) amortisation of incremental acquisition costs included in the pre-claims obligation (see paragraph 57(b)).
(b) changes in additional liabilities for onerous contracts (see paragraph 60).

However, we have concerns as to whether the presentation proposal in the current ED provides useful and meaningful information about portfolios of long term insurance contracts, particularly when the complexity of applying those proposals is taken into account. The meaning of insurance contract revenue as determined under the ED in the context of long term life insurance contracts is not clear, and the examples included in the current ED do not provide sufficient explanation of the meaning of this item.

These concerns include, but are not limited to, the following:

- The approach could be interpreted as a presentation of actual versus expected claims rather than revenue versus expenses.
- It is not clear whether the headline revenue number presented will be meaningful where it includes numbers prepared under differing bases (i.e. the insurance contract revenue model and the approach to revenue and expense presentation under the PAA.) This may particularly be the case for composite insurers.
- Comparability of the revenue numbers across insurance entities, particularly between life and general insurance entities using the PAA may be difficult.
- We have doubts whether comparability between revenue defined for insurance business and revenue reported by other industries will be achieved.
- The splitting of the investment component may be inconsistent if the IASB were to define insurance services as both the coverage of risk and management of investments to service on-going obligations.
- The justification for an asymmetric treatment of ceding commissions has not been clearly set out.
- Theoretically revenue could be negative.

Regarding presentation with respect to disaggregation, to ensure a reasonable comparison between those only writing pure risk business and those providing alternative investment vehicles to customers, determination of the investment component may be difficult and costly for some products where the provision of insurance is very much related to the provision of investment. Such products might include traditional products (such as whole of life or endowments) or lifetime annuities. The IASB should consider whether the cost of disaggregation outweighs the benefits in such cases, and whether some form of exemption should be allowed. In this case we would emphasise, as we have done before, that the investment component is not the same as the surrender value under the contract (if one is payable under the contract).

The return of amounts represented by the investment component is subject to numerous contingencies such as economic stresses and insurance company management decisions. These are not guaranteed and the reporting could give rise to inappropriate policyholder or investor expectations.

Consequently, while we see merit in an approach consistent with revenue recognition principles, we have concerns as to how understandable the outcome of this will be to users. On that basis, we recommend that the IASB consider in-depth field-testing of the proposals with the investor community.

Furthermore, we note that it is highly likely that both during and after implementation of any new insurance accounting standard, traditional measures of premiums and claims etc (e.g. net written premium information) will remain a focus for many preparers and users of financial statements. As such, we believe that the IASB should look to provide specific disclosure requirements around such traditional measures. While doing so would not link directly with the IASB's view on revenue presentation, we believe that it would be beneficial in order to avoid such information becoming a prominent non-GAAP measure, which would consequently be open to considerable inconsistency of presentation.

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?

IAIS members support the use of OCI for insurance contracts liability presentation as optional rather than a requirement as is currently proposed by the IASB.

Ideally, insurers manage their insurance business in a manner that ensures that there are sufficient assets to support insurance liabilities. This is achieved by investing in various types of assets with different attributes (for example, yield, cash flow, risk and duration) that best fulfil various insurance liabilities obligations and which may be classified differently. Accounting should capture economic mismatches between assets and the insurance contract liabilities they support but should not create accounting mismatches on their own. By requiring the mandatory use of OCI, we believe there may be an unintended consequence of reflecting both economic and accounting mismatches in the financial statements, making it difficult for users to distinguish between true economic mismatches and those created by accounting.

We also note that as the proposals stand both here (for the mandatory use of OCI) and in the Exposure Draft for *Classification and Measurement: Limited Amendments to IFRS 9* it is apparent that the overall model for insurers will continue to give rise to accounting mismatches from certain types of assets supporting insurance contract liabilities. If financial assets are managed within the business model for collecting contractual cash flows and for sale, and the cash flows are solely payments of principal and interest, they would be measured at fair value through OCI (FVOCI) and an accounting mismatch would not be expected to arise. However, if financial assets do not qualify for FVOCI (or do qualify but an entity has designated the asset as at fair value through profit or loss), an accounting mismatch would exist.

