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EFRAG

European Financial Reporting Advisory Group

Comments should be submitted by 22 November 2010 to Commentletters@efrag.org

[XX Month 2010]

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir / Madam

Re: IASB Exposure Draft *Insurance Contracts*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Insurance Contracts* ('the ED'). This letter is intended to contribute to IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

EFRAG is pleased that in developing the proposals the IASB addressed a number of concerns expressed in respect of the Discussion Paper *Insurance contracts* that was issued in 2007 and we agree with many of the proposals in the ED. In particular, we agree with the IASB's decision to require measurement based on fulfilment cash flows and a building block approach that includes, separately, the recognition of a risk adjustment and a residual margin. With respect to acquisition costs, we concur with the IASB's decision to include incremental acquisition costs in the fulfilment cash flows.

However, we also have a number of concerns that we would like to highlight below:

- *Residual margin:* The ED proposes to lock-in the residual margin and release it over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage. We believe the residual margin should be adjusted to offset the changes from remeasurement of the present value of fulfilment cash flows that affect future periods. We believe that this would be more appropriate as it is consistent with measurement at contract inception. It is conceptually right that no day one gain is recognised because the insurer earns the profit over the coverage period. Therefore, the changes from remeasurement should be recognised in profit or loss only as far these changes relate to the current period or past periods.

- *Financial statement presentation:* The ED proposes a summarised margin presentation, which does not allow volume information for long duration contracts to be presented on the face of the statement of comprehensive income. We believe volume information, such as premiums, claims, benefit expenses and claims handling expenses should be presented on the face of the statement of comprehensive income for all insurance contracts because they are key information for the users of financial statements. A presentation combining actual volume information and margins is therefore desirable.

- *Transitional requirements:* The ED proposes to record the difference between the insurance liabilities measured under IFRS 4 and the insurance liabilities measured under the new proposals into retained earnings. This is in fact an elimination of all future gains from the insurance business in force. We disagree with this treatment as it will prevent an insurer from recognising gains from its current contracts in profit and loss. We believe that IAS 8, which requires retrospective application unless it is impracticable, should be applied upon initial application of the standard.

Our detailed responses to the questions in the ED are included in Appendix 1 to this letter.

Finally, we believe that the Board has not sufficiently considered the interaction between the proposals in the ED and IFRS 9 *Financial Instruments*. Insurers are generally exposed to a degree of economic mismatch between their investments and their obligations under insurance contracts. We agree that an insurer that applies fair value in accounting for its investments might mitigate the accounting mismatch with the obligations under insurance contracts that are accounted for under a current fulfilment cost approach. However, this approach is not expected to eliminate accounting mismatches completely and does not address the concerns of insurers that have traditionally accounted for their investments at amortised costs. We have included a summary of those concerns in Appendix 2 to this letter.

If you would like to discuss our comments further, please do not hesitate to contact Annemiek Vromans or me.

Yours sincerely,

Françoise Flores
EFRAG, Chairman

APPENDIX 1

EFRAG's response to the questions asked in the exposure draft

MEASUREMENT MODEL

Question 1 – Relevant information for users

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

Notes to EFRAG's constituents

1 *As stated in paragraph BC44 of the ED, the IASB believes that the measurement model proposed in the ED would produce relevant information for users of an insurer's financial statements because it provides:*

(a) *More relevant information about the amount, timing and uncertainty of future cash flows that will arise as the insurer fulfils its existing insurance contracts;*

(b) *Explicit and robust estimates of cash flows, using a consistent approach for all changes in estimates that is also consistent with the approach to estimating future cash flows for other financial and non-financial liabilities in IFRSs;*

(c) *Information about risk, through the inclusion of an explicit risk adjustment. This would be relevant information for users because accepting and managing risk is the essence of insurance;*

(d) *Consistent treatment of both the time value and intrinsic value of all options and guarantees embedded in insurance contracts;*

(e) *Clear reporting of economic mismatches that occur when insurance liabilities and related assets respond differently to the same changes in economic conditions;*

(f) *A reduction in accounting mismatches that arises if changes in economic conditions affect assets and liabilities equally, but the accounting requirements do not adjust the carrying amounts of those assets and liabilities equally in response to those economic changes;*

(g) *Consistency with observable current market prices for financial market variables, such as interest rates and equity prices, to the extent that they are available;*

(h) *A presentation approach that highlights the main drivers of an insurer's profitability during the period;*

(i) *A clear and understandable approach for acquisition costs, by treating incremental acquisition costs as cash flows arising from the related insurance contract. Non-incremental acquisition costs would be recognised as an expense when incurred.*

EFRAG's response

- **EFRAG considers that the measurement model proposed in the ED will be a step forward in accounting for insurance contracts.**
- **EFRAG considers that the proposed measurement model does increase the relevance of information for users since there will be more consistency and comparability in the financial statements of insurers.**
- **However, we have concerns as we do not believe that some of the proposals will improve the usefulness of information provided. Our concerns relate specifically to subsequent measurement of the residual margin, presentation in the statement of comprehensive income and the transitional rules.**

2 EFRAG considers that the measurement model proposed in the ED addresses many concerns expressed in our comment letter to the discussion paper. We consider that the proposals will result in an increase in the usefulness of information for users of an insurer's financial statements. A primary reason for this is that there will be a single regime for insurance contracts under IFRS, resulting in greater consistency in the financial statements of insurers compared to the range of accounting models currently applied.

3 We particularly agree that the proposed measurement model provides more relevant information about the 'amount, timing and uncertainty of future cash flows that will arise as the insurer fulfils its existing insurance contracts.'

4 However, we have concerns regarding certain aspects of the proposals in the ED which we think reduce the relevance of the information for users. In particular we are concerned about the proposals concerning the subsequent measurement of the residual margin, financial statement presentation and the transitional rules. Our concerns are detailed in our responses to question 6, 13 and 17.

Question 2 – Fulfilment cash flows

(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?

(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

Notes to EFRAG's constituents

5 The measurement model proposed in the ED consists of 4 building blocks:

(a) *An estimate of probability-weighted fulfilment cash flows;*

(b) *An adjustment for the time value of money (discounting);*

(c) *A risk adjustment; and*

(d) *A residual margin.*

6 *The ED groups the first three building blocks ((a), (b) and (c)) and uses the term 'present value of fulfilment cash flows' to refer to this (combined) element of the proposed measurement model.*

7 *The first building block for the measurement of the insurance liability considers the cash flows.*

8 *The ED provides that an insurer shall include in its measurement of an insurance contract 'the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract ...' (paragraph 17(a)). Paragraph 22(a) further provides that fulfilment cash flows constitute 'an explicit, unbiased and probability-weighted estimate (i.e. expected value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract.'*

9 *At initial recognition an insurer shall include in the measurement of the insurance contract an estimate of all cash flows that will arise as the insurer fulfils the insurance contract over the life of that contract. 'Estimates of cash flows for a portfolio of insurance contracts shall include all incremental cash inflows and cash outflows arising from that portfolio ...' (paragraph 23). Such estimate of cash flows should be explicit (separate from the effects of discounting and the risk adjustment) and should reflect the perspective of the entity. However, estimates of market variables should be consistent with observable market prices. The estimate should be current and reflect all available information available at the measurement date in an unbiased way, and only include those cash flows that arise from existing contracts.*

10 *In order to estimate future cash flows, paragraph B60 of the ED provides that an insurer shall develop cash flow scenarios that reflect future events, as well as unbiased estimates of the probability-weights for each scenario. Paragraph B61 of the ED provides that cash flows in a scenario include all cash flows within the boundary of an existing contract that are incremental at the level of a portfolio of insurance contracts, except for acquisition costs which are considered at an individual contract level. Incremental cash flows for a portfolio include direct costs and systematic allocations of costs that relate directly to the insurance contracts or contract activities.*

EFRAG's response

- **EFRAG supports a measurement approach for insurance liabilities that is based on the expected present value of the fulfilment cash flows (future cash outflows less future cash inflows).**
- **We agree that the portfolio is the appropriate level of measurement for the probability weighted cash flows of insurance contracts. We have concerns about the different levels of measurement required by the proposals as we believe that a consistent unit-of-account should apply throughout the standard for all building blocks.**
- **We believe that the definition of portfolio may be too wide when it refers to 'broadly similar risks' and 'single pool', which may lead to an imprecise level of aggregation. We note portfolios are also a level of measurement in other standards, notably IAS 39 and IFRS 9. The IASB should ensure consistent interpretation of portfolios. We recommend that the IASB conduct additional outreach activities to determine whether this definition is appropriate.**
- **We believe that the guidance regarding the definition of future cash flows is at the right level of detail. We recommend including guidance on the treatment of taxes in future cash flows.**

Question 2(a) – Measurement of the insurance liability at the expected present value of future cash flows

11 As we indicated in our response to Question 1 of the ED, information about the amount and timing of future cash flows are important elements of a measurement model that provides important information to users and reflects the way insurers measure and manage their insurance contracts.

12 EFRAG therefore agrees that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract.

13 We note that our agreement in response to this question relates to several different aspects of the measurement model, namely:

(a) The estimate considers cash flows that arise as the insurer fulfils its obligations under the insurance contract;

(b) The insurance contract reflects a single package of cash inflows and cash outflows;

(c) The measurement model is based on an estimate of probability-weighted future cash flows;

(d) The portfolio level provides reliable measurement and is in line with the way the insurer manages its business;

(e) However, we believe the definition of the portfolio should be strengthened;

(f) The estimate of probability-weighted future cash flows needs to be discounted to a present value.

14 In order to provide more detail about the reasons for our support, we consider that it is worthwhile addressing the above elements to the question separately below.

<u>Fulfilment cash flows</u>

15 EFRAG agrees with the IASB's proposal that the measurement of an insurance contract should be based on a fulfilment value rather than an exit value for the following reasons:

(a) An insurer generally has the intention to fulfil insurance contracts and is usually not able to sell or transfer them. Consequently the fulfilment concept better reflects the business model of an entity that issues the insurance contract;

(b) The use of fulfilment value entails the use of entity-specific information. In our view, the economic characteristics of an insurance liability are determined by the way the insurer manages these liabilities in combination with its other assets and liabilities. Therefore, the use of entity specific data is appropriate in the measurement of the insurance liability.

<u>The insurance contract reflects a single package of cash inflows and cash outflows</u>

16 EFRAG agrees that the measurement of an insurance contract should combine both cash inflows and cash outflows. These cash flows are generated by insurance, financial and service elements that together form the rights and obligations arising from

the insurance contract. The measurement results in a net value, which we consider reflects the economic substance of an insurance contract.

Probability-weighted future cash flows

17 EFRAG agrees that a key building block of an insurance contact is based on the expected values of future cash flows. We agree that when estimating cash flows:

(a) The inputs used, such as interest rates and equity prices, should be consistent with observed market prices.

(b) The estimate should incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all the cash flows arising from the obligation. That means each possible scenario should be identified; the present value of the expected cash flows from the scenario estimated; and a probability-weighted average calculated.

(c) The estimate should be based on currently available information; in other words, it should take fully into account conditions at the balance sheet date.

Measurement at the portfolio level

18 We note that paragraphs 16 to 22 of the ED (except for paragraph 20) refer to the individual contract in the context of measurement. In paragraph 23 (regarding probability weighted cash flows) and paragraph 35 (regarding the risk adjustment) the measurement is at the portfolio level.

