



DRSC e. V. • Zimmerstr. 30 • 10969 Berlin

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

United Kingdom

Telefon +49 (0)30 206412-12

Telefax +49 (0)30 206412-15

E-Mail info@drsc.de

Berlin, 22 October 2013

Dear Hans,

IASB ED/2013/7 Insurance Contracts

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on the Exposure Draft ED/2013/7 *Insurance Contracts* (hereafter referred to as 'the Re-ED'). We appreciate the opportunity to comment on this revised Exposure Draft.

The ASCG welcomes the IASB's decision to re-expose the 2010 Exposure Draft and appreciates the effort of the IASB to take into account concerns raised by constituents regarding the 2010 ED. Many changes made have led to a good basis for the accounting of insurance contracts, but we believe that there are still a few yet important areas where changes are necessary in order to establish an appropriate and balanced Standard that ensures a faithful presentation for all types of insurance contracts and avoids unnecessary complexity.

We are supportive of many of the changes that the IASB incorporated in the Re-ED. We acknowledge especially the unlocking of the contractual service margin for future periods, the recognition of changes in the discount rate in other comprehensive income and the proposed retrospective approach to transition. Notwithstanding our general support, we have concerns about some proposals. Whilst we acknowledge the IASB's desire to finalise this long-lasting project and publish a globally harmonised Standard for insurance contracts as soon as possible, this should not come at the expense of discriminating against specific types of insurance contracts and the entities that write such policies. We understand that insurance is a

Zimmerstr. 30 · 10969 Berlin · Telefon +49 (0)30 206412-0 · Telefax +49 (0)30 206412-15 · E-Mail: info@drsc.de

Bankverbindung: Deutsche Bank Berlin, Konto-Nr. 0 700 781 00, BLZ 100 700 00

IBAN-Nr. DE26 1007 0000 0070 0781 00, BIC (Swift-Code) DEUTDE33HAN

Vereinsregister: Amtsgericht Berlin-Charlottenburg, VR 18526 Nz

Präsidium:

Dr. h.c. Liesel Knorr (Präsidentin), Dr. Christoph Hütten (Vizepräsident)



highly regulated business and dealt with differently from one jurisdiction to the next, so a one-size-fits-all approach, especially as regards the life insurance business, might not suffice. We believe it is key that the IASB carefully consider the following issues and take the time necessary to address these concerns, so as to provide a suitable solution meeting the expectations of both preparers and users. Specifically:

- We support the IASB's decision to adjust the contractual service margin for changes in estimates of future cash flows. However, we believe that the unlocking of the margin should be implemented more fully in order to achieve a subsequent measurement that is consistent with the measurement at initial recognition and to meet the definition of the service margin representing the unearned profit for future periods. In particular, the margin should be unlocked for changes in the risk adjustment that affect future cash flows or future services. For participating contracts the margin should also be unlocked for changes in the fulfilment value of options and guarantees as well as for changes in the value of underlying items, e.g. for changes in reinvestment assumptions relating to future services.
- We appreciate the IASB's efforts to establish measurement and presentation requirements for participating contracts where liabilities are asset-dependent. Most of the life and health insurance business underwritten in Germany has participating features; therefore, an adequate accounting approach for these types of contracts is of utmost importance. However, we have significant concerns regarding the "mirroring approach"¹ as proposed. Our major concerns refer to the limited scope, the complexity and feasibility of the decomposition of cash flows and the decision usefulness of this proposal. We support the *alternative approach for participating contracts* (see Appendix 5 in EFRAG's Draft Comment Letter) because it establishes requirements that apply to all kinds of participating contracts and are built on the general building blocks approach of the Re-ED. Whilst this proposal is less complex than the "mirroring approach" proposed, it also provides more relevant information as it faithfully represents the entity's financial position and performance: The approach provides for current fulfilment values in the statement of financial position. Furthermore, a complete unlocking of the contractual service margin with a corresponding release represents the entire future profit of the insurance contract. The asset dependence is taken into account for all asset classes (including equities, real estate, bonds and others) through the cash flow projection and through the deter-

¹ The term „mirroring approach“ refers to the requirements for contracts that require the entity to hold underlying items and specify a link to those underlying items.



mination of discount rates. In addition, the requirements of this proposal are fully consistent with the attribute of the contractual service margin for participating contracts as well. In our opinion, the *alternative approach* establishes measurement and presentation requirements for participating contracts that depict the characteristics of this business adequately.

