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Sir David Tweedie  
Chairman of the  
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Berlin, 10. Dezember 2007

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Dear David

### **IASB Discussionpaper 'Preliminary Views on Insurance Contracts'**

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the IASB discussion paper 'Preliminary Views on Insurance Contracts'. We appreciate the opportunity to comment on the discussion paper.

There are several (joint) projects, e.g. fair value measurement, the Framework work on measurement, liabilities and revenue recognition, which are linked with this project. Some of these projects will be finalised after or in parallel to this project. As a general consideration, we support the idea that all standards should be as consistent as possible, no matter whether they are industry specific or of general nature. At the same time, it is our strong belief that an industry specific standard such as IFRS 4 should not be an experimental field for fundamentally new concepts. For example the concept of a current exit value approach as specifically defined in the Discussion Paper is to be applied for insurance contracts for the first time. In contrast, we prefer that the measurement of insurance contracts is comparable to other industries, especially the service industry, but reflecting any special features of the insurance business. Overall, we take the view that the current exit value approach does not reflect economic reality. Hence, for both reasons we developed a new proposal for accounting of insurance contracts.

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Deutsches Rechnungslegungs Standards Committee e.V.

Accounting Standards Committee of Germany



Please find our proposal for accounting of insurance contracts in appendix A followed by our detailed comments on the questions raised in the Discussion Paper in appendix B. Should you or your staff have any questions on our comments, please do not hesitate to contact us.

Yours sincerely,

*Liesel Knorr*

President



## Appendix A – Proposal of the Accounting Standards Committee of Germany

### I. Objectives of the model for Insurance Contracts and key premises as proposed by the GASB

The objective of the proposed model is to faithfully present the substance of the insurance business and to give relevant information on the assets and liabilities of an insurance entity as well as its performance.

In order to accomplish this objective it is key to determine the nature of insurance contracts and its potentially different components and the underlying reasoning and business purposes of both parties to the contract.

As outlined in the Discussion Paper an insurance contract may include three different components, i.e. insurance coverage, deposit features as well as any additional service.

In our opinion, providing insurance coverage by performing over the insured period in the future - the core insurance business - represents by its nature a service contract. Accordingly, the accounting in terms of recognition, derecognition, measurement and presentation should reflect this as such. Buying and/or transferring insurance contracts, as implied by the notions of the Discussion Paper, is not the main business of an insurance entity although this might occur, mostly in circumstances to align and restructure insurance portfolios.

Additional services, if any, would be treated similarly as service contracts whereas deposit features generally represent financial instruments and should therefore be accounted under IAS 32/39 if separable from the insurance contract and separation is not impracticable. Overall, we would agree with the so-called 'unbundling' if the measurement of the deposit feature under IAS 39 is changed. Our model proposes a measurement different to IAS 39, i.e. expected value rather than the amount payable on demand assumed as the fair value of such deposits as promulgated by IAS 39. In contrast to payouts of demand deposits, at least in Germany the policyholder loses the insurance coverage when the deposit feature is paid out as the deposit feature is linked to the insurance coverage. This is in order to better capture the nature and substance of such deposits made by insured parties as part of insurance contracts.

The Discussion Paper is not clear about whether its approach to measure at current exit value is directed to insurance liabilities or the whole insurance contract. We believe that this is an important deficiency in the model proposed because assumed transfer values would be different for the two types of hypothetical transactions. It is not clear, however, on which type of assumed transaction the measurement should be based. In our model this is less relevant when compared to the Discussion Paper's approach and is only of significance when in contrast to the regular insurance business an insurance entity intends to sell an insurance contract or transfer insurance liabilities. Besides a risk or profit margin negotiated by the two parties involved, in the latter case this is comprising solely the expected costs (including benefits to policyholders, servicing and claims handling costs) regarding an insurance coverage component whereas the transfer value for an insurance contract may include compensation for intangibles like customer relationship or other strategic benefits. Accordingly, a future standard should reflect the measurement for both types of possible transaction in particular when in contrast to our view the IASB continues to follow the concept of current exit value, appropriate guidance needs to be given in order to resolve the above issue.

In developing our model for insurance contracts we also carefully considered any potential implications on current accounting for service contracts as well as revenue recognition. We believe that these issues are not sufficiently considered in the Discussion Paper.

Our main objective, however, was not to entertain 'traditional accounting', but, as outlined above, to look for an approach which faithfully presents the substance of the insurance business and its underlying transactions.

## II. Reinsurance

The following detailed description of our approach should be also applied by reinsurance entities.

## III. Recognition/Derecognition

As outlined in section I. the insurance coverage component represents a service contract and a corresponding service obligation of the insurance entity.

Accordingly, except for any payments made in advance by the insured party assets or liabilities deriving from the insurance coverage component should be recognised at the beginning of the insurance coverage period rather than upon signing the contract. In many cases, the date of signing the contract and the date of inception of the insurance coverage differ. Insurance contracts should be recognised when the insurance coverage has become effective, i.e. the first day of the insurance contract period (in analogy to the settlement date accounting as outlined in IAS 39.AG56. In case the insurance contract becomes onerous before the contract period begins, IAS 37.66ff needs to be applied. Derecognition should take place when the insurance coverage has ended.