19 EFRAG agrees with the IASB's proposal in paragraph 23 of the ED that cash flows arising from insurance contracts should be estimated at the portfolio level and agrees with the reasons given in paragraph B65 and B66. We recognise that probability-weighted estimates of future cash flows can be measured more accurately at the portfolio level and that most insurers manage and measure their insurance contracts at that level.

20 We note the residual margin and acquisition costs are measured using different levels of aggregation. We believe the standard should in principle require a consistent level of measurement for all building blocks.

Definition of portfolio

21 The ED defines a portfolio of insurance contracts as comprising 'insurance contracts that are subject to broadly similar risks and managed together as a single pool'. However, including 'broadly' and 'pool' in the definition may lead to inconsistencies between insurers accounts. 'Broadly' can be interpreted as including a wide range of risks and using the term pool suggests a higher level of aggregation than portfolio. Thus an entire group of portfolios may constitute a pool.

22 Other standards also use a portfolio as the unit-of-account, notably IFRS 9 and IAS 39. Neither standard defines a portfolio, but IAS 39 aggregates, for derecognition, assets with similar risks. Removing the term broadly and single pool would provide more consistency across standards.

Present values (discount rate)

23 EFRAG agrees that the time value of money should be taken into account to represent faithfully future cash flows at the reporting date. For further comments on proposals regarding the discount rate in the ED, please refer to our response to Question 3.

Question 2(b) – Application guidance on estimates of future cash flows

24 We believe that the guidance regarding the definition of future cash flows is at the right level of detail.

25 We note that the guidance on cash flows of an insurance contract includes transaction-based taxes (paragraph B61(h) of the ED). The impact of special insurance taxes on future cash flows can be different in different jurisdictions, depending on local tax and insurance legislation. We recommend therefore that the IASB include general guidance on the treatment of tax in the guidance on cash flows to ensure consistency of appliccation.

Question 3 – Discount rate

(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?

(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

Notes to EFRAG's constituents

26 The second measurement building block requires the determination of the present value of the fulfilment cash flows using a discount rate to adjust the expected value of future cash flows for the time value of money.

27 The ED requires a discount rate that is based on the characteristics of the insurance liability (i.e. currency, duration and liquidity). The effect (provided the liability does not depend on the performance of specific assets) is that the discount rate shall reflect the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk (risk-free rate), with an adjustment for illiquidity.

28 An asset-based discount rate is used only where there is a link between the performance of specific assets and the obligation under the insurance liability.

29 The discount rate should be consistent with observable current market prices that reflect instruments with similar characteristics, but that excludes such market prices that are not relevant. For example, in terms of illiquidity, an insurer shall take account of any differences between the liquidity characteristics of the instruments underlying the rates observed in the market and the liquidity characteristics of the insurance contract.

EFRAG's response

- **EFRAG agrees that the discount rate should reflect the characteristics of the liability. In case the amount, timing or uncertainty of the cash flows arising from an insurance contract depends wholly or partly on the performance of specific assets, the discount rate should reflect that.**
- **EFRAG does not consider that the effects of liquidity should be taken into account in determining the discount rate since a liquidity adjustment would be inconsistent with measurement of a fulfilment value.**
- **We agree that the effects of an entity's own credit risk should not be included in the measurement of an insurance liability.**

Question 3(a) – Discount rate reflects the characteristics of the liability

30 EFRAG agrees that the time value of money should be taken into account in order to faithfully represent the value of future cash flows at the reporting date that arise from all existing insurance contracts.

31 EFRAG agrees that the rate used to discount non-participating contracts should be a risk-free rate reflecting the characteristics of the insurance liability because:

(a) In EFRAG's view, the value of an insurance contract is independent of the value of the assets in which an insurer invests unless there is a contractually defined relationship that clearly links the cash flows of both (e.g. participating features);

(b) A risk-free rate that reflects the characteristics of the liability (e.g. currency, duration and country of the insurer) uses observable market information thus adding consistency across different liabilities; and

(c) Under the ED's building block approach, risk is considered when calculating the explicit risk adjustment.

32 We understand that the difference between the discount rate on insurance liabilities and the yield on invested assets will create a mismatch. In EFRAG's view this mismatch reflects the economic difference between assets and insurance liabilities. We consider this as useful information because it highlights the level of 'unmatched' risks in an entity's insurance activities.

33 Paragraph 32 of the ED provides that where the amount, timing and uncertainty of cash flows arising from insurance contract 'depend wholly or partly on the performance of specific assets, the measurement of the insurance contract shall reflect that dependence'.

34 We note that this requirement to reflect the cash flows arising from certain underlying assets impacts all aspects of the present value of fulfilment cash flows (i.e. estimated cash flows, discount rate and the risk adjustment). We therefore consider that its current placement in the ED under the sub-heading 'Time value of money' is confusing.

35 We think that the phrase 'depend wholly or partly on the performance of specific assets' should be clarified. From paragraph BC97 of the ED we understand (and agree) that unit-linked contracts and some participating contracts are within the scope of this paragraph. Paragraph B47 of the ED also indicates that the requirement may also apply to cash flows replicating the performance of a put option on a basket of

traded assets. We are therefore uncertain whether the insurer (or a third party) must actually hold those specified assets. The reference to the 'basket' of traded assets suggests that this is not the case, and we agree to this, but we consider that the IASB should be clearer on this point.

Question 3(b) – Liquidity adjustment

36 EFRAG interprets 'risk-free rate' as the observable market rate for highly-liquid assets (government bonds). We understand that long-term assets are less liquid than shorter term assets and command a premium over the (highly-liquid) risk-free rate.

37 Generally, insurance contracts are not liquid because they cannot be freely sold by the policyholder or put back to the insurer without significant additional cost. Insurance contracts also tend to be long-term in nature. Therefore, by analogy, the liquidity premium that attaches to less liquid long-term assets should be reflected in the measurement of (long-term) insurance liabilities. EFRAG also understands that the 'illiquidity' of an insurance liability measures the extent up to which its cash flows are certain in amount and in timing due to consideration being given to the resilience to forced sales.'[1]

38 EFRAG is concerned about the requirement to adjust the discount rate used in measuring an insurance liability for the effects of illiquidity. We consider that adjusting the discount rate for the effects of illiquidity is not appropriate in the context of measuring a fulfilment value (i.e. in respect of how the insurer expects to extinguish the liability). Liquidity is, at least in part, a measure of the ability of a policyholder to sell an insurance contract or let an insurance contract lapse and is therefore better suited to a measure based on exit value.

39 Based on the above, EFRAG does not support the proposed requirement in paragraph 34 of the ED to require the effects of liquidity to be taken into account in determining the discount rate when measuring an insurance liability.

Question to Constituents

The majority of members of EFRAG's Insurance Accounting Working Group (IAWG) supported the ED's proposal to consider the effects of liquidity in determining the discount rate when measuring an insurance contract. In their view, the risk-free rate does not faithfully represent the characteristics of the insurance contract.

EFRAG would be particularly interested in understanding constituents' views on whether and why the effects of liquidity should or should not be considered when determining the discount rate to be used in measuring an insurance contract.

Question 3(c) – Impact on long-duration insurance contracts

40 EFRAG considers that own credit risk is not a relevant characteristic of a liability as the fulfilment value of the insurance liability does not change because of changes in the credit status of the insurer.

[1] See page 6/33 of Committee of European Insurance and Occupational Pensions (CEIOPS) Task Force on the Illiquidity Premium (2010): Report. Ref. CEIOPS-SEC-34/10, 1 March 2010.

Question 4 – Risk adjustment versus composite margin

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

Notes to EFRAG's constituents

41 *The ED proposes that a third building block, an explicit risk adjustment (the risk adjustment), is included in the measurement of an insurance liability.*

42 *The risk adjustment is the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. The adjustment reflects estimate uncertainty.*

43 *The fourth building block is the residual margin. It reflects the residual profitability of the insurance contract that is estimated on initial recognition after allowing for the entity specific risk adjustment representing the profit the entity would require for bearing risk at balance sheet date. It is calculated as the difference between the present value of fulfilment cash flows and the future premiums receivable. The IASB proposes to calculate and disclose the risk adjustment and the residual margin separately ('two margin' approach).*

44 *The FASB and some IASB board members would prefer to depict uncertainty in the insurance contract together with the profitability in a single composite margin.*

45 *The IASB chose to propose an explicit risk adjustment because:*

(a) *Conveys useful information about risk;*

(b) *Reflects the insurer's view of the economic burden imposed on it by the presence of the uncertainty;*

(c) *Broadly consistent with the existing requirements of IAS 37;*

(d) *Reduces the amount of the residual margin for which the release pattern is somewhat arbitrary;*

(e) *Consistent with pricing of financial instruments which reflect the risk of the instrument.*

46 *Those that oppose the inclusion of an explicit risk adjustment do so because:*

(a) *No single technique for estimating the risk adjustment is universally accepted;*

(b) *Some techniques are difficult to explain and disclose to users;*

(c) *No current ability to perform direct back-tests to assess retrospectively whether a particular adjustment was reasonable;*

(d) *Some question whether the costs of developing systems to calculate a risk adjustment outweighs the benefits;*

(e) *The inclusion of an explicitly measured risk adjustment is inconsistent with the IASB's proposals on revenue recognition (a composite margin is more consistent);*

(f) *If the remeasurement of the risk adjustment results in a loss, will result in an inevitable reversal over the duration of the contract(s). This may be confusing.*

EFRAG's response

- **EFRAG supports the proposed separate recognition of a risk adjustment and a residual margin and not the recognition of a single composite margin.**
- **EFRAG also believes that the risk adjustment can be reliably measured and therefore can be explicitly included as a separate building block.**

47 We support the explicit recognition and measurement of a separate risk adjustment because:

(a) It separates two distinct elements of an insurer's liability;

(b) The different natures of the risk adjustment and residual margin require the release of both elements based on different patterns (i.e. over the claims period and coverage period, respectively);

(c) A separate risk adjustment could result in more contracts being determined as onerous on initial recognition, since its inclusion reduces the difference between the premiums and the present value of fulfilment cash flows. Given that we consider that including a risk adjustment reflects more accurately an insurer's view of its obligations under the contract, we consider this earlier recognition of onerous contracts provides more relevant information;

(d) It provides useful insight into an insurer's view about the uncertainty of its estimate of future cash flows arising from its insurance contracts and the uncertainty and risk affecting different products;

(e) EFRAG considers that given the nature of insurance portfolios and the way insurance businesses are managed, the uncertainty around estimates of cash flows is an important and material component of that business;

(f) In our view, it can be reliably measured. Unlike other liabilities that have uncertain amounts, in our view a risk adjustment can be reliably determined for an insurance contract because:

(i) Insurance contracts represent a bundle of contractual cash flows. In our view, a value representing the uncertainty in estimates of contractual cash flows can be more reliably measured than the uncertainty of non-contractual cash flows such as those arising from civil or criminal lawsuits.

(ii) A measure for the uncertainty of estimated future cash flows arising from an insurance contract will generally be considered when pricing that contract. It follows that the techniques used to measure that uncertainty for pricing purposes can also be used for accounting purposes.