- While welcoming the IASB's proposals regarding the recognition and presentation of interest expense in profit or loss and the recognition of changes in discount rates in other comprehensive income, we do not support the mandatory use of other comprehensive income. In cases where liabilities are dependent on returns on assets, which are measured at fair value through profit or loss (FVTPL) because these assets are either not eligible for measurement at fair value through other comprehensive income (FVTOCI) or the contracts are managed on a FVTPL basis, an accounting mismatch might arise. To reduce this accounting mismatch, an option to recognise the effect of changes in the discount rate directly in profit or loss for those liabilities should be introduced.

Please find our detailed comments on the questions raised in the Re-ED as well as comments on additional issues not covered by the questions in the appendices to this letter. If you would like to discuss our views further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President



Appendix A – Answers to the questions of the Exposure Draft

Question 1 - Adjusting the contractual service margin

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

- (a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and
- (b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

- 1 In general, the ASCG agrees with the proposal to recalibrate the contractual service margin (CSM) for changes in estimates that have an impact on future periods and supports the proposal to recognise changes relating to present or past events immediately in profit or loss as we suggested in our comment letter in 2010. We appreciate the principle of unlocking the CSM for changes in estimates of future cash flows related to future coverage and other future services because it ensures consistency with the definition of the margin representing the unearned profit at inception over the duration of the contract. Further, the adjustments of the CSM provide information about the future profitability of insurance contracts at each reporting date.
- 2 While we agree with the proposal in general, we believe that the underlying unlocking principle should be extended to encompass all changes in estimates related to future coverage or other future services. We do not agree with recognising changes in the risk adjustment immediately in profit or loss (ED.60(d)) since it contradicts the definition of the CSM. As the CSM represents the entire unearned profit, it should also be adjusted to reflect changes in estimates of the risk adjustment that are related to future coverage or other future services. We are being told by our insurance working group that the necessary differentiation between experienced and future changes of the risk adjustment is operationally feasible. The risk adjustment reflects a major service that the insurer provides, and changes of the risk adjustment affect future services and future profitability. If the entity expects changes in future profits because of changes in the risk adjustment, this should lead to an adjustment of the CSM.
- 3 We also have concerns regarding determination and subsequent measurement of the CSM for participating contracts, especially with reference to the treatment of options and guarantees as well as the recognition of changes in financial estimates. Since this relates mainly to the second question, we refer to our response to question 2.



- 4 In addition, we do not fully agree with the accretion of interest on the carrying amount of the contractual service margin (ED.30(a)). In our point of view, the accretion rate should be linked to the discount rate used to determine the interest expense from the unwinding of the insurance liability in profit or loss and, thus, not always remain locked in. Further, for insurance contracts where an entity may simplify the measurement of the liability for the remaining coverage using the premium allocation approach (PAA), there should be no accretion of interest on the CSM for contracts where the entity could use the PAA, but decides to determine the insurance liability under the building blocks approach (BBA). With a view to the principle of materiality the accretion of interest should be mandatory only for those contracts for which the interest accretion leads to a significant benefit. As the PAA results in a reasonable approximation of the BBA, there should not be any significant difference when omitting the accretion of interest under the BBA for contracts where the entity would be allowed to apply the PAA. Thus, paragraph 40 should be applicable, too, when the entity uses the BBA but is allowed to simplify the measurement under the PAA.

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

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

- (a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?
- (b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?
- (c) recognises changes in the fulfilment cash flows as follows:
 - (i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;
 - (ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and
 - (iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?