As outlined in section I. the deposit feature is linked to the insurance coverage. Because of this close link the settlement date accounting should also be applied to the deposit feature to ensure that insurance coverage component and deposit features would be recognised at the same time. Recognition at different times would not make any sense. Derecognition should also take place when the insurance coverage has ended.

Overall, we would prefer to have recognition and derecognition principles incorporated in a separate part of a future standard on insurance contracts.

Financial assets backing obligations arising from insurance contracts fall under IAS 32/39 and our model does not introduce new requirements for such assets.

## IV. Measurement

### ***Appropriate measurement attribute for insurance liabilities and benefits (premiums) arising from insurance contracts***

In our view insurance liabilities should be measured at the 'ultimate fulfilment value' (defined as: amount that would be paid to fulfil the liability by performance in the future and discounted at the applicable current market interest rate at the measurement date), unless the insurance entity intends to sell these insurance liabilities (or the insurance contract).

Insurance liabilities are normally fulfilled by the originating insurance entity, i.e. the insurance entity holds the contract until the end of the insurance coverage. This is very important and should be reflected by the measurement of the insurance liabilities. It is apparent that, in contrast to the Discussion Paper, we strongly believe that the measurement of such liabilities



should not be determined on the basis of hypothetical transfers of such liabilities as this would not faithfully represent regular insurance business. Accordingly, the proposed measurement attribute of 'current exit value' would not faithfully represent the substance of business transactions and is therefore not considered to be relevant.

Accordingly, we do not agree with all aspects of the three building blocks for the determination of the insurance liabilities as suggested by the IASB; in fact we propose two building blocks, i.e. the best estimate of insurance liabilities incl. risk margin and the profit margin included in the insurance contract.

Benefits from insurance contracts, i.e. premiums should be recognised as assets and measured at the present value of expected cash inflows from policyholders. For further details refer to the following sections, in particular with regard to the discount rate used and policyholder behaviour.

***First block: Best estimate of insurance liabilities regarding the insurance coverage component contained in an insurance contract***

In our view the measurement should be based on management's best estimate of all **expected costs** (including benefits to policyholders, servicing and claims handling costs) under the insurance coverage component including appropriate assessment of the risks attached to the obligation. Thereby the risk margin is determined separately using actuarial methods on a portfolio basis and considering effects of diversification. At any measurement date the best estimate liability is discounted to its present value using the applicable current market interest rate according to the nature and risk of the obligation. The same applies to calculating the present value of the premiums arising from the insurance contract.

Under our suggested measurement approach entity-specific data shall be used for (non-financial) variables necessary to calculate the best estimate of insurance liabilities as well as cash inflows represented by the expected cash inflows, i.e. premiums by the policyholder, if for the relevant underlying types of insurance contracts sufficiently large populations as well as adequate historical experience exist to allow for reliable assumptions.

In summary, the obligations are estimated by weighting all possible outcomes by their associated probabilities. This statistical method of estimation is named 'expected value' (see IAS 37.39). Appropriate risk assessment to be applied by management should neither reflect any overly optimistic or prudent view nor general standardised risk allowances. If the above criteria cannot be accomplished because a 'single obligation' is to be measured, for example for insurance of single events where significant damages can occur, the individual most likely outcome is seen as the best estimate of the liability. However, other possible outcomes should also be considered (see IAS 37.40).

Using entity-specific data should not be seen as ignoring market data. "Financial" assumptions, e.g. interest rates, should be derived from market. "Non-financial" assumptions, e.g. benefits to policyholders or claims handling should be entity-specific. But as far as available management should continuously compare its own assessment with market data to probe whether its own assessment is still appropriate or requires adjustment. For example, the constant evaluation of life expectation by outside experts and such regularly updated results need to be considered. Nevertheless, results of such studies may also need adjustment if the entity's respective portfolio shows a different underlying population when compared to the scope of the experts' study.



An important feature of insurance business refers to the impact of policyholder behaviour. From an economic point of view all reasonably expected future cash inflows and cash outflows should be considered to present a complete picture of the economics of the insurance contract. Beneficial policyholder behaviour (including expected renewals) therefore needs to be taken into account in measuring insurance assets and liabilities. Again, for all relevant underlying types of insurance contracts this is subject to the meeting certain criteria, i.e. sufficiently large populations and availability of adequate historical experience, to allow for reliable assumptions on policyholder behaviour. Otherwise policyholder behaviour should not be reflected and the accounting should consider only those future cash inflows contractually agreed and which are therefore controlled by the insurance entity.