(iii) Insurance contracts are generally grouped into portfolios that form large well-understood populations and insurers have a wealth of statistical information available. As a result the accuracy of estimates of future cash flows arising from these populations can be more reliably estimated.

48 Given that EFRAG considers that the risk adjustment provides useful information and can be reliably measured, we would not support a composite margin approach.

Question 5 – Risk adjustment

(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?

(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?

(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?

(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (i.e. a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

Notes to EFRAG's constituents

49 See notes to Question 4 regarding the characteristic of the risk adjustment and the reason why the IASB prefers a separate risk adjustment.

50 An insurer shall estimate the risk adjustment at the level of a portfolio of insurance contracts. Therefore, the risk adjustment shall reflect the effects of diversification that arise within a portfolio of insurance contracts, but not the effects of diversification between that portfolio and other portfolios of insurance contracts.

51 An insurer shall use only the following techniques for estimating risk adjustments: confidence level, conditional tail expectation, and cost of capital. The exposure draft outlines in paragraphs B91 to B103 the main features of those methods and application guidance.

52 Regardless of the method for measuring the risk adjustment, the insurer has to disclose the confidence level to which the risk adjustment corresponds.

EFRAG's response

- **EFRAG agrees that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.**

- **EFRAG believes that methods that can be used to measure the risk adjustment should not be limited. Instead, a principle should be developed that drives the selection of an appropriate measurement methodology.**
- **We disagree that the confidence level to which the risk adjustment corresponds should be disclosed. The insurer should generally be required to explain the level of prudence applicable in measuring the risk adjustment.**
- **EFRAG supports measuring the risk adjustment at the portfolio level. Additionally, EFRAG believes that diversification between portfolios should be taken into account under specific circumstances.**
- **The level of application guidance in Appendix B on risk adjustments is sufficiently detailed.**

Question 5(a) – Definition of the risk adjustment

53 We agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. We support this definition because we consider it is consistent with a fulfilment notion as it represents the entity's assessment of the risk. It can be differentiated from a 'transfer' or 'exit' notion that would represent the amount a market participant would charge in relation to the uncertainty in cash flows.

Question 5(b) – Techniques for estimating the risk adjustment

54 EFRAG is of the view, that the risk adjustment, along with the estimate of cash flows, should be remeasured each period.

55 Whilst we agree that the three techniques set-out in paragraphs B73-B90 would enable an entity to measure the risk adjustment reliably, we do not agree that it is necessary to limit the measurement to these techniques.

56 EFRAG would recommend limiting measurement techniques only on the basis of a stated principle. Stating a principle, rather than prescribing specific techniques would allow for the use of techniques that may be developed in the future.

57 In our view the ED should allow an entity to use the technique that results in the fair depiction of the maximum amount the insurer would rationally pay to be relieved of the risk arising from of the uncertainty in an insurance contract's cash flows. This principle is similar to the criteria used by the IASB to decide on the three techniques prescribed in the ED.

58 However, we recognise that limiting the choice of methods that can be used for measuring the risk adjustment enhances comparability. Therefore, we suggest that there should be a rebuttable presumption that an entity will use one of the three methods prescribed in the ED unless an entity can prove that a different method would be more appropriate as it better reflects the risks of its portfolio in the notes.

59 We acknowledge that the principle should be accompanied by clear disclosure requirements about the methodology used in determining the risk adjustment including why it meets the measurement objective.

Question 5(c) –Confidence level disclosure

60 EFRAG is concerned that requiring disclosure of confidence level information may bias the choice of the technique used for measuring the risk adjustment. The requirement creates an incentive to apply the confidence level technique, which is not necessarily the most appropriate approach in every circumstance. Alternatively, it may mean that many entities would, at least to some extent, apply two techniques to calculate the risk adjustment.

61 From a user perspective, EFRAG is also concerned that the disclosure of the confidence level, if this is not the most appropriate technique, would not be useful information.

62 We believe that users of financial statements need disclosures that give an indication of the prudence level of an insurer's operations (i.e. information on the riskiness of its insurance contracts). We agree with the proposals in the ED that this could be given by disclosure of confidence level information on a portfolio basis. However, in our view other disclosures could also provide this information. Therefore, we suggest requiring insurers to provide the following information about the methods used to estimate the risk adjustment (paragraph 90 of the ED):

(a) General description of the method used, the underlying assumptions and the input parameters;

(b) Information that explains the level of uncertainty about the amount and timing of the cash flows inherent in an entity's insurance contracts (for example this could be given by providing confidence level information, or by explaining how often it is expected that the actual insurance benefits paid will exceed the present value of fulfilment cash flows);

(c) Overall confidence level for regulatory purposes, if applicable;

(d) Reasons for choosing this methodology.

Question to constituents

Do constituents think that confidence level information provides useful information or do constituents think that other disclosures could provide equal information?

Question 5(d) – Risk adjustment: Level of aggregation and diversification

63 As we indicated in our response to Question 2, we consider that insurance contracts should be aggregated at the portfolio level for the purposes of estimating future cash flows. It therefore follows that we support measurement of the risk adjustment at the portfolio level.

64 Measurement of the risk adjustment at the portfolio level will naturally take into account the impact of diversification within the portfolio. EFRAG considers that diversification between portfolios should also be considered when measuring the risk adjustment, but only when:

(a) Insurers manage their portfolios in such a way that risks are offset (or increased) across portfolios because this means an alignment with the business model; and

(b) The insurer is able to legally and practically take advantage of the risk diversification. This means, there should be no legal or practical impediment to realising the diversification effects e.g. the legal restrictions that may exist between portfolios.

65 Where the above criteria are met, EFRAG considers that including the diversification effects between portfolios would more faithfully reflect how insurance contracts are managed. It would also reflect better the financial position of the company.

66 EFRAG considers that if diversification across portfolios has been taken into account when measuring the risk adjustment, the amount and nature of that diversification should be disclosed.

Question 5(e) – Level of detail of application guidance

67 We consider that the level of application guidance in Appendix B on risk adjustments is sufficiently detailed.

Question 6 – Residual/composite margin

(a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?

(b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?

(c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?

(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?

(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?

(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

Notes to EFRAG's constituents

68 An insurer shall recognise the residual margin determined at initial recognition as income in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage. This usually is on the basis of the passage of time, or on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

69 An insurer shall accrete interest on the carrying amount of the residual margin, using the discount rate specified in paragraph 30 as determined at initial recognition.

70 In result, the ED proposes to lock-in the residual margin and release it over the coverage period in a systematic way. The residual margin will not be recalibrated due to changes in estimates, e.g. when the discount rate changes.

71 An insurer shall initially determine the residual margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period.

EFRAG's response

- **EFRAG agrees with the proposed method for measuring the residual margin at inception and agrees that no gain should be recognised at the inception date. However, losses on initial recognition should be recognised immediately.**

- **EFRAG believe that the residual margin should be measured at portfolio level as all other building blocks.**

- **EFRAG agrees with the IASB's proposals regarding the pattern of release of the residual margin. However, in EFRAG's view the residual margin should be adjusted to offset the changes from remeasurement of the present value of the fulfilment cash flows.**

- **EFRAG disagrees with the accretion of interest on the residual margin.**

Question 6(a) – No gain at initial recognition

72 EFRAG agrees that an insurer should not recognise any gain at initial recognition of an insurance contract, because:

(a) This is in line with the selected measurement attribute of fulfilment value and the fact that the insurer is not earning any profit at inception but over the coverage period;

(b) The residual margin represents the estimated margin that will be earned during the term of the contract.

Question 6(b) – Losses recognised at initial recognition

73 We agree with the proposals in the ED that a loss at initial recognition of an insurance contract should be recognised immediately in profit or loss when the present value of the expected future cash outflows plus the risk adjustment exceeds the present value of expected future cash inflows. It would not be appropriate to defer losses over the coverage period. A loss on initial recognition is different to a residual margin as an initial loss does not relate to the reward the insurer earns from bearing risk and fulfilling the contract.

Question 6(c) – Level of aggregation

74 As we indicated in our response to Question 2, EFRAG considers that the level of aggregation for the measurement of insurance contracts should generally be at the portfolio level. Also the risk adjustment should be measured at the portfolio level (Question 5).

75 Because the residual margin is a product of components that will be measured at the portfolio level we consider that the residual should also be measured at the portfolio level.

Question 6(d) – Release of the residual margin

76 EFRAG agrees that the residual margin generally should be released in a systematic way that best reflects the exposure from providing insurance coverage.

77 However, we do not agree with the IASB's proposals regarding the release of the residual margin. In EFRAG's view the residual margin should be adjusted to offset changes from the remeasurement of the present value of the fulfilment cash flows. Any expense arising from a remeasurement of the present value of fulfilment cash flows that exceeds the residual margin should be recognised immediately in profit or loss. Thus, the residual margin cannot become negative.

78 Our reasons for this view are detailed below:

(a) In EFRAG's view, not allowing income and expenses resulting from the remeasurement of the fulfilment cash flows to be offset against the residual margin can lead to counterintuitive results. For example, under the proposals in the ED, an adverse change in the estimate of fulfilment cash flows arising from a portfolio of insurance contracts will result in a loss being recognised immediately in profit or loss. However, profit from the residual margin attributable to that same portfolio of contracts will continued to be recognised in that period and over the remaining coverage period.

(b) We consider that adjusting the residual margin for changes in estimates of future fulfilment cash flows is consistent with the methodology used at initial recognition of the insurance contract. At initial recognition the residual margin was calculated as the difference of these future estimates and the future premiums receivable. At a point in time estimates of future cash flows will change and therefore it seems consistent with the calculation at initial recognition, to adjust the residual margin in line with these re-estimates. We consider that the adjusted residual margin would better reflect the insurer's view of the profitability of the contract given current information. The adjustment should be both positive and negative up to the 'unearned' amount of the residual margin.

79 In order for subsequent measurement of the residual margin to be consistent with its measurement at initial recognition, EFRAG believes that changes in the assumptions/estimates relating to the current period or prior periods should be distinguished from changes impacting the insurance contracts future/expected profitability. As a result changes in assumption/estimates that have an impact on the current period or prior periods should be reflected in profit and loss. Changes in assumptions/estimates that have an impact on future periods should lead to an adjustment in the residual margin such that the residual margin represents the expected profitability of the contract at the reporting date.

80 This means that if there is a change in assumption or estimates impacting the present value of fulfilment cash flows, then the residual margin should be recalculated as if the change had been known at the time of the contract's inception. This revised residual margin would then be amortised over the coverage period, resulting in a 'catch-up' adjustment in profit or loss for current period and prior periods and recognising the remaining profitability over the remaining coverage period based on the new amortisation schedule.

We also understand that from a user perspective, a residual margin that is released independently of the movements in the other building blocks does not provide useful information. EFRAG acknowledges that adjustments to the residual margin must be transparent and therefore must be accompanied by appropriate disclosure.

Question to constituents

With respect to accounting for changes in estimates we refer to Appendix 2, which provides a summary of possible accounting mismatches caused by the interaction between IFRS 9 and the proposals in the ED. EFRAG asks constituents' input on this issue.

Question 6(e) – Release of the composite margin

81 As we indicated in our response to Question 4, EFRAG does not support the composite margin approach. On this basis and in line with our response to question 6(d) above we do not support the method of accounting proposed for the release of the composite margin.