- 5 While we appreciate the IASB's efforts to provide an adequate proposal for participating contracts, we have significant concerns regarding the "mirroring approach" and do not support the proposal as drafted. In our opinion, the IASB's "mirroring approach" does not provide relevant information that faithfully represents the entity's financial position and performance, as the approach:
- Applies only to a narrow scope of participating contracts;
 - Increases the complexity because of the arbitrary decomposition of cash flows;
 - Reduces comparability as it differs from the general fulfilment cash flow model (building blocks model) that applies to all other insurance contracts; and
 - Allows only for a limited unlocking of the CSM which contradicts the definition of the CSM as the unearned profit.
- 6 We do not agree with the scope of the "mirroring approach". According to paragraphs 33(a) and (b) of the Re-ED, the "mirroring approach" should be applied only to those contracts that require the entity to hold underlying items and that specify a link between the payments to the policyholder and the returns on those underlying items. In our opinion, there is no need for different measurement models for participating and non-participating contracts. The general building block approach should be applied for all kinds of insurance contracts. For insurance contracts where the insurance contract liability is dependent on underlying items (e.g. asset returns), the entity should take that dependence into account when determining the discount rate used to present interest expense in profit or loss – something that is already required under paragraph 26(a) of the Re-ED. Not having a separate model for certain asset-dependent insurance contracts provides a principle-based accounting for insurance contracts and allows for similar accounting to be applied to economically similar contracts. For further details regarding features of participating contracts, please see our remarks on the *alternative approach* in paragraph 9.
- 7 Additionally, we have concerns as regards the requirement in B86 to decompose cash flows. In our view, and as first results from the field testing exercise in Germany are demonstrating, the IASB's proposal leads to insurmountable hurdles, especially when considering more complex insurance products. We do not support splitting the insurance contract liability into multiple components that are to be measured and presented differently. The proposed decomposition does not appear to be common in actuarial practice and seems very complex; also, we wonder whether it is used at all when assessing and managing the business. Furthermore, the proposed splitting seems to be artificial and enabling arbitrage. We do not understand why the IASB requires bifurcation of options and guarantees that are clearly and closely related to the other cash flows of insurance contracts and require them to be treated differently. Cash flows from options and guarantees should be treated the same as any other



cash flows arising from the insurance contract. Another difficulty is the necessary assignment of assets to liabilities. Apart from being highly complex for preparers we have doubts as to the decision usefulness of the decomposition proposals for users of financial statements. Due to the decomposition of cash flows the liability is no longer presented at its current fulfilment value. It is for these reasons that we do not agree with the proposal.

- 8 Another key concern relates to the limited unlocking of the CSM for changes in underlying items. We do not agree with the proposal in ED.66(b) to recognise changes of options and guarantees, which do not need to be separated under paragraph 10, in profit or loss. In our view, this is not in line with the general requirements to adjust the CSM for changes in estimates of future cash flows that are related to future coverage and other future services. In addition, we do not agree with not unlocking the CSM for changes in underlying items, especially for changes in reinvestment assumptions. Changes in reinvestment assumptions relating to future services should result in an adjustment of the CSM, as this affects the future profitability of the entity.
- 9 We support the *alternative approach for participating contracts* (see Appendix 5 of EFRAG's Draft Comment Letter; hereafter the *alternative approach*) that the insurance industry developed for participating contracts. See also Appendix C where the *alternative approach* is described based on the four building blocks. The key advantages of the *alternative approach* over the proposals in the Re-ED as we see them can be summarised as follows:
- The proposed model is built on the general measurement requirements of the Re-ED and is therefore easy to implement and increases comparability across the insurance industry;
 - The proposal establishes a single measurement model for all kinds of insurance contracts; economically similar contracts are accounted for in the same way, and there is no scope distinction into participating and non-participating contracts;
 - The proposal leads to a significant reduction of complexity, because there is no need to split the liability; prospective measurement is applicable without historical assumptions;
 - The proposal regarding the CSM establishes a clear segregation between the earned profit and the expected future profit through the prospective measurement and adjustment of the CSM. Thus, it is possible for users to evaluate the entity's performance in the long run, as the approach provides for a complete unlocking of the CSM for any changes in estimates relating to future coverage or other future services;
 - The definition of the CSM as the unearned profit is maintained for participating contracts as well;
 - The proposal simplifies the approach to transition as there is no need to determine historical figures since it is based on a prospective measurement;



- The *alternative approach* also avoids accounting mismatches due to determining an asset-based discount rate and through consideration of asset returns in the cash flow projection.

10 Although we see merits in the *alternative approach*, we believe that there are still some aspects where it needs to be developed further should the IASB follow our recommendation to pursue that approach. First of all, guidance is needed in order to clarify which contracts are deemed to be in the scope of participating contracts and therefore have to reflect the asset dependence using an asset-based discount rate. It should be clarified in which cases the insurance contract liability is dependent on underlying items when there is no contractual link in order to facilitate a consistent application of the *alternative approach*. Secondly, the determination of reinvestment assumptions, which are necessary in order to determine the expected asset returns for contracts for which the liability duration exceeds the asset duration, needs to be clarified, too. Specifically, principles to ensure an unbiased determination of reinvestment returns are needed in order to ringfence the proposal.