We strongly believe that our above approach of incorporating entity-specific data in the measurement better reflects the financial position of an insurance entity and provides a better basis for determining the performance of an insurance entity when compared to the approach outlined in the Discussion Paper. The Discussion Paper requires in principle the use of market data whenever available and to measure the obligation at "current exit value", i.e. the price an entity could transfer its insurance liability to a third party. Measurement against the market is in our view not relevant when there is no intention to transfer insurance liabilities (or insurance contracts as a whole) to other parties (see section I.) and therefore does not mirror the business reality. On the other hand the market participants approach as proposed by the Discussion Paper can easily result in inappropriate and not just counter-intuitive accounting which, again, does not reflect economic reality. For example, if an insurer is more efficient than others the use of the other market participants' data and pricing would result in a higher liability at the beginning with gains in future years, when the entity's actual costs are lower than assumed in the market participants' data.

As described in section II. the accounting under the above principles should commence with the date when the insurance coverage becomes effective. To complete the description of our measurement principles it is noteworthy that at the date of signing the contract the entity should determine whether an onerous contract exists.

To do so, a liability adequacy test should be made applying the above principles to determine whether the insurance contract as a whole is expected to result in a loss requiring the accounting for onerous contracts according to IAS 37.

***Second block: Assumed profit margin contained in the insurance coverage component of an insurance contract***

Because all elements related to the liability to the insured party are reflected in our model in the best estimate liability only one component remains to be considered which is the profit margin contained in the insurance contract.

Again, the following considerations refer to the insurance coverage component and any other service component and not to any separable deposit component to be dealt with as a financial instrument (see section I.).

Following our approach to reflect all expected premiums and expected costs under the insurance coverage component (see section I. and above) the profit margin for the whole component is to be reflected. This is the difference between expected premiums (without any separable savings part and acquisition costs) less best estimate liability (both at their present value) as defined above and this should be recognised as deferred income.

We understand that proponents of the pure Assets-Liability-Approach would not accept such deferral but we believe that this item would best reflect and give best information what mar-

gin is estimated to be contained in the insurance contract. In addition it should be noted that the approach proposed by the Discussion Paper is disguising such profit margin as part of the so-called 'risk and service margin' and is incorporating it in the liability. This is achieved by applying 'current exit value' in a sense that a third party would require such profit margin under the hypothetical scenario of a transfer of the insurance liabilities. Nevertheless, when looking at the business reality and how regular insurance business is maintained, the inclusion of the contract's profit margin under liabilities is in our view clearly unacceptable and does not conform to any transparency objective. The open classification as deferred income represents what it is, i.e. profit deferred over the period of risk coverage.

According to the nature of a service contract the deferred income should be recognised in profit or loss in accordance with the release from insurance risks by servicing. The latter is the same principle currently applied for service contracts (see IAS 18). In that but more specifically the principles of the percentage of completion method should be followed and at each reporting date a thorough review of the status of the contract should be carried out including any potential changes in policyholder behaviour and expected costs. Except for any fundamental errors in previous estimates all other changes would be recognised by means of a cumulative catch-up adjustment if necessary.

It is realistic to assume that such changes will often occur in particular when taking into account that some insurance contracts such as life insurance contracts are of a long-term nature. The following forms part of our approach and represents in some way a response to what the Discussion Papers describes under the heading 'shock absorber', in our view a term which is debatable as it may raise incorrect perceptions.

As long as the expected premiums exceed the expected liabilities, there is no loss for the insurance contract as a whole. If based on the above assessment there is an increase in the liability, any increase should be recognised taking the following steps: firstly, the recognised expected deferred income is simultaneously decreased against the increase in the liability, because no additional net liability is recognised for a reduction in the expected profit. Secondly, if the deferred income has been decreased to zero, any further increase of the liability should be recognised in profit or loss. If there is a decrease of the best estimate liability, then the expected deferred income should be increased, accordingly.

The same principles apply vice versa to any changes in the present value of expected premiums, obviously mainly due to changes in estimated policyholder behaviour which may or may not incur at the same time as changes in the insurance liabilities.

The effect of changes in the discount rate as well as the so-called unwinding of the present value, however, should be recognised directly in profit or loss.

### **Deposit features**

As indicated in section I. we propose to measure such deposit features at expected present value, which is in contrast to the current requirements for such financial instruments. Accordingly, we advocate an amendment of IAS 39 in line with the measurement approach proposed by us herein. This is not a new discussion; but the current treatment for such financial instruments was seriously debated and criticised by many constituents of the IASB. If the measurement base would be the same for both components insurance coverage and deposit features, in principle unbundling would become obsolete.



## **Policyholder Participation**

In our view the participation of policyholders is to be considered as part of the best estimate liability. Policyholder participations therefore should be measured at the expected amounts to be paid according to the participation arrangements or, if applicable, existing legal requirements. We believe that this important area for the insurance business should not just be covered by IAS 37 but should be separately dealt with in a future standard for insurance contracts and appropriate provisions incorporated in order to capture all possible features of policyholder participations.

## **Reinsurance Assets**

In general, the measurement of assets and liabilities should be based on consistent principles. Based on this view, it is essential to recognise that the measurement of reinsurance assets needs to be based on an assessment of the risk relief for the reinsured party by the reinsurance contract, following e.g. the reasoning of paragraph 210 of the Discussion Paper. This applies independently of the question whether the underlying insurance liability is measured on current exit value or ultimate fulfilment value.