Question 6(f) – Accretion of interest on the residual margin

82 The residual margin represents the difference between the present value of fulfilment cash flows and the premium at inception and thus depends on the measurement of the other building blocks.

83 If a change in assumptions/estimates leads to an adjustment to the residual margin the accretion of interest would be inconsistent with our view that the residual margin should only be remeasured for changes in assumptions/estimates.

Question 7 – Acquisition costs

Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

Notes to EFRAG's constituents

84 Insurers often incur significant costs to sell, underwrite and initiate a new insurance contract. These costs are commonly referred to as acquisition costs. The ED proposes that, at initial recognition, an insurer shall include incremental acquisition costs in the present value of the fulfilment cash flows and recognise all other acquisition costs as an expense when incurred.

85 Incremental acquisition costs are those costs of selling, underwriting and initiating a contract that the insurer would not have incurred if it had not issued that particular contract. The IASB proposed to limit acquisition costs to be included in the cash flows to incremental costs because those costs can be clearly identified and such limitation is consistent with how IAS 39 and IFRS 9 determine the transaction costs of financial instruments.

86 By including acquisition costs in the contract cash flows, the residual margin at initial recognition of the contract will be reduced. If the cash inflows expected to arise on the *insurance contract are insufficient to recover all the incremental acquisition costs, a loss will arise at initial recognition.*

EFRAG's response

- **EFRAG agrees that incremental acquisition costs should be included in the present value of the fulfilment cash flows. We believe the level of measurement is the portfolio as we support a uniform level of measurement.**

Acquisition costs included in estimate of fulfilment cash flows

87 EFRAG agrees that acquisition costs should be included in the initial measurement of the insurance contract as contract cash outflows for the following reasons:

(a) In EFRAG's view, acquisition costs are a necessary and unavoidable part of the fulfilment costs of the contract;

(b) On the basis that acquisition costs are compensated by the premiums paid under an insurance contract, then expensing acquisition costs on initial recognition would be inconsistent with recognising the attributable compensation when the residual margin is released. In EFRAG's view recognising a day one loss on an otherwise profitable contract does not provide useful information.

Incremental acquisition costs only

88 EFRAG agrees that only acquisition costs that relate to recognised insurance contracts should be included in the estimate of cash flows. We therefore agree that acquisition costs relating to unsuccessful underwriting should be expensed as they do not relate to a recognised insurance asset or liability. Likewise, we agree that if the contract pricing is insufficient to recover all of the relevant acquisition costs, a loss should be recognised at initial recognition.

89 EFRAG therefore agrees that acquisition costs should be limited to incremental costs. We consider that acquisition costs relating to successful insurance contracts should form part of the contractual cash flows if those costs can be clearly identified as relating specifically to the contracts.

90 However, we do not agree to limit the measurement of acquisition costs to the level of the individual contract. As we indicated in our response to Question 2, EFRAG believes that the level of measurement for insurance contracts is the portfolio and this should be consistently applied.

SHORT-DURATION CONTRACTS

Question 8 – Premium allocation approach

(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?

(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

Notes to EFRAG's constituents

91 *The ED requires a simplified/shortcut measurement approach for certain short-term insurance contracts. This approach is referred to as the premium allocation approach or unearned premium approach.*

92 *The premium allocation approach applies to contracts that have a coverage period of approximately one year or less, and that do not contain embedded options or other derivatives that significantly affect the variability of cash flows.*

93 *Under the premium allocation approach, an insurer will have pre-claims and claims liabilities. A pre-claims liability is the obligation reported before claims are expected to be incurred. A (post) claims liability is the obligation reported after claims are expected to have been incurred. The combined value of the pre-claims liability and the claims liability represents the reported measurement of the insurance liability.*

94 *The ED proposes that the pre-claims liability is calculated initially as the present value of the premiums expected to be received under the contract less incremental acquisition costs. For eligible insurance contracts, these amounts are generally paid up front and released into income over the duration of the contract (usually reflecting the passage of time), adjusted to reflect actual claims activity or other relevant circumstances.*

95 *The ED proposes that the claims liability of these contracts is measured at the present value of the fulfilment cash flows. This means the insurer has to measure claims liabilities using three building blocks (i.e. estimate of fulfilment cash flows, adjusted for the time value of money, plus a risk adjustment). Setting up a residual margin is not necessary as the release of the pre-claims liability (the unearned part of the premium) includes the residual margin to be released. The (post) claims liability will be recognised at each reporting date considering all claims that are expected to have been happening in the expired reporting period. In result, while the pre-claims liability will be smaller over the course of the coverage period, the claims liability will increase from reporting period to reporting period (quarter to quarter). This procedure is in line with what many companies currently do regarding there property and casualty business.*

96 *Regarding rather short and simple contracts, in particular regarding the pattern of expected claims, this approach is mathematically, regarding the total amount of insurance liabilities, a reasonable approximation compared to the full prospective approach.*

97 *If an insurance contract is onerous, the insurer shall recognise an additional amount (balance sheet and expense) such that the total insurance liability is equal to the present value of the fulfilment cash flows. This additional liability is assessed at each reporting date at a portfolio level and can be reversed to the extent that the insurance contract is no longer onerous.*

EFRAG's response

- **EFRAG believes that a modified measurement approach should only be allowed for short-duration contracts with a coverage period of one year or less.**

- **EFRAG considers the modified measurement approach for the measurement of a pre-claims liability on certain short-duration contracts is an acceptable measurement methodology as it is a reasonable proxy for the full measurement model proposed in the ED. We do however have concerns as to whether the modified approach represents a simplification over the full measurement model.**
- **EFRAG considers that the modified measurement approach should not be a requirement for short-duration insurance contracts. Instead an insurer should be able to apply the full measurement model proposed in the ED to all insurance contracts.**
- **We do not believe that the pre-claim liability should accrete interest.**

98 The ED proposes a modified measurement approach for the pre-claims liabilities of some short-duration contracts. We understand that under this measurement approach the pre-claims liability of an insurance contract is measured separately (and differently) from (post) claims liabilities. The pre-claims liability is measured as the unearned premium and allocated to profit or loss, following the same principle as for the release of the residual margin. The claims liability is measured on the same basis as other insurance contracts, except that no residual margin is included. Together they constitute the balance sheet liability.

99 We agree that the use of the premium allocation approach should be limited as the method is an exemption. We therefore agree that the proposed modification should be for short duration contracts only. We believe, however, that the IASB should set an explicit coverage period of one year or less.

100 That said, we understand that the IASB has proposed this approach because it is a simplification to the full measurement approach, but still provides a reasonable proxy of the present value of the fulfilment cash flows and the residual margin for some insurance contracts. We therefore agree with the IASB's objective to provide a pragmatic, simplified approach for certain short-duration contracts. However, given the need to estimate the post claims liability on the same basis as longer duration insurance contracts, we question whether the proposals result in any significant level of simplification.

101 In addition, EFRAG does not agree that the premium allocation approach should be mandatory for relevant contracts. In our view, the premium allocation approach represents a proxy for the full measurement methodology and therefore should not preclude a reporting entity from applying the full methodology which, in our view, would provide similar but more accurate measurement results. We do not consider that allowing some entities to providing more accurate measurements under the full methodology would impede comparability. In fact it would enhance comparability between insurance contracts held by that entity.

102 We generally think that the accretion of interest in the pre-claim liability should be consisted with treatment of the residual margin within the full current measurement approach. For this reason and because the premium allocation approach is a simplified measurement approach, we believe that the pre-claim liability should not accrete interest.

Question 9 – Contract boundary principle

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

Notes to EFRAG's constituents

103 *Determining the boundary of an insurance contract is important as it enables an insurer to identify the future cash flows that are expected to arise as the insurer fulfils its obligation. The ED provides that the measurement of an insurance contract shall include premiums and other cash flows (e.g. claims and expenses) resulting from those premiums if, and only if:*

(a) *The insurer can compel the policyholder to pay the premiums, or*

(b) *The premiums are within the boundary of that contract.*

104 *Thus, cash flows that are expected to arise from the existing contract should be included in the liability measurement. Cash flows arising from future contracts are not included.*

105 *The ED defines the boundary of an insurance contract as the point in time at which an insurer either:*

(a) *Is no longer required to provide coverage; or*

(b) *Has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set the price that fully reflects that risk. In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance.*

EFRAG's response

- **EFRAG supports the contract boundary as defined in the ED.**
- **In order to achieve a consistent application, the IASB should provide more extensive application guidance.**

106 As we discussed in response to Question 2(a), EFRAG supports the IASB's decision to recognise and measure insurance contracts on the basis of the net cash flows arising from each contract. An insurance contract reflects a bundle of rights and obligations that include options held by a policyholder to cancel or renew a contract.

107 EFRAG also supports the proposed definition of a contract boundary. We support the incorporation of criteria based on the insurer's contractual ability to re-price an insurance contract based on a reassessment of risk of the particular policyholder. We believe that the ability to re-price as a result of such policyholder risk is a key element in determining the contract boundary.

108 We suggest the Board considers including as application guidance some examples regarding specific insurance contracts in order to ensure consistent application in practice.

109 Paragraph BC57 of the ED explains that an ability to re-price that does not mean a reassessment of the individual policyholder's risk profile will lie within the boundary of an existing contract.

110 However, different contracts may contain different features, for example in group insurance policies the policyholder may not be clear. In these contracts individual policies are part of the overall contract and it is not clear if the risks of those individual policies should be taken into account to define the contract boundary. We think in this case the contract boundary is assessed at the group level. There may be other examples. Therefore the definition should be more clear, or the IASB should provide more extensive implementation guidance.

111 We note that paragraph B61(j) of the ED refers to future policyholders. It is not clear to us why future policyholders, with whom an insurer does not yet have a contractual relationship, would be relevant in this context. Therefore, we would like to ask the IASB to explain and clarify this paragraph.

PARTICIPATING FEATURES

Question 10 – Participating features

(a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?

(b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?

(c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?

(d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

Notes to EFRAG's constituents

112 Some insurance contracts contain participating or 'with profits' features. These features give the policyholder the right to share in the experience of a portfolio of insurance contracts, specified assets held by the insurer or both. The insurer can have contractual discretion over the amount or timing of distributions, although the discretion is often subject to some contractual, regulatory, or competitive constraints. Generally insurers and policyholders will expect a certain level of distribution unless the portfolio performs significantly worse than expected.

113 A feature will be considered as a discretionary participating feature if it provides benefits that are additional to any guaranteed benefits:

(a) *That are likely to be a significant portion of the total contractual benefits;*

(b) *Whose amount or timing is contractually at the discretion of the issuer; and*

(c) *That is based on the performance of pool or specified type of insurance contracts, specified pool of assets held by the issuer or the profit or loss of the company, fund or other entity that issues the contract.*

114 The ED proposes not to limit the cash flows included in the measurement of an insurance contract to those for which there is a legal or constructive obligation. This means that in estimating the future cash flows the discretionary participating features (whether legal, constructive or otherwise) will be treated as any other expected cash outflows.

115 Although a financial instrument with participation features does not include significant insurance risk, the IASB also decided to include these types of contracts in the scope of the standard if it includes a discretionary participating feature. It is proposed that such a financial instrument will be within the scope of the insurance standard if similar participation features (i.e. right to participate in the same insurance contracts, assets or company performance) exist in insurance contracts.