Question 3 - Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

11 We appreciate the IASB's decision to consider the request for presenting volume information when developing a proposal for the presentation of revenue in the income statement. We also welcome the aim for consistency with the revenue recognition project.

12 Generally speaking, the aim of presenting a certain revenue number should be to provide relevant information to the user reflecting the nature of the business. Feedback from discussions with users and preparers of financial information show that for different types of insurance products a different rather than the same type of revenue figure seems appropriate:

- Entities whose main business is the property and casualty insurance tend to accept the proposed definition of insurance contract revenue as their traditional numbers would continue to be disclosed and as most of them would probably use the simplified approach anyway.
- On the other hand, entities that provide mainly life insurance products do not tend to support the proposed presentation of revenue. From their point of view, the proposed



approach for presenting revenue does not provide relevant information for the user. In addition, we hear complaints about determining the proposed number being a very costly exercise due to the decomposition of investment components.

Hence, balancing the needs for providing relevant and comparable information for users of financial statements and having a balanced cost-benefit ratio, a single number for presenting revenue does not seem achievable for all kinds of insurance products.

Question 4 - Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

- (a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and
- (b) recognising, in other comprehensive income, the difference between:
 - (i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and
 - (ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

13 We agree with the proposal to recognise the interest expense in profit or loss determined using discount rates that applied at the date that the contract was initially recognised. We also agree with recognising the difference between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised in OCI for those contracts where the liability is not asset-dependent. We are supportive of the proposal to recognise these changes in OCI, as this balances the wish to present insurance liabilities at a current value, yet at the same time preserving the information content of the income statement as a depiction of the performance of the period. This reflects the long-term nature of the insurance business.

14 For contracts where the liability is asset-dependent the discount rate shall be updated according to ED.60(h), when the entity expects any changes in those returns. We support this approach as this achieves an alignment between the projected cash flows and the discount rate used. The discount rate used to recognise the interest expense on the insurance liability in profit or loss should be updated to reflect the corresponding revenue recognition of



the underlying assets. This avoids an accounting mismatch in profit or loss, even if a mixed measurement basis exists for contracts with asset dependent liability cash flows.

- 15 As was already mentioned in our answer to question 2, we do not support a mandatory use of OCI. The FVTOCI category does not apply to a number of asset classes (e.g. equity instruments, non-plain vanilla debt instruments, property, etc.). If a large proportion of the assets backing an insurance liability was not eligible for measurement at FVTOCI, but would instead be measured at FVTPL, there would be a need to recognise any changes in the discount rate of the corresponding liabilities in profit or loss, too, in order to avoid an accounting mismatch. Furthermore, some contracts, such as unit-linked contracts or variable annuities, are managed on a FVTPL basis. Recognising the effect of a change in the discount rate on the insurance liability in OCI does not appear appropriate in these cases. Thus, we suggest adding an option to recognise changes in the discount rate of insurance liabilities in profit or loss under the condition that doing so would avoid an accounting mismatch and taking the high degree of asset dependence into account.
- 16 Another possibility to avoid accounting mismatches might be to consider the use of hedge accounting. We suggest considering the implications for insurers and other entities having to apply the new requirements stemming from the insurance project when developing the proposals for macro hedge accounting.

Question 5 – Effective date and transition

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

- 17 We support the proposed retrospective approach to transition. A retrospective application of the Standard provides relevant information as it allows comparability between existing and new business. The ASCG also supports the simplified retrospective approach when the entity cannot apply the Standard fully retrospectively, as this facilitates transition. Although the retrospective approach to transition enhances comparability, it increases the complexity at the same time. We point out that the complexity arises mainly from the proposed decomposition of cash flows under the “mirroring approach”, as this requirement would have to be implemented retrospectively as well. In addition, not to unlock the CSM for any changes that affect the future service complicates a retrospective determination of the margin. Thus, we strongly suggest a complete unlocking of the CSM as proposed in the *alternative approach* (both for changes in the risk margin and for changes of the value of options and guarantees) to further facilitate transition. There would be no need to determine historical information.