As such, we believe the interaction between IFRS 4 phase II and IFRS 9 needs further consideration to take into account insurers' asset-liability matching and to avoid accounting mismatches. We urge the IASB, when finalising these standards to consider fully the

interaction between the two standards and enable insurers to reflect their business models in the accounting results.

We acknowledge that the IASB may have concerns about introducing optionality on the use of OCI, including the potential reduction in comparability of entities' income statements and statements of other comprehensive income. This risk is mitigated if the optional use is introduced with a requirement that the presentation of changes in both assets and insurance liabilities should be consistent and accompanied with additional disclosures. We are firmly of the view that the advantages of including an option outweigh the negatives.

Clearly, two approaches are possible: (i) a general approach of OCI for amounts attributable to changes in the discount rate with an option to take those changes through P&L, or (ii) a general approach of 'through P&L' with an option to take amounts attributable to changes in discount rates through OCI. Any option, of course, should not be a free choice but should be constrained by appropriate conditions such as consistent application across an insurance entity, a class of business or a particular portfolio and irrevocable designation.

Optionality is undoubtedly more difficult to design in this instance, where its application is dependent on the interaction with other standards (particularly IFRS 9), than when it is prescribed within a standard where measurement approaches and the nature of instruments are clearly consistent across assets and liabilities. Such a design is possible given the technical expertise available to the IASB.

We would like to emphasise the fact that the proposal for use of OCI creates additional complexity because of the need to maintain the discount rates that the entity applied at the date of initial recognition. Given that other proposed changes also increase the potential complexity of the model, the IASB should be mindful of this during their re-deliberations.

There are a number of areas in the OCI approach where further detail or clarification is necessary, such as whether discount rates are to be determined at inception for each individual contract or at a higher level, and with what frequency (e.g. yearly, monthly, daily or intra-day). This latter issue of the frequency of calculation may be of particular concern as a high frequency would be suggestive of a requirement to split insurance contract information into much more granular detail than is perhaps currently expected to be the case.

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?

The IAIS supports the ED proposal to require entities to set up a contractual service margin for existing contracts on transition. We believe this should help to enhance comparability in the subsequent measurement of contracts in force at the transition date and contracts that are recognised after transition. While there will be subjectivity in the amount of contractual service margin recorded at transition, the need for auditor review and disclosure requirements should provide discipline on the process of setting the contractual service margin at transition.

The IAIS strongly believes that the effective dates of IFRS 9 and the insurance contracts standard must be aligned for insurers. The effective dates of both standards should be set to allow sufficient time for implementation. If the effective dates of these two standards cannot

be aligned, we encourage the IASB to consider introducing an exception for insurers so as to enable implementation of IFRS 9 and IFRS 4 phase II concurrently.

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 IAIS is concerned with both general purpose accounting and solvency issues. We believe that it is most desirable that the methodologies for calculating items in general purpose financial reports can be used for, or are substantially consistent with, the methodologies used for regulatory reporting purposes. Achieving this aim would likely reduce costs for regulated insurance entities and thus for policyholders. Many IAIS jurisdictions base their regulatory reporting requirements on general purpose financial statements, or at least on equivalent quantities determined using the same methodologies as for the general purpose financial statements.

We note that in issuing a comprehensive insurance standard the IASB will improve IFRS insurance accounting requirements and increase the comparability of insurers' financial statements prepared under IFRS. Moreover, we note that a consistently applied, converged global international insurance contracts standard would enhance comparability between financial statements of entities that issue insurance contracts and, to that end, we emphasise the importance of consistency globally and urge the IASB and FASB to redouble their efforts to reach a converged solution.

The issue of costs and benefits of implementing the ED is perhaps best addressed by preparers, auditors and users of the financial statements. There is a high cost associated with making the required changes, much of which is unavoidable if the objective of having a single comprehensive accounting model for insurance contracts under IFRS is to be achieved. That said, the additional benefit compared to expected costs of some of the changes proposed in the ED is not always clear, particularly where doubts exist about whether the requirements will lead to useful and meaningful information.