116 In addition, the ED provides the following specific guidance (that overrides other provisions in the ED relating to insurance contracts) relating to financial instruments that contain discretionary participating features:

(a) *The boundary of the contract is the point at which the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature;*

(b) *The residual margin for a financial instrument with a discretionary participation feature shall be recognised as income in profit or loss over the life of the contract in a systematic way that best reflects the asset management services; this will be usually the passage of time.*

EFRAG's response

- **EFRAG agrees that the liability for discretionary participation features should be measured on an expected cash flow basis.**
- **We agree that financial instruments with discretionary participation features should be within the scope of the insurance standard since the inclusion results in the consistent treatment with similar features in insurance contracts.**
- **We consider that all financial instruments with discretionary participation features should be measured consistently. We therefore disagree that only financial instruments with discretionary participation features that share the performance of a pool of assets with insurance contracts with discretionary participation features should be within the scope of the insurance standard.**
- **We agree to the definition of discretionary participating features, except for the provision that there should also exist insurance contracts that provide similar contractual rights. We believe the same accounting treatment should be extended to all similar benefits.**
- **The modifications regarding the investment contracts with discretionary participating features are appropriate.**

Question 10(a) – Measurement of insurance contracts includes participating features

117 EFRAG agrees that expected cash outflows from discretionary participation features should be included in the estimation of future cash flows of an insurance contract for measurement purposes, because they are integral to the contract.

Question 10(b) – Financial instruments with discretionary participation features are in the scope

118 Although financial instruments with discretionary participating features do not transfer significant insurance risk we agree that these contracts should be in the scope of the insurance accounting standard because:

(a) The inclusion results in the consistent treatment with similar participating features in insurance contracts;

(b) In EFRAG's view the current provisions of IAS 39 *Financial Instruments: Recognition and Measurement* and the proposed provisions relating to liabilities in IFRS 9 *Financial Instruments* would not provide the most representative measure for contracts with discretionary participation features. For example splitting the complex package of independent options and guarantees into its components may not provide a faithful representation of the contract as a whole.

Question 10(c) – Investment contracts participate along with insurance contracts

119 As indicated above, we agree with the IASB's proposal to include financial instruments with discretionary participation features within the scope of the insurance standard. We therefore do not understand why the IASB proposes to limit the scope-in to such contracts only if they share the performance of the same pool of assets as do participating insurance contract.

120 In our view, if discretionary participation features are to be treated consistently whether they are embedded in insurance contracts or financial instruments, it should not be restricted to situations where both participate in the performance of the same pool of assets. For that reason we would not support making the scope-in subject to this restriction.

Question 10(d) – Modification of the measurement provisions for financial instruments with discretionary participation features

121 EFRAG considers that the proposals in the ED to modify the measurement requirements regarding contract boundaries and the release of the residual margin are appropriate.

122 As financial instruments with discretionary participating features do not include significant insurance risk it follows that the contract boundary of such contracts cannot be defined by reference to insurance risk. We consider that setting the contract boundary at the point where the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature is appropriate.

123 We also agree that linking the release of the residual margin to the asset management service is appropriate.

DEFINITION AND SCOPE

Question 11 – Definition and scope

(a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?

(b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?

(c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

Notes to EFRAG's constituents

124 *The ED applies to insurance contracts (including reinsurance contracts) that an insurer issues, reinsurance contracts that it holds, and certain financial instruments that contain a discretionary participation feature.*

125 *The definition of an insurance contract is based on whether the contract includes significant insurance risk by compensating the policyholder if a specified uncertain future event adversely affects the policyholder.*

126 *The definition and scope proposals in the ED are similar to current provisions of IFRS 4. There are however two changes in the definition:*

(a) *In addition, a contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums.*

(b) *The insurer takes into account the effect of the time value of money in determining whether it will pay significant additional benefits.*

127 *Furthermore, the ED clarifies the treatment of financial guarantees (referred to as 'credit insurance' in paragraph B18(g) in the ED). IFRS defines a financial guarantee contract as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument.*

128 *The ED proposes that all financial guarantees that meet the definition of an insurance contract should be treated as an insurance contract. For the guarantee to be an insurance contract, it is key that the holder actually incurs a loss.*

129 *Fixed-fee service contracts that have as their primary purpose the provision of services, but expose the service provider to risk because the level of service depends on an uncertain event, are excluded from the scope of the ED. For example maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction will be outside of the scope of the ED. However, an insurer shall apply this IFRS to insurance contracts in which the insurer provides goods or services to the policyholder to compensate the policyholder for insured events.*

130 *Paragraph BC209 of the ED clarifies that fixed-fee service contracts are only excluded if their primary purpose is the provision of services. In the IASB's view there should be no change in accounting practice for fixed-fee service contracts since 'changing the existing accounting for these contracts would impose costs and disruptions for no significant benefit'.*

EFRAG's response

- **EFRAG agrees with the definition of an insurance contract, the scope and the guidance, but with respect to the exclusion of fixed fee contracts from the scope of the standard we believe the criteria for exclusion are not clear enough.**
- **Regarding financial guarantee contracts, we believe those contracts should be assessed in the same way as other contracts to determine if they are insurance contracts or financial instruments.**

131 The definition of insurance contract is largely the same as the definition in the current IFRS 4. The additional requirement to take into account the time value of money affects the assessment of the significance of insurance risk and improves the ability to differentiate between a financial contract and an insurance contract. We understand that making this requirement explicit will not change current practice under IFRS.

132 Although financial instruments with discretionary participating features do not include significant insurance risk we agree that these contracts should be in the scope as the inclusion results in the consistent treatment with similar participating features in insurance contracts. Please see also our comments regarding Question 10.

133 Regarding the exclusion of fixed-fee service contracts we note that the distinction between contracts is not clear-cut. Fixed fee service contracts will often meet the definition of an insurance contract and we understand from the Board's reasoning in paragraph BC209 of the ED that contracts issued by companies that provide services should be excluded, if providing such services is the main purpose of the contract. However, paragraph 4(e) requires an insurer that has insurance contracts in which goods and services are provided for insured events to apply the insurance standard. We think the Board should clarify the wording, as it is ambiguous and likely to result in many implementation issues.

134 We understand that some financial guarantee contracts are currently out of the scope of IFRS 4 for practical reasons. The ED proposes that financial guarantee contracts are assessed in the same way as other contracts to determine if they are insurance contracts or financial instruments. We agree with this approach as the scope determination will reflect the substance of the underlying contract.

Question to constituents

The ED proposes to exclude fixed fee service contracts from the scope of the standard if the primary purpose of the contract is the provision of services. EFRAG supports the Board's reasoning, however EFRAG does not find the criteria to assess whether or not a contract is in the scope of the standard to be clear enough.

Do you agree with the Board's intent that contracts whose primary purpose is the provision of services should be out of the scope of the standard, even if they meet the definition of the insurance contract?

Do you share EFRAG's concerns about the wording of the scope exclusion?

Question to constituents

The proposals in the ED will bring financial guarantee contracts that meet the definition of an insurance contract within the scope of the new insurance standard.

Do you think there could be a reason to exclude financial guarantees from the scope of the insurance standard?

Financial guarantees are currently in the scope of IAS 39, except for those contracts that are explicitly 'selected' and treated as insurance contracts. IAS 39 requires such contracts to be measured at the higher of the amount determined in accordance with IAS 37 and the initially recognised amount less cumulative amortisation.

The proposed amendments to IAS 39 mean that a financial guarantee contract that does not meet the definition of an insurance contract should be measured as a derivative in accordance with IAS 39. Do you agree with these classification and measurement requirements?

UNBUNDLING

Question 12 – Unbundling

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

Notes to EFRAG's constituents

135 The ED proposes that components of an insurance contract should be unbundled (recognised and measured separately) if these components are not closely related to the insurance coverage. This general principle is accompanied by specific examples for which components that are not closely related and hence unbundling is required. Thus, the following components have to be unbundled:

(a) *An investment component reflecting an account balance that meets both of the following conditions:*

(i) *The account balance is credited with an explicit return; and*

(ii) *The crediting rate for the account balance is based on the investment performance of the underlying investments, namely a specified pool of investments for unit-linked contracts, a notional pool of investments for index-linked contracts or a general account pool of investments for universal life contracts. That crediting rate must pass on to the individual policyholder all investment performance, net of contract fees and assessments. Contracts meeting those criteria can specify conditions under* *which there may be a minimum guarantee, but not a ceiling, because a ceiling would mean that not all investment performance is passed through to the contract holder.*

(b) *An embedded derivative that is separated from its host contract in accordance with IAS 39.*

(c) *Contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.*

136 IFRS 9 requires bifurcation in accordance with IAS 39 if the host is not within the scope of IFRS 9. Consequently, an embedded derivative in an insurance contract has to be bifurcated if the insurance coverage and the derivative are not closely related.

EFRAG's response

- **EFRAG agrees that unbundling can enhance the usefulness of information by increasing transparency and comparability.**
- **EFRAG is concerned that the term 'closely related' is not clearly defined and we would like to understand why the IASB has changed the wording from cash flows which are 'interdependent' to cash flows which are 'closely related'.**
- **The underlying principle should be further clarified as unbundling can appear contradictory to the decision in the proposals not to split insurance contracts into different components.**
- **We suggest the IASB consider that if an insurer manages separately different components of a product, then unbundling may be appropriate. If they are managed together then they may be considered as one contract.**

137 As we indicated in our response to Question 2, EFRAG agrees that the measurement of an insurance contract should combine both cash inflows and cash outflows generated by its insurance, financial and service elements. However, EFRAG recognises that in some circumstances unbundling the non-insurance components can increase transparency allowing users of financial statements to get an insight into the non-insurance components of insurance contracts.

138 EFRAG believes that unbundling is appropriate when separate recognition and measurement of the components better reflects the substance of the instrument and thus provides more useful information. We agree with the IASB that proposing unbundling when components are not closely related to the insurance coverage is heading in the right direction. Where components are not closely related to the insurance coverage, measuring cash flows arising from the non-insurance component as if it was an insurance contract would not produce relevant information. In addition comingling those cash flows with insurance related cash flows can obscure the true nature of the risks arising from both the insurance and financial component.

139 However, we consider that the proposals in the ED do not go far enough to provide guidance on how to interpret the term 'closely related'. In particular we are concerned that the guidance in paragraph 9(a) that introduces the term is made-up primarily of specific examples. However, specific examples may not sufficiently cover the nature of contracts to be considered. We also note the difficulties encountered by constituents in interpreting a similar requirement for embedded derivatives in paragraph 11(a) of IAS

39. So although we agree with the examples in paragraph 8(a) of the ED, we consider that further guidance may be needed.

140 We note that in paragraph 9, the ED proposes to require that an entity separate charges and fees from the investment component, while in paragraph 8 the investment results should be considered net of fees and charges. We recommend that the IASB clarify which charges are meant in each paragraph.

Questions to constituents

Do you agree that unbundling can enhance the usefulness of information by increasing transparency and comparability?

Do you agree the underlying principle should be further clarified especially how the terms closely related and interdependent should be interpreted in the context of unbundling?

Do you believe the guidance and examples in the ED change the current practice of unbundling?

Do you think the way a product is structured and monitored may present an appropriate basis for deciding if components of the insurance contracts should be unbundled?