In our view the measurement should be based on management's best estimate of the expected income from the reinsurance contract. The reinsurance assets should be presented separately in the balance sheet.

## **V. Intention to sell insurance liabilities or contracts**

If an insurer intends to sell insurance liabilities or contracts then insurer should measure a insurance liability or an insurance contract at the higher of its carrying amount and transfer value similar IFRS 5. A loss should be recognised directly in profit and loss. A gain should be only realised when there is a contract.

## **VI. Profit and Loss – Performance**

In accordance with the release from insurance risks by servicing, the revenue entries are made up by the corresponding decreases of the liability and deferred income item respectively.

As noted above any increased expected costs would be posted against deferred income first. Only increases in expected costs exceeding the deferred income at that point of time would not be recognised as revenues but expensed so that total revenues posted would not exceed the premiums paid. Vice versa if expected costs prove to be lower any decreases in the insurance liabilities would be reflected first as increases in deferred income and then released to revenue according to the release from insurance risk.

Actual costs (including benefits to policyholders, servicing and claims handling costs) are posted as expense when incurred.

## **VII. Presentation**

In our view, expected premiums and best estimated liabilities resulting from the insurance coverage component should be presented on a gross basis as assets and liabilities respectively. Expected premiums and best estimate liabilities include the effects of policyholder behaviour as outlined in section IV.





Insurance payments received from policyholders should be separately presented by deducting these from the gross assets, either in a separate line on the face of the balance sheet or by a respective breakdown in the notes.

In order to increase transparency the presentation of premiums recognised on the balance sheet should be improved by separately disclosing contractually enforceable premiums and expected premiums respectively. The insurance liability and deferred income should also be split in this way. Furthermore, the deferred income item should be presented separately.



## Appendix B – Answers to the questions of the discussion paper

### Chapter 2

#### Question 1

**Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?**

As outlined in appendix A section I. we do not believe that the insurance coverage component represents a financial instrument but a service contract and corresponding service obligation by the insurance entity. Accordingly, we reject the concept to account for insurance contracts as financial instruments.

Furthermore, there are several criteria for derecognition of financial assets and financial liabilities under IAS 39. Particularly, regarding financial assets a set of criteria has to be satisfied before derecognition is permitted. We believe a consistent criterion should be applied for assets and liabilities resulting from insurance contracts. Hence, we prefer the insurance coverage as criterion as mentioned in appendix A section I.

### Chapter 3

#### Question 2

**Should an insurer measure all its insurance liabilities using the following three building blocks:**

- (a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,**
- (b) current market discount rates that adjust the estimated future cash flows for the time value of money, and**
- (c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?**

**If not, what approach do you propose, and why?**

As outlined in appendix A in our view the Discussion Paper is not clear whether its approach to measure current exit value is directed to insurance liabilities or the whole insurance contract. Paragraph 90 in the Discussion Paper (description of three building blocks) and the question above reflect this.

We do not agree with all aspects of the three building blocks. We support (a) with the exception of market-consistent and contractual cash flows.

The Discussion Paper requires in principle the use of market data whenever available and to measure the obligation at current exit value, i.e. the price an entity could transfer its insurance liability to a third party. Measurement against the market is in our view not relevant when there is no intention to transfer insurance liabilities (or insurance contracts as a whole) to other parties (see appendix A section I.) and therefore does not mirror the business reality. On the other hand the market participants approach as proposed by the Discussion Paper



can easily result in inappropriate and not just counter-intuitive accounting which, again, does not reflect economic reality. For example, if an insurer is more efficient than others the use of the other market participants' data and pricing would result in a higher liability at the beginning with gains in future years, when the entity's actual costs are lower than assumed in the market participants' data.

An important feature of insurance business refers to the impact of policyholder behaviour. From an economic point of view all reasonably expected future cash inflows and cash outflows should be considered to present a complete picture of the economics of the insurance contract. Beneficial policyholder behaviour (including expected renewals) therefore needs to be taken into account in measuring insurance assets and liabilities.

We support (b).

We disagree with (c), i.e. the exclusive consideration of the market participants' view, thus inherently including the assumed profit margin in the liability and the recognition of the service margin.

Insurance liabilities are normally fulfilled by the originating insurance entity. It is apparent that, in contrast to the Discussion Paper, we strongly believe that the measurement of such liabilities should not be determined on the basis of market participants' view and hypothetical transfers of such liabilities respectively as this would not faithfully represent regular insurance business.

It should be noted that the approach proposed by the Discussion Paper is disguising profit margin as part of the so-called 'risk and service margin' and is incorporating it in the liability. This is achieved by applying 'current exit value' in a sense that a third party would require such profit margin under the hypothetical scenario of a transfer of the insurance liabilities. Nevertheless, when looking at the business reality and how regular insurance business is maintained, the inclusion of the contract's profit margin under liabilities is in our view clearly unacceptable and does not conform to any transparency objective.