- 18 As regards the effective date of this Standard, we recommend setting a date no sooner than three years from the date of publication given the huge task that insurers face when implementing the requirements.
- 19 Regarding the interaction of IFRS 9 and IFRS 4 we continue to believe that a single effective date for both Standards would be most beneficial for insurance entities and other entities having to apply the proposal. These entities would have the benefit of implementing both Standards at the same time, which minimises operational complexity. Furthermore, it would increase comparability and understandability for financial statement users (this applies specifically to a business that is long term in nature).
- 20 On the other hand, we understand that the IASB is conscious not have the two Standards leapfrog each other and that IFRS 9 is meant to provide an answer to the challenges stemming from the financial crisis. Hence, if the possibility of aligning the effective dates for both Standards was limited, thus leading to different effective dates, we strongly recommend granting entities with insurance business the possibility of reclassifying financial assets upon adoption of the new insurance proposals. This would allow these entities avoiding accounting mismatches otherwise occurring if they were forced to keep their original designation (which had to be made not knowing what the final outcome of the new Standard on insurance would look like).

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

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5? How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft?

Please describe the likely effect of the proposed Standard as a whole on:

- (a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and
- (b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

- 21 In general, implementation of the new insurance requirements represents a significant investment for all stakeholders in the insurance industry, preparers as well as users of financial statements. Some proposals, such as the introduction of a FVTOCI measurement, increase the complexity of implementation in comparison to the 2010 ED's proposals. Nonetheless, in our opinion, we believe this complexity to be appropriate in order to adequately depict the insurance business, which is a complex business. In addition, the costs associated with implementing and meeting the proposed requirements are justified if they make other



non-GAAP measures redundant that are currently used in internal and external communication (such as Embedded Value).

22 However, we believe that some of the IASB's proposals in the Re-ED may cause unnecessary costs where there is no corresponding benefit at the same time.

- According to paragraph 84 of the Re-ED, an entity must disclose a translation of the result of the technique used to measure the insurance contracts into a confidence level. As already mentioned in our comment letter in 2010, we have significant concerns regarding the requirement to translate the insurer's risk adjustment into a confidence level for disclosure purposes. The ASCG acknowledges the IASB's reasons for this proposal, namely to provide comparability. Nevertheless, we do not support that for the following reasons: The requirement represents a rule and contradicts a principle-based Standard; further, it is evidently not in line with paragraph B81 where the Standard does not contain a requirement to specify the technique used to determine the risk adjustment. We understand from the industry that the IASB's proposal represents a significant workload for entities for no equivalent increase in benefits. We would therefore suggest the IASB just require disclosure as well as a description of the methods chosen. Such a description would include quantitative information at an appropriate level of aggregation in the notes in order to provide users with information on the underlying risk averseness.
- In many cases, the proposed method of determining the lock-in discount rate that applied when the contract was initially recognised does not seem appropriate. We are being told that locking in the discount rate at contract inception on an individual contract basis would not be possible using generally accepted property-casualty reserving techniques, as this is inconsistent with how the data is aggregated and modelled (most often on an accident year basis). In the property-casualty business systems for claims and systems for existing contracts are often managed separately. The PAA will therefore be applied broadly, since it does not require any cash flow estimations at inception. This advantage would get lost, if locked-in interest rates at inception were to be applied. Therefore, we recommend the IASB loosen the requirements around the "lock-in" of the discount rate for the liability for incurred claims under the simplified approach in order to avoid unnecessary complexity and to alleviate implementation. Feedback obtained from our working group suggests that the costs for implementing new systems to be able to determine the locked-in rate would be enormous and not accompanied with a corresponding benefit due to the short coverage period for those contracts. We suggest considering providing more flexibility in the determination of the discount rate, e.g. using the discount rate



that applied at the time when the claim is incurred. This would seem an appropriate simplification to avoid disproportionate costs.

- With regard to the second question, we would like to reemphasise that the decomposition of cash flows required under B86 does not appear to be proportionate and does not seem to come with a corresponding benefit for the user of financial statements.

Question 7 - Clarity of drafting

Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB?

If not, please describe any proposal that is not clear. How would you clarify it?