PRESENTATION

Question 13 – Presentation

(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?

(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

Notes to EFRAG's constituents

141 The ED proposes that an insurance contract should be presented in the financial statements using a 'summarised margin' approach. This approach reflects all cash inflows associated with an insurance contract as deposits received from its policyholders and all the cash outflows as repayments to policyholders. It does not present any items of income or expense relating directly to those cash flows. The volume information on premiums, claims and expenses will be required in the disclosures, except for short-duration contracts; for those the insurer has the option to present volume information either on the face of the income statement or in the notes.

142 On the statement of financial position, an insurer shall present each insurance contract as a single item within insurance contract assets or insurance contract liabilities. Liabilities arising from unit-linked contracts and the underlying assets should be presented as separate line items.

143 There will be no significant change regarding presentation on the statement of financial position. The only difference will be that deferred acquisition cost assets will not be reported as these costs will either be expensed or form part of the cash flow estimate of the insurance liability.

144 *The following line items should be presented on the statement of comprehensive income:*

(a) *The underwriting margin, disaggregated (either on the face of the statement of comprehensive income or in the notes) into:*

(i) *The change in the risk adjustment;*

(ii) *The release of the residual margin.*

(b) *Gains and losses at initial recognition, disaggregated either in the statement of comprehensive income or in the notes into:*

(i) *Losses on insurance contracts acquired in a portfolio transfer;*

(ii) *Gains on reinsurance contracts bought by a cedant;*

(iii) *Losses at initial recognition of an insurance contract.*

(c) *Acquisition costs that are not incremental at the level of an individual contract.*

(d) *Experience adjustments and changes in estimates disaggregated either on the face of the statement of comprehensive income or in the notes, into the following:*

(i) *differences between actual cash flows for the current period and previous estimates of those cash flows (experience adjustments);*

(ii) *Changes in estimates of cash flows and changes in discount rates;*

(iii) *Impairment losses on reinsurance assets;*

(e) *Interest expense on insurance liabilities ('unwinding' of the discount).*

EFRAG's response

- **EFRAG supports the proposals for the presentation in the balance sheet.**
- **EFRAG also supports a margin based approach for the statement of comprehensive income because it is driven by the measurement model and because margins provide decision-useful information.**
- **EFRAG considers that volume information, such as premiums written, claims expenses, and claims handling expenses, should be presented on the face of the statement of comprehensive income for all insurance contracts next to the underwriting margins. Thus, we are in favour of a margin approach combined with volume information**
- **We do not think the expanded margin approach as developed by the IASB is appropriate as the numbers are contrived.**
- **EFRAG does not support the proposal to require all income and expenses arising from insurance contracts to be reported in profit or loss. In our view, income and expenses arising from certain changes in estimates should be offset against the residual margin.**
- **Where participating features relate to equity securities measured at fair value though OCI, it may be appropriate to report some income or expenses in OCI.**

145 EFRAG agrees with the IASB's proposal for presentation of insurance contracts in the balance sheet as a net presentation of the rights and obligations arising from insurance contracts.

146 We broadly support a margins-based model for the presentation in the statement of comprehensive income because we consider that such an approach provides the best link with the measurement model proposed in the ED.

147 However, EFRAG does have concerns about how this has been developed into the summarised margin approach. These concerns are detailed below.

<u>Volume information should be presented on the face of the income statement</u>

148 We understand that volume information about insurance contracts has historically been reported on the face of the statement of comprehensive income by many entities. Such reporting presents insurance contracts' inflows (e.g. premiums) as revenue and the outflows (e.g. claims, claims handling costs, etc) as expenses. Paragraph 74 of the ED proposes that volume information will no longer be allowed to be presented on the face of the income statement.

149 EFRAG considers that both margin and volume information is key to understanding the performance of an insurer and should be included in the financial statements for the following reasons:

(a) We consider it provides, in many cases, valuable information about the level of activity of the insurer. As indicated in paragraph AV13 of the ED we believe that 'Insurance can be described as being paid to assume risk, reimburse insurance claims, have some internal expenses and possibly earn a financial return between the payments of premiums and claims'. We agree with those Board members that consider that financial statement presentation should reflect this information.

(b) In our view gross flows are easier to predict than the net flows. Similarly, an increase in the net profit could result from an increase in margins or an increase in volume, but this would be difficult to determine if information about the gross cash flows was not transparent.

150 However, we also recognise that margin information is better suited to some insurance products (e.g. life products) and revenue (volume) information better suited to others (e.g. non-life products). For example, revenue is less informative for products with a deposit component, since these deposits may increase revenue, which is based on the level premiums, but does not provide any information about profitability[2]. Profitability is better presented by the margins approach and links directly into movements in the balance sheet, but it does not provide information about the level of activity of the insurer.

151 In the case of insurance contracts with significant service elements, we believe that the summarised margin approach would provide insufficient decision-useful information. Instead, we believe that if significant service elements exist, they should be presented

[2] Although the deposit element may become a component of profit if it reverts to the insurer on (untimely) death.

in the same way as services that are accounted for under the Revenue Recognition proposals.

152 As a result we consider that a margin approach, similar to the requirements in paragraph 75 for short duration contracts should be developed. This approach would provide a link between the measurement (building block approach) and also provide information about volumes (premiums). We consider this information should be on the face of the financial statements.

153 We note that the views expressed in this comment letter with respect to presentation of insurance contracts do not relate to views that we may have with respect to the project for financial statement presentation.

<u>Optional presentation approach for short-duration contracts</u>

154 The ED proposes to require a pure margin approach for the presentation of insurance contracts, other than short-duration contracts that meet the conditions in paragraph 54 of the ED. It is proposed that these short-duration contracts should be accounted for under the premium allocation approach (as specified in paragraphs 55-60 of the ED). In terms of presentation of short-duration contracts, the ED requires that a reporting entity presents the underwriting margin on the face of the statement of comprehensive income, but also gives the entity the option to disaggregate that margin into volume information on the face of the statement for comprehensive income (see paragraph 75(a) of the ED).

155 EFRAG does not support a mandatory application of the modified measurement approach, but no alternative presentational methods should be allowed for insurers that apply this approach as that would reduce comparability. For example, if a company uses the approach in paragraph 75 for its short-duration contracts, the amounts shown in the statement of comprehensive income of that company (e.g. premium income) may be disproportionately high in comparisons to similar companies that did not use the approach. In addition, it will make presentation between the long-duration and short-duration businesses inconsistent. That is, the long-duration business will be only presented in the statement of comprehensive income by the release of margin which is not comparable with the 'gross flows' presentation provided for short-duration contracts. We therefore consider that the approach in paragraph 75(a) of the ED should be a required presentation on the face of the statement of comprehensive income as we also prefer it for long-duration contracts.

<u>Information to be provided in the statement of comprehensive income or in the notes</u>

156 Sub-paragraphs 72(a), (b) and (d) of the ED provide reporting entities with the option to present relevant measurement results on the face of the statement of comprehensive income or in the notes. Unlike volume information, we do not consider that disaggregated information set out in paragraph 72 is necessary on the face of the statement of comprehensive income. We are in favour of a concise income statement as possible. In addition, we consider that the provision of options decreases comparability. We therefore consider that the disaggregation options in paragraph 72 should be required disclosures only.

<u>All income and expenses recognised in profit or loss</u>

157 Paragraph 76 of the ED provides that all income and expenses from insurance contracts should be recognised in profit or loss. EFRAG has two concerns arising from this proposal, which we discuss below.

Changes in estimates offset against the residual margin

158 In accordance with our response to Question 6 of the ED, EFRAG considers that certain income and expenses that arise from changes in the present value of the fulfilment cash flows should not be reported in profit or loss, but rather should offset the residual margin.

Other comprehensive income (OCI)

159 The IASB proposes not to allow any changes in value of an insurance contract to be reported in OCI. However, because the changes in the fair value of equity securities can be reported in OCI in accordance with IFRS 9, there is a concern that an accounting mismatch could be created. This would occur, where under the terms of an insurance contract (or certain financial instruments) with participating features, the insurer will recognise the change in the equity instruments in OCI, while the change in the linked participating feature will be recognised in profit or loss.

160 EFRAG acknowledges that this mismatch could be significantly mitigated by the insurer not electing to classify the equity security at fair value through OCI, but instead reporting it at fair value through profit or loss. If it is appropriate to allow the use of OCI in IFRS 9, insurers should not be deprived from that election because it would create an accounting mismatch.

161 We refer to appendix two in which we provide an overview of the issues identified in relation to accounting mismatches.

Other comments

162 With respect to paragraph 72 of the ED, we are uncertain where a change in the estimate of the risk adjustment would be presented. We assume it would be presented in accordance with paragraph 72(d) but consider that this interpretation is not clear. We therefore recommend that the scope of paragraph 72(d) is clarified with respect to changes in estimates of the risk adjustment.

163 We are unsure what the IASB is trying to achieve in paragraph 73 of the ED. We think it is based on the understanding that assets and liabilities in a balance sheet are somehow linked. We do not agree with this view. Except in cases where policyholders have a legal claim on certain assets, any other linkage would exist only in theory. We would recommend the requirements of paragraph 73 are either removed or the IASB clarifies what it is proposing either through examples or further guidance.

DISCLOSURES

Question 14 – Disclosures

(a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?

(b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?

(c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

Notes to EFRAG's constituents

164 *The objective of the proposed disclosure requirements is to help users of financial statements understand the amount, timing and uncertainty of cash flows arising from insurance contracts. An entity shall disclose qualitative and quantitative information about:*

(a) *The amounts recognised in its financial statements arising from insurance contracts; and*

(b) *The nature and extent of risks arising from those contracts.*

165 *The IASB used the disclosure requirements in IFRS 4 as a basis for its proposals. In addition, the Board proposes to require the following disclosures:*

(a) *More detailed reconciliations of line items;*

(b) *More detailed explanation of methods, inputs and processes used in the measurement;*

(c) *Confidence level of the risk adjustment;*

(d) *Measurement uncertainty analysis; and*

(e) *The effect of the regulatory framework in which the insurer operates.*

EFRAG's response

- **We agree with the proposed disclosure principle and broadly agree with the proposed disclosure requirements.**
- **EFRAG considers that volume/revenue information regarding all insurance contracts should be shown on the face of the statement of comprehensive income for all types of insurance contracts.**
- **EFRAG considers that the disaggregated amounts proposed as presentation requirements in sub-paragraphs 72(a), (b) and (d) should be required as disclosures in the notes.**

Question 14(a) – Disclosure objective

166 EFRAG agrees with the proposed disclosure objective, set out in paragraphs 79-80 of the ED, to provide information that enables users to understand the amount, timing and uncertainty of future cash flows arising from insurance contracts.

167 However, we note the proposal in paragraph 83 of the ED that information shall not be aggregated if it relates to different reportable segments, as defined in IFRS 8 Operating Segments ('IFRS 8'). As IFRS 8 reporting is based on a reporting entity's internal reporting structure and information requirements, it seems unlikely that the summarised margin approach would form the basis for this internal reporting. Therefore, whilst we understand that the IASB wants to prohibit aggregation of information at the segment level for the purposes of the disclosure requirements proposed in the ED, we consider that such aggregation is unlikely to occur in practice and therefore the prohibition seems superfluous.