The discussion paper defines the service margin as an explicit and unbiased measurement of the compensation that entities demand for providing services other than the bearing of risk. In this regard, investment management service in unit-linked products is mentioned as an important example. In our view additional services, if any, would be similarly treated as service contracts, so there is no need to describe it in the future standard on insurance contracts separately.

In our concept portrayed in appendix A, we propose two building blocks:

- (a) Best estimate of insurance liabilities (including any appropriate actuarial risk margin as well as the effects of diversification between portfolios; refer to our comments regarding question No. 11)
- (b) Profit margin included in the insurance contract.

*First block: Best estimate of insurance liabilities regarding the insurance coverage component contained in an insurance contract*

In our view the measurement should be based on management's best estimate of all **expected costs** (including benefits to policyholders, servicing and claims handling costs) under the insurance coverage component including appropriate assessment of the risks attached to the obligation. Thereby the risk margin is determined separately applying actuarial methods

on a portfolio basis and considering effects of diversification. At any measurement date the best estimate liability is discounted to its present value using the applicable current market interest rate according to the nature and risk of the obligation. The same applies to calculating the present value of the premiums arising from the insurance contract.

Under our suggested measurement approach entity-specific data shall be used for (non-financial) variables necessary to calculate the best estimate of insurance liabilities (including entity-specific claims handling costs) as well as cash inflows represented by the expected cash inflows, i.e. premiums by the policyholder, if for the relevant underlying types of insurance contracts sufficiently large populations as well as adequate historical experience exist to allow for reliable assumptions.

In summary, the obligations are estimated by weighting all possible outcomes by their associated probabilities. This statistical method of estimation is labeled 'expected value' (see IAS 37.39). Appropriate risk assessment to be applied by management should neither reflect any overly optimistic or prudent view nor general standardised risk allowances. If the above criteria cannot be accomplished because a 'single obligation' is to be measured, for example for insurance of single events where significant damages can occur, the individual most likely outcome is seen as the best estimate of the liability. However, other possible outcomes should also be considered (see IAS 37.40).

Using entity-specific data should not be seen as ignoring market data. Financial assumptions, e.g. interest rates should be derived from market. Non-financial assumptions, e.g. benefits to policyholders or handling costs should be entity-specific. But as far as available management should continuously compare its own assessment with market data to probe whether its own assessment is still appropriate or requires adjustment. For example the permanent evaluation of life expectation by outside experts and such regularly updated results need to be considered. Nevertheless, results of such studies may also need adjustment if the entity's respective portfolio shows a different underlying population when compared to the scope of the experts' study.

As mentioned above in our view all reasonably expected future cash inflows and cash outflows should be considered to present a complete picture of the economics of the insurance contract. Beneficial policyholder behaviour (including expected renewals) therefore needs to be taken into account in measuring insurance assets and liabilities. Again, for all relevant underlying types of insurance contracts this is subject to the meeting the criteria outlined above, i.e. sufficiently large populations and availability of adequate historical experience, to allow for reliable assumptions on policyholder behaviour. Otherwise policyholder behaviour should not be reflected and the accounting should consider only those future cash inflows contractually agreed and which are therefore controlled by the insurance entity.

We strongly believe that our above approach of incorporating entity-specific data in the measurement better reflects the financial position of an insurance entity and provides a better basis for determining the performance of an insurance entity when compared to the approach outlined in the Discussion Paper.

At the date of signing the contract the entity should determine whether an onerous contract exists. To do so, a liability adequacy test should be made applying the above principles to determine whether the insurance contract as a whole is expected to result in a loss requiring the accounting for onerous contracts according to IAS 37.



*Second block: Assumed profit margin contained in the insurance coverage component of an insurance contract*

Because all elements related to the liability to the insured party are reflected in our model in the best estimate liability only one component remains to be considered which is the profit margin contained in the insurance contract.

Again, the following considerations refer to the insurance coverage component and any other service component and not to any separable deposit component to be dealt with as a financial instrument (see appendix A section I.).

Following our approach to reflect all expected premiums and expected costs under the insurance coverage component (see appendix A section I. and IV.) the profit margin for the whole component is to be reflected. This is the difference between expected premiums (without any separable savings part and acquisition costs) less best estimate liability (both at their present value) as defined above and should be recognised as deferred income.

We understand that proponents of the pure Assets-Liability-Approach would not accept such deferral but we believe that this item would best reflect and give best information what margin is estimated to be contained in the insurance contract. The open classification as deferred income represents what it is, i.e. profit deferred over the period of risk coverage.

According to the nature of a service contract the deferred income should be recognised in profit or loss in accordance with the release from insurance risks by servicing. The latter is the same principle currently applied for service contracts (see IAS 18). In that but more specifically the principles of the percentage of completion methods should be followed and at each reporting date a thorough review of the status of the contract should be carried out including any potential changes in policyholder behaviour and expected costs. Except for any fundamental errors in previous estimates all other changes would be recognised by means of a cumulative catch-up adjustment if necessary.