However, we note that the standard, as currently drafted, introduces considerable complexity such that any benefit may be outweighed by the costs. Moreover, the complexity and comprehensiveness of the changes proposed will strain financial and technical resources for all entities, at least in the near term, and the cost of compliance is likely to be disproportionately burdensome for small to mid-sized entities. The limited availability of technical resources could further result in a significant disparate impact on these insurers.

Whilst we acknowledge that much of the complexity introduced in this ED responds to criticisms raised against the 2010 ED, we are concerned that the IASB must strike the right balance between stakeholders' desires and overall complexity. Each of the major changes introduced by the ED results in an increase in complexity; in some cases this will be warranted, in other cases it will not be. We encourage the IASB to consider feedback both on the proposals including the results of field testing, and the issue of complexity, not just by individual question but especially in the context of the model overall.

The IASB should ensure that the risk adjustment measurement and disclosure requirements within the ED are sufficient to mitigate the risk of divergent practices emerging and the potential for earnings management given the interaction of the risk adjustment and the CSM.

A question may also be raised as to whether the one year threshold in paragraph 39(b) that may be applied when determining whether to discount is appropriate. Given that the impact of discounting will vary depending on the rates that are applicable, this threshold appears arbitrary rather than principled. In high-interest rate environments this threshold may be too long, while in low interest environments a longer time horizon could be applied without having a material effect on the accounts.

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?

Concerns exist as to the clarity of drafting in a number of areas of the ED. This can be seen particularly strongly in respect of the 'mirroring approach', where there appears to be no single view yet on how the requirements will be interpreted and applied. Other areas where clarifications are required, as highlighted elsewhere in our responses to the ED questions, include the contractual service margin (such as the inclusion or not of amounts attributable to changes in discount rates, and defining what is meant by the term 'service') and discount rates (for example, frequency of calculation). We also note that the unit of account is not clear in all instances and so this is also an area where further clarity could be provided.

We also note the following areas where there is a lack of guidance or examples:

- Guidance on how premium receivables are recorded under IFRS 4 (or under IFRS 9). We note that the FASB ED proposals 834-10-35-11 specifically state that premium receivables are recognised as an asset.
- Examples ensuring a better understanding of how to determine changes in the investment component (not previously separate at inception) that should be excluded from the revenue recognition. The FASB ED includes two examples (Example 18 (life) and 19 (non life)) showing the complexity of the approach.
- Guidance and examples regarding the subsequent impacts on revenue of the reversal of a loss recorded in P&L (imputation of the claims incurred on the respective liabilities including or related to amounts recognised in P&L and the modality of re-establishment of the CSM).
- Guidance and examples relative to the amortisation of acquisition costs paid in the subsequent periods and also in case of recognition of a loss.
- Guidance and examples about the recognition in OCI of changes in the insurance liability due to changes in the current discount rate.

- Guidance on how to understand paragraph 47(b).
- The strict reading of paragraph 33 may require that there be a specified link <u>in the contract</u> between the obligation and an underlying item even if the requirement arises by law or regulation. We do not believe that this was the IASB's intention. We recommend the following drafting change to paragraph 33:

  > The entity shall determine whether ~~the contract specifies~~ a link to returns on underlying items <u>has been contractually or constructively specified</u> by considering all of the substantive terms of the contract, ~~whether they arise from a contract,~~ the law and regulation.

It is vital that the IASB address any areas of uncertainty in the text before it is finalised.

Also, we recommend that the IASB consider forming an implementation group with an objective to ensure that the standard is interpreted and applied consistently during the period between final publication and the effective date. It would be more cost-effective for preparers and the IASB to ensure that the standard are understood and applied appropriately, in so far as is possible, upon initial implementation.

Other

Discounting

While the IASB believes that its changes to the discount rate used under the building block model represent a clarification rather than a substantive change, IAIS members are not convinced that this is the case. Instead of providing additional requirements and guidance for determining a discount rate that reflects that characteristics of the insurance liability, which would have aided preparers and addressed some of the concerns of other stakeholders, the IASB has chosen to clarify that the means by which the rate should be calculated may vary (namely, through both 'bottom-up' and 'top-down' approaches).