Question 14(b) – Explanation of recognised amounts

Reconciliation of contract balances

168 EFRAG broadly agrees with the disclosure requirements set out in paragraphs 86 to 87 of the ED and considers they meet the disclosure objective. In our view the proposed measurement model is the fundamental basis underlying the new regime for accounting and reporting of insurance contracts. We therefore think it is critical to provide transparent disclosures about the movement, during a reporting period, in the reported values of insurance contracts.

169 As mentioned in our response to Question 13, we consider that volume/revenue information regarding insurance contracts is very important to the users of an insurer's financial statements. Although we recognise that the proposed disclosure requirements in paragraphs 86-87 will provide this information, we reiterate our view that this information should be shown on the face of the statement of comprehensive income for all types of insurance contracts.

170 In addition, we have the following minor concerns regarding these disclosure proposals:

(a) There is no requirement to show ceding commissions separately, while there is a requirement to show incremental acquisition costs. We find this requirement inconsistent as these commissions are relevant information.

(b) We see no separate line item for discounting (and unwinding). It may be covered by sub-paragraph 87(f) that requires disaggregation of income and expenses but this is not clear. We consider it should be a separate line item, since this would be much more transparent and fully in line with the building block approach;

171 We recommend to clarify the disclosure requirements by including some examples in the application guidance.

Methods and inputs

172 EFRAG agrees that an insurer should disclose information about the methods and inputs used to develop the measurements of insurance contracts. This information is crucial for a user to understand how and upon what basis the measurement amount attributable to contract was determined. It therefore provides information on the amounts recognised and meets the disclosure objective.

173 However, we do have the following minor comments regarding these disclosure proposals:

(a) Paragraph 90(a) of the ED requires that quantitative information about inputs is required unless it is impracticable. Given the whole measurement model is based on quantitative inputs, we do not agree that the requirement to provide quantitative information about inputs should be limited.

(b) Paragraph 90(d) of the ED requires a measurement uncertainty analysis of inputs that takes into account the effect of correlation where relevant. Such an analysis provides a realistic economic alternative value to the amount presented in the financial statements. EFRAG believes this is meaningful information. EFRAG also agrees that correlation is an important factor in providing a meaningful analysis of measurement uncertainty where that correlation is relevant and significant. In our view, a measurement uncertainty (sensitivity) analysis that considers correlation between inputs provides more relevant information than a similar analysis that has not taken into account the effects of correlation.

Question 14(b) continued – Nature and extent of risks

174 EFRAG broadly agrees with the proposed disclosure requirements in paragraphs 91-97 of the ED regarding the nature and extent of risks arising from insurance contracts. Given that the transfer, pricing and management of risks are fundamental to an insurer's business, we agree that disclosure about the nature and extent of risks is essential and meets the disclosure objective set out in the ED.

175 We do however have the following comments on the specific proposed risk disclosure requirements:

(a) We refer to sub-paragraph 92(e)(iii) of the ED that requires disclosure of actual claims compared with previous estimates of the undiscounted amount of the claims (i.e. claims development). We note that the claims period may differ considerably between classes of business (e.g. fire insurance versus liability insurance). Therefore, we suggest this requirement should be focused at the portfolio level, where homogenous risks have already been grouped.

(b) Paragraph 94 of the ED includes a reference to 'other insurance contracts'. It is not clear to us what would be included in this category.

(c) Paragraph 95(a) of the ED proposes that an insurer shall disclose a maturity analysis that shows the remaining contractual maturities or information about the estimated timing of cash out flows resulting from insurance liabilities. Since the measurement model for insurance contracts proposed by the IASB is based on expected values, in our view expected maturities would provide a more logical and consistent basis for this disclosure. This information would also be more readily available since it is used for measurement purposes.

Question 14(c) – Additional disclosures

176 As we indicated in our response to Question 13, EFRAG considers that the disaggregation options in paragraph 72 of the ED regarding presentation on the statement of comprehensive income should be eliminated since they compromise comparability. We therefore consider that the disaggregation of amounts proposed in sub-paragraphs 72(a), (b) and (d) should be required disclosures.

UNIT-LINKED CONTRACTS

Question 15 –Unit-linked contracts

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

Notes to EFRAG's constituents

177 A unit-linked contract (also known as a variable contract) is a contract for which some or all of the benefits are determined by the price of units in an internal or external investment fund.

178 The ED proposed that an insurer shall present assets underlying unit-linked contracts as a single line item and not commingle with the insurer's other assets. The portion of *the liabilities arising from unit-linked contracts shall also be presented as a single line item and not commingled with the insurer's other insurance liabilities.*

179 *In the statement of comprehensive income, the insurer should present income and expense from unit-linked contracts as a single line item. The income and expense from assets underlying unit-linked contracts should also be separately presented as a single line item.*

180 *The ED also addresses the following accounting mismatches that can occur under current accounting rules for unit-linked insurance contracts:*

(a) *Insurer's own shares: These are not recognised as assets under IAS 32 'Financial Instruments: Presentation';*

(b) *Property occupied by the insurer: An accounting mismatch occurs because IAS 16 'Property, Plant and Equipment' would treat it as owner-occupied in which changes in fair value would be recognised in profit or loss.*

181 *The ED proposes to eliminate the accounting mismatches by requiring the above items to be measured at fair value through profit or loss to the extent those changes in the value of the pool of assets relate to the interest of unit-linked contract holders.*

EFRAG's response

- **EFRAG agrees with the proposed approach for unit-linked contracts.**

182 In EFRAG's view there are two aspects to the IASB's proposals on unit-linked contracts, namely presentation and accounting mismatch.

Presentation

183 EFRAG agrees with the proposals in the ED regarding presentation. We consider that presenting assets and liabilities relating to unit-linked contracts as single line items on the balance sheet highlights to users that the assets relating to such contracts are effectively ring-fenced and are not for the benefit of other policyholders. The approach is consistent with the proposed unbundling principle, namely to require unbundling if components are not closely related. As the insurer actually holds the assets that are assigned to the policyholder in unit-linked contracts, the asset balance is not closely related to the other activities or obligations of the insurer.

184 Likewise, separate presentation for the income and expenses of unit-linked contracts and the assets that back those contracts isolates and highlights the performance directly related to such contracts. Separate presentation of income and expenses ensures that such income is not attributed to the performance of the insurer.

Changes to other standards to address accounting mismatches

185 EFRAG agrees to the proposed approach, as it is a pragmatic way to avoid creating an accounting mismatch.

REINSURANCE

Question 16 – Reinsurance

(a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?

(b) Do you have any other comments on the reinsurance proposals?

Notes to EFRAG's constituents

186 The proposal in the exposure draft also applies to the reinsurance contracts that an insurer holds. The Board has identified no reason for different measurement approaches for direct insurance liabilities and reinsurance liabilities.

187 As a consequence, the measurement of a reinsurance asset is also based on the building block approach incorporating the expected present value of cash flows, a risk adjustment, and a residual margin. The residual margin is calculated by calibrating the expected present value of cash flows and the risk adjustment to the premium ceded. In addition, the cedant (the insurer of the re-insured insurance liability) shall consider the non-performance risk (credit risk) of the reinsurer when estimating the future fulfilment cash flows.

188 The ED also proposes that a reinsurance asset is tested for impairment using the expected loss model.

EFRAG's response

- **EFRAG agrees with the proposals in the ED on reinsurance.**

189 We agree with the IASB's proposals in the ED regarding reinsurance assets.

190 We note however, the definition of a reinsurance contract in Appendix A. We consider that a reinsurance contract is an insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more insurance contracts issued by the cedant. If the contract compensates for losses on a non-insurance contract, e.g. for losses on a financial instrument, this would be a normal insurance contract and therefore from a policyholder perspective outside of the scope of the proposed standard.

TRANSITION AND EFFECTIVE DATE

Question 17 – Transition

(a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?

(b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?

(c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?

(d)	Please provide an estimate of how long insurers would require to adopt the proposed requirements.

Notes to EFRAG's constituents

191 The proposed transitional provisions in the ED require that upon transition entities recognise the following items in retained earnings:

(a) *The decrease in the carrying value of insurance liabilities (the difference of the carrying value of insurance liabilities under current GAAP and the present value of fulfilment cash flows);*

(b) *The derecognition of the deferred acquisition costs; and*

(c) *The derecognition of intangibles arising from insurance contracts assumed in previously recognised business combinations.*

192 Given that the present value of fulfilment cash flows incorporates the estimates of cash flows adjusted for the effects of the time value of money and uncertainty, upon transition the residual margin for all of an entity's existing insurance liabilities would be set at zero.

193 There is an example illustrating the IASB's proposal on transition in B110 of the ED. It gives the impression that the impact on retained earnings will be low as the adjustment in retained earnings is smaller than 1% compared to the present value of future fulfilment cash flows. It is understood that the transition adjustment in retained earnings could be significant for many entities. The size of the transition adjustment will be dependent on the current rules that the entity applies for measuring its insurance liabilities.

194 Under the FASB's approach, the composite margin would be set to equal the risk adjustment. That adjustment would not be remeasured subsequently, but would be released to income in the same way as any other composite margin. This is the only purpose for which a risk adjustment would be used in the composite margin approach (as normally a separate risk adjustment is not part of the measurement).

195 The ED is not proposing a specific effective date.

EFRAG's response

- **We disagree with setting to zero the residual margin for contracts in force at transition.**
- **The standard should require retrospective application in accordance with IAS 8.**
- **In order to minimise the operational burden it is crucial that insurance companies will have the opportunity to apply IFRS 9 and the final insurance contracts standard at the same time. The ability to redesignate financial assets at the time of adoption of the new standard on insurance contracts is less preferable but is should be open in both directions.**

Question 17(a) – IASB's proposed transition approach

196 EFRAG disagrees with the proposal in sub-paragraph 100(a) of the ED to set the residual margin to zero for insurance contracts reported at the transition date. In our view, such treatment prevents insurers from reporting a potentially significant part of the profits on existing contracts through profit and loss and reduces comparability between the results on existing and new business. After transition, profit arising from the release of the residual margin would only relate to insurance contracts entered into after the transition date. To the extent that the level of pre-transition insurance contracts remains significant after transition, we do not consider such reporting would fairly reflect the performance of the insurer. In addition, we are concerned that these transitional rules may reduce the usefulness of financial statements for many years in the case of long-term insurance contracts.

197 We recognise that the IASB proposed this transition approach (e.g. eliminating the residual margin for existing contracts) for practical reasons. We understand that the IASB was concerned that a residual margin on existing contracts could not be recreated at the date of transition without undue cost and the use of hindsight (see paragraph BC247 of the ED). In EFRAG's view it is inappropriate to seek to minimise the use of hindsight at the expense of providing relevant information. This is because we consider that in many circumstances the use of hindsight can be less harmful than the dramatic reduction in the comparability of the financial information.

198 We consider that the transition provisions in a final insurance standard should require IAS 8 *Accounting Policies, Changes in Estimates and Errors* (IAS 8) to be applied. This means full retrospective application or application from the earliest date possible if full retrospective application is impracticable. In accordance with IAS 8, individual entities will assess whether they are able to apply the provisions of the new standard retrospectively or not, considering the potential use of hindsight and considering whether the costs outweigh the ongoing benefits to users.