It is realistic to assume that such changes will often occur in particular when taking into account that some insurance contracts such as life insurance contracts are of a long-term nature. The following forms part of our approach and represents in some way a response to what the Discussion Papers describes under the heading 'shock absorber', in our view a term which is debatable as it may raise incorrect perceptions.

As long as the expected premiums exceed the expected liabilities, there is no loss for the insurance contract as a whole. If based on the above assessment there is an increase in the liability, any increase should be recognised taking the following steps: firstly, the recognised expected deferred income is simultaneously decreased against the increase in the liability, because no additional net liability is recognised for a reduction in the expected profit. Secondly, if the deferred income has been decreased to zero, any further increase of the liability should be recognised in profit or loss. If there is a decrease of the best estimate liability, then the expected deferred income should be increased, accordingly.

The same principles apply vice versa to any changes in the present value of expected premiums, obviously mainly due to changes in estimated policyholder behaviour which may or may not incur at the same time as changes in the insurance liabilities.

The effect of changes in the discount rate as well as the so-called unwinding of the present value, however, should be recognised directly in profit and loss.



### Question 3

**Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?**

We support that principles for estimating the liability should be established, but specific methods should not be required. Hence, we recommend a principle based approach, as followed in the discussion paper. In our view the level of detail is right.

### Question 4

**What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.**

**(a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.**

**(b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?**

**(c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.**

**(d) Other (please specify).**

As described above we disagree with the market participants' approach. Hence, we do not support the alternatives (b) and (c).

Our proposed model is close to alternative (a). But in distinction we would recognise the difference between the actual premium (without any separable savings part and acquisition costs) and the best estimate liability including the risk assessment as deferred income.

If the IASB retains the market participants' approach obviously favoured in the DP we would nevertheless favour b). This means that in subsequent measurements no changes in market participants' views would be reflected.

### Question 5

**This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.**

**(a) Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?**

**(b) Is 'current exit value' the best label for that measurement attribute? Why or why not?**



- (a) As outlined in our previous comments we disagree with the view that current exit value represents a measurement attribute appropriate for insurance liabilities. In our view insurance liabilities should be measured at the 'ultimate fulfilment value' (defined as: amount that would be paid to fulfil the liability by performance in the future and discounted at the applicable current market interest rate at the measurement date), unless the insurance entity intends to sell these insurance liabilities (or the insurance contract).

Insurance liabilities are normally fulfilled by the originating insurance entity, i.e. the insurance entity holds the contract until the end of the insurance coverage and this should be reflected by the measurement of the insurance liabilities. It is apparent that, in contrast to the Discussion Paper, we strongly believe that the measurement of such liabilities should not be determined on the basis of hypothetical transfers of such liabilities as this would not faithfully represent regular insurance business. Accordingly, the proposed measurement attribute of 'current exit value' would not faithfully represent the substance of business transactions and is therefore not considered to be relevant.

- (b) The label is appropriate for the measurement attribute used by the IASB but, as outlined above, we strongly disagree with the appropriateness of such measurement attribute.

## Chapter 4

### Question 6

**In this paper, beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:**

- (a) incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?**  
**(b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?**  
**(c) not recognise them? Why or why not**

As outlined in appendix A in our view the Discussion Paper is not clear whether its approach to measure current exit value is directed to insurance liabilities or the whole insurance contract. Paragraph 147 in the Discussion Paper (Board's preliminary view on customer relationship) and the question above reflect this.

In case an insurance contract would be transferred in our view it would be appropriate under the IASB approach to recognise a separate customer relationship asset.

We reject alternative (b), because this alternative does not really encourage transparency in accounting. In this alternative changes in best estimate liability, profit margin and customer relationship can not be assessed without significant disclosures.

In our view, expected premiums and best estimated liabilities resulting from the insurance coverage component should be presented on a gross basis as assets and liabilities respec-

tively. Expected premiums should include the effects of policyholder behaviour as described in our comments to question No. 7.

In order to increase transparency the presentation of premiums recognised on the balance sheet should be improved by separately disclosing contractually enforceable premiums and expected premiums respectively. The insurance liability and deferred income should also be split in this way. Furthermore, the deferred income item should be presented separately.

#### **Question 7**

**A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?**

**(a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.**

**(b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?**

**(c) All cash flows that arise from those terms of existing contracts that have commercial substance (i.e. have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).**

**(d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained,**

**(i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.**

**(e) No cash flows that result from beneficial policyholder behaviour.**

**(f) Other (please specify).**

In order to reflect business reality we would support alternative (b) in a sense that we would support the inclusion of all expected cash flows from existing contracts where insurance coverage has commenced.

As outlined in appendix A section IV. beneficial policyholder behaviour (including expected renewals) therefore needs to be taken into account in measuring insurance assets and liabilities. For all relevant underlying types of insurance contracts this is subject to the meeting certain criteria, i.e. sufficiently large populations and availability of adequate historical experience, to allow for reliable assumptions on policyholder behaviour. Otherwise policyholder behaviour should not be reflected and the accounting should consider only those future cash inflows contractually agreed and which are therefore controlled by the insurance entity. Thus, we would prevent that newly founded entities consider large future cash inflows without using reliable assumptions.