23 Some of the examples in the ED should be revisited, as they are very detailed (and, thus, are contrary to a principles-based approach), do not always depict real-life case and are hard to understand:

- Parts of the Standard are written in a style that is almost incomprehensible even to an informed reader familiar with the business. Especially entities that are not mainly insurance entities but have to apply the Standard to some parts of their business are likely to have serious difficulty when applying the Standard. The language used is very industry-based and therefore hard to understand for non-insurance entities (this specifically applies to the description of the “mirroring approach”).
- As stated previously, the decomposition of cash flows is not clear. The way splitting up of the liability in Illustrative Example 11 is done appears to be illogical and counter-intuitive. We refer to our general concerns provided in our answer to question 2.
- We believe the drafting regarding the reversal of a negative CSM is not clear and could be improved. It remains unclear whether an entity must reverse prior losses through profit or loss before re-establishing a positive margin or not. We support re-establishing the CSM prospectively when the entity forecasts future profits again, which seems to be less complex from an operational point of view. It is also more aligned with the principle that changes of future cash flows related to future coverage or other future services are not recognised in current period profit or loss, but are deferred via the CSM.
- Lastly, the Standard does not provide a definition for “options” and “guarantees”, yet uses this term widely. While it seems that the Re-ED partly refers to the “time value of option and guarantees”, a clear definition would help to avoid misinterpretations of the proposals.



Appendix B – Other issues not covered by questions of the Exposure Draft

Scope – Fixed-fee service contracts

- 1 The proposals may extend the scope of the Re-ED to contract types for which, in our view, an application of IFRS X *Revenue from Contracts with Customers* would be more appropriate (and that have not been considered to be within the scope of IFRS 4 *Insurance Contracts* by constituents, hitherto). In many industries with products specifically designed to meet specific customer needs – this particularly applies to construction contracts as defined in IAS 11 *Construction Contracts* – it is common practice that the relevant manufacturers also provide the associated long-term maintenance. Such long-term maintenance – including the provision of spare parts – requires services specifically tailored to the customised products. This, together with the fact that such maintenance contracts typically have long durations and are material in terms of volume, results in transaction prices being calculated individually for each contract. In other words, transaction prices reflect the risks that are associated with individual contracts. Therefore, one might take the view that the scope exception in paragraph 7(e)(i) does not apply and, accordingly, such contracts are in the scope of the Re-ED. This is because we think that the individual pricing on a contract level does even more reflect the associated risks compared to a pricing on an individual customer level (as discussed in paragraph 7(e)(ii)).
- 2 In our view, scoping such contracts into the Re-ED does not appropriately reflect the economic substance of the contracts, because it is not a predominant purpose of such contracts to ‘insure’ the customer against defects of the maintained product. Instead, the purpose is to minimise downtimes of the product by providing ‘preventive maintenance’. That is, the objective of the maintenance contract typically is to avoid and not to repair defects. Hence, due to the nature of the services to be provided to customers, an application of IFRS X *Revenue from Contracts with Customers* seems more appropriate. Furthermore, the proposals in the Re-ED seem to imply that comparable services may be treated differently. Service contracts for ‘standard products’, for which risks are typically assessed on portfolio level rather than on contract level seem to meet the criterion in paragraph 7(e)(i). It is not clear to us why these contracts should be treated differently from the above-mentioned service contracts for assets designed and manufactured according to specifications by the customer, even if comparable services were provided.
- 3 In order to avoid the consequences described above we suggest considering to delete the relevant criterion in paragraph 7(e)(i) or to find a language that does not result in scoping such contracts into the Re-ED.



Reinsurance contracts held

- 4 We are aware of concerns raised by reinsurers that the Re-ED's proposals for reinsurance contracts on an individual loss basis do not depict the economic relationship between the reinsurance contract and the underlying insurance contract appropriately. In particular, the high dependence of the reinsurance contract on the underlying insurance contract is not taken into consideration adequately. We understand that five global reinsurance entities represented in the *CFO Forum* developed an *alternative approach for reinsurance contracts*: The proposal provides for the determination of the contractual service margin based on the underlying business because of the 1:1 relationship of the reinsurance and the underlying insurance contract. The CSM of the reinsurance asset should reflect the reinsurer's share in the risk of the underlying business. In particular, determination of the CSM is based on the ratio of the risk adjustment that is applied to the CSM of the underlying contract. Furthermore, they argue that the gain or loss from buying reinsurance on an individual loss basis is definitive (except for the credit risk of the reinsurer, which is considered through the determination of the CSM) and should therefore be recognised immediately in profit or loss in order to avoid the possibility of accounting arbitrage.