199 We share the concerns of the IASB with regard to retaining the difference between carrying amounts under previous accounting standards and the first three building blocks as residual margin, as the profits that would be carried forward would not be comparable between insurers and would not reflect profits under the new proposals. We agree that the IASB rejected this approach for the reasons given in BC 249.

Question 17(b) – FASB's proposed transition approach

200 The FASB proposes that upon transition the composite margin would be set equal to the risk adjustment determined under the IASB's approach. This risk adjustment would not be subsequently remeasured.

201 EFRAG does not consider that this will put an insurer in a significantly different position to the IASB's transition proposals, except that on an ongoing basis the composite margin/risk adjustment at the transition date would not be remeasured. Given our view that a risk adjustment should be subsequently remeasured (see our response to Question 5) and our response to the IASB's transition proposals regarding the residual margin (Question 17(a) above) we do not agree with the FASB approach.

Question 17(c) – Interaction with IFRS 9

202 In EFRAG's view, it is crucial for users (in terms of comparability) and preparers (in terms of operational burden) that insurers have the opportunity to apply IFRS 9 and the final insurance standard at the same time.

203 Accounting volatility that results from a differences in measurement bases, rather than economic mismatches, is misleading to users of financial statements. It is therefore important that the measurement of insurance liabilities and directly related financial assets reflects the nature of that relationship. Where that relationship is not reflected i.e. where offsetting financial assets and insurance liabilities are measured on a significantly different basis, accounting volatility in profit and loss would be created.

204 In order to avoid an accounting mismatch, insurers should be able to designate the measurement classification of financial assets in a way that best reflects their relationship with insurance liabilities e.g. minimises the measurement mismatch. It follows, that the classification decision on the asset side cannot be made before the accounting treatment of insurance liabilities is certain.

205 If effective dates for the insurance standard and IFRS 9 do not align, insurers should be given the ability to redesignate financial assets at the time that the new insurance standard is adopted. However this approach would not be EFRAG's preference since:

(a) It would be confusing for users if an entity adopts IFRS 9 in one period and a later period reclassifies some of its financial assets;

(b) It would impose an additional operational burden on the insurer who needs to create two transition dates, one under IFRS 9 for its financial assets and financial liabilities and another for its insurance contracts.

206 EFRAG therefore believes it is more efficient and effective to require insurance companies to adopt IFRS 9 and the final insurance standard at the same time.

207 If the IASB proceeds with proposals that allows or requires different transition dates for IFRS 9 and the insurance standard, but that allows redesignation of financial assets and financial liabilities upon adoption of the insurance standard, we consider that an insurer should not be bound by any previous designations under IFRS 9. That is designations at fair value through profit or loss using the fair value option, at amortised cost or at fair value through OCI, should be allowed to be reversed and redesignated at the date of transition for the new insurance standard.

Question 17(d) – Expected period required for adoption

208 Insurers, in particular insurance companies, will need a reasonable period of time in order to adopt the new standard. It will be in the interest of all stakeholders for the IASB to allow a reasonable transition period in order to ensure a high quality application of this complex standard.

Question to constituents

We do not refer to a specific transition date as requested in question 17d.

Can you provide an indication of the time needed for changing insurance processes and policies and implementing the new requirements?

What is in your opinion a feasible transition date?

OTHER COMMENTS

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

EFRAG has no further comments at this stage.

BENEFITS AND COSTS

Question 19 – Benefits and costs

Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

EFRAG's response

- **EFRAG is of the opinion that this standard is very important and we are convinced that the benefits will exceed the costs of the implementation of this standard.**

209 EFRAG considers that a consistent and comprehensive IFRS for insurance contracts is urgently needed. Currently IFRS 4 allows insurers to keep using pre-existing accounting policies for their insurance contracts. The financial impact of these policies is included in IFRS financial statements. This means that some entities use local or another set of accounting standards such as US GAAP and some international groups may even use different local GAAPs. This significantly impedes the comparability of companies within the insurance sector.

210 Given this current situation, we understand there is strong support and commitment for a new comprehensive standard on insurance contracts from both insurers and users of insurers' financial statements. Such support makes cost benefit less onerous than would normally be the case for an improvement to an existing regime. Consequently, we strongly encourage the IASB to move forward with this project, preferably within the timeframe scheduled.

211 Nevertheless, we expect the IASB to consider carefully both the comments we have raised in this comment letter and that it receives from all other respondents to the ED.

Question to constituents

In our response to question 17 we have stated that we believe IAS 8 should be required. IAS 8 requires retrospective application (unless impracticable). Could you provide an assessment of the benefits and costs of applying IAS 8?

Appendix 2 – accounting mismatch

Introduction

212 Many European insurers have highlighted to EFRAG significant concerns regarding the interaction of the proposals in the ED and IFRS 9 *Financial Instruments*. In particular, concerns exist regarding potential accounting mismatches that insurers may encounter due to the different measurement models for financial assets (IFRS 9) and insurance liabilities.

213 The ED proposes requirements for the measurement of insurance contracts in isolation; it does not consider the inter-relationship of financial assets and insurance liabilities that forms a key component of many insurers' business models. In these insurers' view, the approach adopted by the IASB in developing the ED and IFRS 9 separately has meant that insurers will not benefit from the same holistic approach to business models that was afforded to banks and other financial institutions and that is reflected in the provisions of IFRS 9.

214 EFRAG's broad understanding is that the business model employed across the insurance industry is to earn a return between premiums received and claims paid under insurance contracts. Financial assets are held to achieve the best backing for an insurer's insurance liabilities. Thus debt securities and other interest bearing financial assets are generally held long term to match the duration of insurance liabilities. Given the nature of life insurance and pension annuities, insurance contracts can have very long durations (for example 30 years). Based on this understanding, three key characteristics arise from the general model of an insurer's business, namely:

(a) Insurers generally hold financial assets as long-term investments;

(b) Financial assets are held to offset economically some of the financial risks associated with insurance liabilities. However, changes in financial variables (e.g. interest rate curves) may not affect financial assets and insurance liabilities to the same extent; and

(c) While insurance liabilities are subject to changes in non-financial variables (e.g. mortality and longevity), this is generally not offset by similar changes in the financial assets.

215 The concern raised by many insurers is that the long-term nature of their business and the economic offset described above cannot be reflected appropriately by applying the proposals in the ED in conjunction with IFRS 9. In their view, the existence of significant accounting mismatches would prevent them from accurately presenting the performance of their business.

216 To illustrate this concern we discuss two scenarios below.

Insurers that measure financial assets at amortised cost

217 Insurers that measure interest bearing financial assets at amortised cost want to reflect their intention to hold its interest bearing financial assets for the long-term (to match its long-term insurance liabilities). Those financial assets are measured at amortised cost in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9. In this scenario, the proposals in the ED result in an accounting mismatch because the financial assets are measured at amortised cost while the insurance liabilities are measured using current interest rates.

218 The IASB considered this issue and concluded that insurers can prevent the accounting mismatch by accounting for their financial assets at fair value (see paragraphs BC172 to BC183 of the ED).

219 However, as IFRS 9 uses the business model as the basis for the classification (and subsequent measurement) of financial assets, it would seem that an insurer must ignore its business model in order to address the accounting mismatch.

220 These accounting mismatches could be mitigated by:

(a) Including the effect of changes in estimates (both of financial and non-financial variables) in the residual margin, unless the residual margin would become negative; or

(b) Reporting changes in financial variables through other comprehensive income as changes in financial variables may reflect short-time volatility.

221 EFRAG suggests in the comment to Question 6(d) to account for changes in estimates relating to the current period and past periods in profit or loss and for changes in estimates relating to future periods in the residual margin.

Insurers that measure financial assets at fair value

222 Other insurers currently measure most financial assets at fair value trough profit or loss, using the fair value through profit or loss classification in IAS 39. These insurers also measure most of their insurance liabilities using current estimates with changes accounted for in profit or loss. There is no accounting mismatch.

223 Such insurers will elect to measure financial assets under IFRS 9 at fair value. In many cases, such an election does not contradict the view that short-term volatility in the market is not reflective of the long-term economic characteristics of the insurance business model.

224 Insurers that apply the fair value option under IFRS 9 would not have an accounting mismatch only to the extent that measurement under the model proposed in the ED differs from measurement at fair value. For example, the release of the residual margin over the coverage period will result in an accounting mismatch. However, all changes in estimates in the insurance liability will be reported in profit or loss. Changes relating to the matched financial variables will be offset by changes in the fair value of the financial assets, the remaining net effect largely reflects the economic mismatches (e.g. duration, credit spread and changes in non-financial assumptions).

225 However, if the changes in estimates of fulfilment cash flows of an insurance liability are adjusted against the residual margin (as recommended by EFRAG in its response to Question 6) an accounting mismatch will result. This is because the effect of changes in financial (and non-financial) variables on the value of insurance liability will be deferred to the extent that they relate to the future. Whilst all changes in offsetting financial assets will be reporting in profit or loss immediately.

226 This accounting mismatch could be mitigated by allowing these insurers to elect to account for the changes in estimates of in profit or loss as proposed in the ED.

Insurers that apply the OCI option for financial instruments

227 A different type of mismatch exists when changes in the fair value of investments are accounted for in other comprehensive income. Under current IAS 39 *Financial Instruments: Recognition and Measurement*, many insurers classify financial

investments as available-for-sale financial assets. Gains and losses on those investments are accounted for in other comprehensive income and only reclassified to the statement of comprehensive income when the investments are sold or impaired. The insurance liabilities are measured using financial assumptions based on those existing at their date of inception. Consequently, the mismatch in the statement of financial position is included in other comprehensive income. There is only a mismatch in the statement of comprehensive income as far as reclassification of other comprehensive income is not offset by changes in the value of the insurance liabilities.

228 However, under IFRS 9, only changes in the fair value of investments in equity instruments may be accounted for in other comprehensive income. Gains or losses on investments in equity instruments that are accounted for in other comprehensive income, may not be reclassified to profit or loss where they can offset changes in the value of the insurance liabilities.

229 A further mismatch could arise, under IFRS 9, when an insurer designates equity instruments at fair value through other comprehensive income when these instruments are part of a portfolio subject to participation features. In that case, the remeasurement of the financial asset would be recognised in other comprehensive income and the related impact on the insurance liability would be recognised in profit or loss.

230 A potential solution is discussed in paragraph BC181(b) of the ED,: the application of a form of shadow accounting. This approach is comparable to the accounting treatment of deferred tax, the recognition of which follows the presentation (in profit or loss, other comprehensive income or equity) of the ‘underlying’ item (paragraphs 58 and 61A of IAS 12). The IASB rejected shadow accounting because it would not be easy for users to understand or for preparers to apply.

Question to constituents

Do you consider that the IASB should address the interaction of IFRS 9 and the proposals in the ED? In particular:

- *Do you agree with the view held by some insurers that they are unable to reflect their business model in the measurement of their financial assets and/or insurance liabilities?*

- *Do you think the IASB should address the accounting mismatch for insurers that measure financial assets at amortised cost? If so, how?*

- *Do you believe that the effect of changes in assumptions of financial and/or non-financial variables should be accounted for in the residual margin? How do you believe the IASB should address the resulting mismatch for insurers that account for financial assets at fair value?*

- *Do you think that the IASB should allow or require shadow accounting in the cases described in paragraph 18? Do you support the arguments presented by the IASB to reject shadow accounting? Please explain why or why not.*