**Question 8**

**Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?**

In our view it would be appropriate under the IASB approach to treat acquisition costs as an expense when incurred.

**Question 9**

**Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?**

In a business combination or portfolio transfer intangible assets acquired should be identified separately and recognised.

**Chapter 5**

**Question 10**

**Do you have any comments on the measurement of assets held to back insurance liabilities?**

Financial assets backing obligations arising from insurance contracts fall under IAS 32/39 and our model does not introduce new requirements for such assets.

However, we recommend extending the fair value option for those financial assets that are already recognised in the statement of financial position if they cover insurance liabilities. Using the extended fair value option should be possible when the new standard on insurance contracts would be applied.

**Question 11**

**Should risk margins:**

**(a) be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?**

**(b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?**

(a) Insurance is based on the concept of balancing risks in a collective of insurance contracts. This needs to be reflected in the measurement of such contracts. Accordingly, as outlined in the discussion paper, measurement of the risk margin needs to reflect the corresponding portfolio effect and, hence, risk margins should be determined for a portfolio of insurance contracts. In order to present relevant and reliable information for the users of financial statements, however, the portfolio needs to reflect the way the insurance business is managed. The notion of 'a broadly similar risk' in defining a portfolio provides less relevant numbers since such a constraint may not reflect appropriately the way an



insurance entity manages its risk. Neither will such a concept increase the reliability of the numbers.

This applies also to the negative correlation, e.g. regarding term assurance and annuity books. In many cases insurers manage these books together by explicitly managing their underwriting policy appropriately in order to reduce the risk exposure. It would be difficult, however, to argue that they constitute 'broadly similar risks'.

- (b) The diversification between different portfolios within an insurance entity is another integral part of an insurer's business model. It is fundamental therefore that the accounting reflects these effects when measuring portfolios of insurance contract liabilities. We believe that this form of diversification between the portfolios of an insurance entity should be reflected as described in appendix A section IV.

#### Question 12

**(a) Should a cedant measure reinsurance assets at current exit value? Why or why not?**

**(b) Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?**

**(i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.**

**(ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.**

**(iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.**

(a)

In general, the measurement of assets and liabilities should be based on consistent principles. Based on this view, it is essential to recognise that the measurement of reinsurance assets needs to be based on an assessment of the risk relief for the reinsured party by the reinsurance contract, following e.g. the reasoning of paragraph 210 of the Discussion Paper. This applies independently of the question whether the underlying insurance liability is measured on current exit value or at ultimate fulfilment value.

In our view the measurement should be based on management's best estimate of the expected incomes of the reinsurance contract. The reinsurance assets should be presented separately in the balance sheet.

(b) (ii)

From a conceptual point of view we support an expected loss model, but users told us that a sufficient empirical basis for a reliable measurement of that probability is not available. Furthermore, in practice the probability for reinsurers to default is very low. The users would be therefore retained the incurred loss model. In a field test should be verified if an expected loss model is applicable and practicable.



(b) (iii)

Including future contracts not yet issued in the measurement would be in contrast to our model. Hence, we disagree with the proposal of the IASB.

### Question 13

**If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?**

Deposit features generally represent financial instruments and should therefore be accounted under IAS 32/39 if separable from the insurance contract and separation is not impracticable. Overall, we would agree with the so-called 'unbundling' if the measurement of the deposit feature under IAS 39 is changed.

Our model proposes a measurement different to IAS 39, i.e. expected value rather than the amount payable on demand assumed as the fair value of such deposits as promulgated by IAS 39. In contrast to payouts of demand deposits, at least in Germany the policyholder loses the insurance coverage when the deposit feature is paid out as the deposit feature is linked to the insurance coverage. This is in order to better capture the nature and substance of such deposits made by insured parties as part of insurance contracts. If the measurement basis would be the same for both components insurance coverage and deposit features, in principle unbundling would become obsolete.

### Question 14

**(a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?**

**(b) Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?**

We strongly believe that including changes in a reporting entity's own credit spread would not be adequate to measure the exit value of an insurance liability due to the following reason:

The current exit value is defined as the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The insurer will not be able to realise adjustments based on changes of its own credit spread when it transfers its insurance liability to another party because another insurer will not take into account any change in the value of a liability due to a deterioration of the insurer's own credit risk and will thus not be willing to take over a liability for an amount that is lower than the expected obligation under the insurance contract. We, therefore, believe that adjustments for credit characteristics are irrelevant when an insurance liability was to be measured at its current exit price as the adjustments for credit characteristics can not be realised by transferring the liability.

Overall the consideration of changes in an entity's own credit spread when measuring liabilities leads to counterintuitive results: A deterioration of an entity's credit worthiness results in a decline in the liability's fair value and therefore to income effects and an increase in equity respectively, which in our view would not provide useful information to the users of financial statements. In our view the reporting entity would not be 'better off or worse' as inappropriately indicated by such income effects. Only in case a full fair valuing of the whole balance



sheet and the recognition of self generated intangible assets is mandatory such accounting implications will be eliminated.