- 5 We believe that the requirements for reinsurance contracts held should be dependent on the respective type of reinsurance contract. There might be situations where recognition of the gain or loss from buying reinsurance immediately in profit or loss seems fully appropriate, whilst there might be other contracts where the gain or loss should be recognised over the coverage period. We believe that the accounting treatment of the underlying primary insurance contracts should remain unaffected by the reinsurance contracts held (no derecognition). The requirements for the recognition of any gain or loss from buying reinsurance should always reflect the credit risk of the reinsurer. We suggest that the IASB carefully reconsider the guidance provided on reinsurance contracts held and ensure that the economics of these transactions are reflected appropriately in the cedent's accounts.

**Appendix C – A brief summary of the key features of the *alternative approach***

(For a complete description please refer to Appendix 5 in EFRAG's Draft Comment Letter)

1. Projection of future cash flows

- 1 To determine the insurance contract liability in cases where it depends on underlying items, the entity determines the contract liability prospectively at each reporting date. If the insurer's cash outflows are dependent on what the entity earns on the asset side – regardless of whether participation is contractually determined or discretionary – this dependence should be taken into account when determining the insurance contract liability. In other words, the entity should consider all expected contractual or discretionary benefits when determining the liability. If the insurer expects changes in the returns of the assets, the entity has to adjust the cash flows on the liability side, too, if they are asset-dependent. Thus, any asset dependence is considered when projecting the cash flows on the liability side. For those liabilities where the duration exceeds the assets' duration, the entity has to make reinvestment assumptions and consider them when determining the insurance contract liability.
- 2 The value of options and guarantees is included in the fulfilment cash flows using stochastic valuations. Including options and guarantees as part of the fulfilment cash flows (unless they are not separated according to Re-ED.9-11) is in line with the Re-ED's basic requirement to include all cash inflows and outflows when determining the fulfilment cash flows. Options and guarantees are part of the service of the insurer and are therefore recognised through the cash flow projection and treated consistently with the other parts of the fulfilment cash flows.

2. Discount rate to reflect the time value of money

- 3 The discount rate used for unwinding the time value of money into the income statement should be unlocked for asset-dependent liabilities in order to reflect that asset dependence, as is already envisaged in the Re-ED. Cash flow projections and discount rates need to be aligned to avoid a distortion of results. In the *alternative approach* the asset dependence is also taken into account when determining the discount rate. If the entity expects changes of the amounts to be allocated to the policyholder in future periods this should result in an adjustment of the discount rate as well. In practice, there are many contracts where the duration of the assets is shorter than the duration of the liabilities. The *alternative approach* reflects this as follows when determining the yield curve used for discounting: For that part of the liability that is matched with an underlying item (same durations), the entity has to determine the discount rate depending on the asset returns; for the part of the liability for which the duration of the liability exceeds the duration of the underlying assets, the discount rate is based on the expected reinvestment return based on current market information where



available. If the entity expects any changes of the asset returns, it adjusts the discount rate to reflect these changes. Thus, the cash flow projection and the determination of the discount rate are made on a consistent basis.

3. Risk adjustment

- 4 The determination of the risk adjustment for contracts with a link to underlying items does not differ from the risk adjustment determined for non-participating contracts. The general requirements of the Re-ED apply.

4. Contractual service margin

- 5 The *alternative approach* requires a prospective measurement of the CSM. Considering that the CSM represents the unearned profit, it has to be adjusted for changes that affect future cash flows and the future profitability of the insurer. Changes in asset returns or crediting rates are going hand in hand with changes of the shareholder's portion of the asset returns. For example, falling interest rates on assets result in a decreasing asset return for future assets that has to be split between the shareholder and the policyholder. As these changes affect future cash flows as well as the future profitability of the insurer, the CSM must be adjusted for changes in returns on underlying items, including reinvestment assumptions, retained by the insurer. Recalibrating the CSM for prospective changes in estimates meets the definition of the CSM as the unearned profit. Since the generation of asset returns is an integral part of services under a participating contract, changes in estimates regarding these cash flows must therefore lead to an adjustment of the CSM.
- 6 As the CSM must not be negative, the *alternative approach* encompasses an implicit loss recognition test as it is based on updated assumptions and reflects the current time value of options and guarantees. To enhance transparency a disclosure requirement for the time value of options and guarantees should be included.
- 7 Under the *alternative approach* the entity accretes interest on the CSM based on an updated discount rate in the same way as the entity recognises interest expense in profit or loss for the other components of the liability. Since the unlocking of the discount rate includes assumptions on reinvestment rates, the CSM based on that discount rate enables a reflection of future profit expectations.