All IAIS members observe that the optionality described by 2013 ED makes clear the potential for a lack of comparability between entities and the potential to facilitate earnings management, especially as the ED does not appear to prevent switching between approaches. We are concerned that the requirements, including disclosure, and guidance that the IASB has provided is not sufficient and encourage the Board to consider this issue further before finalising the standard.

Reinsurance

The IAIS is not convinced that reinsurance is properly treated in all cases under the proposals. From a regulatory perspective reinsurance is a form of risk mitigant (a negative insurance) such that the insurance risk is transferred from the direct writer to the reinsurer. The IASB needs to consider whether it is then appropriate for accounting to assume that the direct writer accounts for all the insurance risk, regardless of any transfer of insurance risk, or whether it would be more appropriate to view the accounting for the direct writer from a net position (i.e. net of reinsurance).

Investment components

A more specific concern caused by the current drafting is the treatment of investment components. The ED proposes that components that are 'distinct' should be measured separately. However, the description of 'distinct' set out in the ED appears to limit this to components capable of being sold on a stand-alone basis, while in reality there may be products which contain both investment and insurance components that are not highly inter-related but nonetheless are not able to be sold separately. We question whether the resulting accounting (measurement of the underlying and the additional component together) will in all cases be appropriate, and as such recommend that the IASB consider a solution that permits such components to be separated.

IAIS

With reference to the existing concepts in the ED of ‘distinct’ and ‘highly interrelated’, a solution that utilises these concepts but addresses the concern noted above would therefore be:

- If components are distinct then they must be separated.
- If components are highly inter-related then they must not be separated.
- If components are not distinct but not highly inter-related then it is permitted for them to be separated.

While a concern about comparability could be raised with such a permission we believe that the resulting information would be more relevant and useful to users of financial statements.

Proposed below are changes to the ED text that might achieve this objective:

Para 10 b delete final sentence:

> separate an investment component from the host insurance contract and account for it in accordance with IFRS 9 if that investment component is distinct (see paragraphs B31–B32). ~~The entity shall measure a distinct investment component as if it had issued it as a stand-alone financial instrument that is initially measured in accordance with IFRS 9 and attribute any remaining cash flows to the other components of the insurance contract.~~

Para 10 add 2 new sub-paragraphs:

> e. be permitted to separate an investment component from the host insurance contract and account for it in accordance with IFRS 9 if that investment component is not distinct but not highly interrelated with the other components of the insurance contract (see paragraphs B31–B32).
>
> f. measure a separated investment component as if it had issued it as a stand-alone financial instrument that is initially measured in accordance with IFRS 9 and attribute any remaining cash flows to the other components of the insurance contract.

Amend B31 and B32 as follows:

B31. ~~Paragraph 10(b) requires an entity to separate a distinct investment component from the host insurance contract. Unless the investment component and insurance component are highly interrelated, a~~An investment component is distinct if a contract with ~~equivalent~~ competitively similar terms is currently sold, or could be sold in the future, or has been sold in the past, separately in the same market or same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity shall take into account all information that is reasonably available in making this determination. The entity need not undertake an exhaustive search to identify whether an investment component is sold separately.

B32 An investment component and insurance component are highly interrelated if:

> ~~(a)~~ the entity is unable to measure at least ~~the~~ one component without considering the other. Thus, if the value of each ~~one~~ component varies according to the value of the other, an entity shall apply this [draft] Standard to account for the whole contract containing the investment component and the insurance component, but if one component can be measured without considering the other then that component can be separated and the value of the other component determined by subtraction as if the entity applied this [draft] Standard to account for the whole contract containing the investment component and the insurance component as well as the separated component.~~; or~~

~~(b) the policyholder is unable to benefit from one component unless the other is also present. Thus, if the lapse or maturity of one component in a contract causes the lapse or maturity of~~

~~the other, the entity shall apply this [draft] Standard to account for the whole contract containing the investment component and the insurance component~~.