According to the above comments in our model as described in appendix A changes in own credit risk are not taken into account.

#### Question 15

**Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?**

From our point of view the insurance coverage component does not represent a financial instrument, but a service contract and corresponding service obligation of the insurance entity. Accordingly, we reject the concept to account for insurance contracts as financial instruments. Hence, an amendment of IAS 39 in this regard is not necessary because IAS 39 would not be applicable.

In order to avoid accounting mismatches in the future the fair value option under IAS 39 should be also applied to investments which are already part of a portfolio of an insurer. It should be possible to use the extended fair value option when the new standard on insurance contracts would be applied.

Our model proposes a measurement of any separable deposit features which is different to IAS 39, i.e. expected value rather than the amount payable on demand assumed as the fair value of such deposits as promulgated by IAS 39. This is in order to better capture the nature and substance of such deposits made by insured parties as part of insurance contracts. Hence, we recommend an amendment of IAS 39.

## Chapter 6

#### Question 16

**(a) For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?**

**(b) An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247–253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?**

(a) In our view the participation of policyholders is to be considered as part of the best estimate liability. Policyholder participations therefore should be measured at the expected amounts to be paid according to the participation arrangements or, if applicable, existing legal requirements. We believe that this important area for the insurance business should not just be covered by IAS 37 but should be separately dealt with in a future standard for insurance contracts and appropriate provisions incorporated in order to capture all possible features of policyholder participations.



- (b) From our point of view currently, there is uncertainty how the notion of a constructive obligation will be applied to participating contracts under the proposed requirements of ED IAS 37. The discussions in the IAS 37 project are moving. We do not believe that basing requirements for insurance contracts on a standard still under debate which will cover such an important topic as the measurement of participating contracts is appropriate.

**Question 17**

**Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?**

- (a) Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).
- (b) Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).
- (c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).
- (d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).

The measurement of unit-linked insurance liabilities should be based on the fair value of the shares in a fund. Hence, the corresponding unit-linked assets should be also measured at fair value. But not all assets are currently measured at fair value. In order to avoid an accounting mismatch in the future this gap should be closed.

**Chapter 7**

**Question 18**

**Should an insurer present premiums as revenue or as deposits? Why?**

In our proposal the revenue entries are triggered by corresponding decreases of the liability and deferred income.

**Question 19**

**Which items of income and expense should an insurer present separately on the face of its income statement? Why?**

We believe that it is important to develop an overall presentation approach that optimises the usefulness of the information provided.

Under the existing IAS 1 additional line items, headings and subtotals shall be presented on the face of the income statement when such presentation is relevant to an understanding of the entity's financial performance. This possibility should be used whenever appropriate.



The existing IAS 1 requires additional disclosure of various items of income and expense. To satisfy these requirements, the IASB suggests a list of items under IFRS 4 IG26 that an insurer might need to include either on the face of the income statement or in the notes of the financial statement. We would therefore suggest reviewing this list.

The items that we believe to be presented on the face of the income statement are for example:

- Revenue from insurance and investment contracts including any revenues from other services
- Cost of insurance business
- Interest costs including unwinding of discount and effect of changes in interest rate used for discounting premiums and insurance liabilities
- Impact of reinsurance activities
- Investment income/expenses

Note disclosures should include for example:

- Breakdown of revenue from insurance, investment and other services
- Losses recognised as a result of applying the liability adequacy test
- Explanation of all major changes in assumptions
- Effect of changes between actual and expected experience
- Movements in deferred income and income statement effects

**Question 20**

**Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?**

Under our proposed approach, the revenue entries are triggered by the corresponding decreases of the liability and deferred income item respectively.

As noted above any increase in expected costs would be posted against deferred income first. Only increases in expected costs exceeding the deferred income at that point in time would not be recognised as revenues but expensed so that total revenues posted would not exceed the premiums paid. Vice versa if expected costs prove to be lower any decreases in the insurance liabilities would be reflected first as increases in deferred income and then released to revenue according to the release from insurance risk.

Actual costs (including benefits to policyholders, servicing and claims handling costs) are posted as expense when incurred.



## Other matters

### Question 21

Do you have other comments on this paper?

#### Field test

We strongly recommend testing the proposed measurement principles for typical insurance products in the field before progressing to the next due process stage of an exposure draft.

#### Definition of insurance contracts

We agree with the existing definition in IFRS 4 Insurance Contracts. We see no reason to amend or specify the definition of insurance contracts for direct insurance and reinsurance business.

#### Credit insurance

In our view all contracts that meet the definition of an insurance contract should be treated as such. Hence, if credit insurance meets the definition of an insurance contract, it should be in the scope of any future standard on insurance contracts.

#### Transition

We believe that the changes proposed require significant adjustments to IT systems. We therefore recommend allowing sufficient time before any final standard would come into effect.