

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

22. Sitzung IFRS-FA am 04.12.2013  
22\_13b\_IFRS-FA\_Insurance\_SN\_EFRAG

15 November 2013

Dear Hans,

**Re: Insurance Contracts**

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the revised Exposure Draft *Insurance Contracts*, issued by the IASB on 20 June 2013 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG welcomes the IASB's decision to re-expose the initial Exposure Draft *Insurance Contracts* that was issued in July 2010 (the '2010 Exposure Draft'). We note that changes to the 2010 Exposure Draft have been proposed based on the comments received from constituents, including EFRAG. We appreciate the effort with which the IASB has considered its requests to address the accounting mismatches that may arise from the application of different measurement models to financial assets and insurance liabilities, to distinguish short-term volatility from performance of an insurer, to review the proposals relating to the adjustment of the contractual service margin and to introduce retrospective application of the future standard.

We provide below a summary of EFRAG's position on the revised proposals together with our recommendations on how to address our remaining concerns.

Regarding the general measurement and presentation requirements, EFRAG does not support the mandatory use of other comprehensive income to report the impact of changes in the discount rate of the insurance liabilities. EFRAG believes that avoiding mismatches calls for alignment of measurement of assets that are backing insurance liabilities.

EFRAG recommends the IASB to identify a third 'liability-driven' long-term investment business model as stated in our letter of 25 October 2013, which was based on the feedback received in our 'Long-term investing activities business model' consultation. On that basis, entities would need to make an accounting policy choice on an entity level whether to report the impact of changes in the discount rate of the insurance liabilities in the statement of profit or loss or the statement of other comprehensive income. However, if an entity elects the latter, it should be eligible, for portfolios managed on a fair value through profit or loss basis, to report the impact in profit or loss.

In case our preferred approach is not adopted (i.e. the fair value through other comprehensive income is not extended to more assets in IFRS as they stand or have

been proposed), we believe that insurers should have the option to make an accounting policy choice at portfolio level to report the impact of changes in the discount rate of the insurance liabilities in the statement of profit or loss or the statement of other comprehensive income. Without such flexibility insurers would not be able to eliminate accounting mismatches to an acceptable extent.

EFRAG recommends including insurance liabilities in the scope of the macro hedging project to address accounting mismatches that may result from measuring at fair value through profit or loss derivatives held as part of hedging strategies when the fair value through other comprehensive income is selected.

We note that the IASB's proposals include a measurement and presentation exception for contracts that require the entity to hold the underlying items and specify a link to the returns of those items. EFRAG appreciates the IASB's efforts to address the accounting mismatch issue for contracts with asset dependent cash flows. However, EFRAG does not support the proposed 'mirroring approach', because:

- (a) The proposed measurement and presentation exception will only apply to limited types of contracts;
- (b) Increases the complexity because of the arbitrary decomposition of cash flows;
- (c) Part of the insurance liability will be measured on a basis different from the present value of the fulfilment cash flows;
- (d) In EFRAG's view, any adjustment to solve the accounting mismatch issue should start from the liabilities side and not from the assets side;
- (e) Allows only for a limited unlocking of the contractual service margin which contradicts the definition of the contractual service margin as the unearned profit; and
- (f) Presenting the effects of changes in the discount rate partly in the statement of profit or loss and partly in the statement of other comprehensive income would make financial statements difficult to understand and would impair comparability of contracts with similar economic features.

In the context of contracts with asset dependent cash flows, EFRAG has considered the key principles and mechanics of an insurance industry alternative approach. EFRAG believes that this approach, can address some of the concerns which EFRAG expresses in respect of the 'mirroring approach'. Therefore, EFRAG supports the key principles of the insurance industry alternative approach. However, EFRAG believes that there are still some aspects in this alternative approach that need to be further developed. EFRAG notes that the same applies for the IASB approach, although aspects may be different.

EFRAG believes that the IASB should allow sufficient time for testing any alternative proposal to ensure that the application mechanisms work appropriately for various products under different economic scenarios.

In relation to the proposals for adjusting the contractual service margin, EFRAG agrees with the IASB's proposal to adjust the contractual service margin, as differences between the current and previous estimates of cash flows that relate to future coverage or services will affect the profitability of the contracts. EFRAG believes that the contractual service margin shall represent the unearned profit in an insurance contract as this would result in decision-useful information. Accordingly, EFRAG believes that this margin should also be adjusted to reflect changes in the estimates of the risk adjustment associated with future coverage.

Regarding the proposals on transition, EFRAG agrees with the proposed modified retrospective approach as we understand that in many circumstances entities would be able to make a reasonable estimate of the remaining contractual service margin based on historic public and internal information about portfolios. However, if the IASB were to require different effective dates for IFRS 9 and the new insurance contracts standard and IFRS 9 would be effective earlier, EFRAG recommends that for all entities where insurance forms a significant part of an entity's activities:

- (a) The effective date of IFRS 9 should be deferred until the effective date of the new insurance contracts standard. In our view, early application of both IFRS 9 and the new insurance contracts standard should be permitted, so as to facilitate the parallel application of IFRS 9 and the new standard on insurance contracts at the earliest possible date;
- (b) However, if IFRS 9 is not deferred to align with the effective date of the future insurance contracts standard, EFRAG believes entities should be permitted to reconsider designations (of hedges and the fair value option) and classifications of investment portfolios accounted for under IFRS 9 when they first apply the new insurance contracts standard.

EFRAG further recommends a three year implementation period from the date of publication of the new insurance contracts standard.

In relation to the ED proposals for insurance contract revenue and expense, EFRAG believes that the earned premium approach, which recognises revenue as services are provided, offers the promise of significant advantages. Answers differ depending on whether the companies apply the simplified approach. EFRAG believes that for companies applying the simplified approach, the proposed earned premium approach is suitable as traditional numbers would continue to be disclosed. However, based on the results of our consultation process and field-test, we are concerned that the revenue figure that would result is not an indicator that is currently used in the life insurance industry today and the costs of implementing such an approach might outweigh the benefits.

Therefore, for companies not applying the simplified approach, EFRAG is supportive of a summarised margin presentation with volume information disclosed in the notes to the financial statements.

To support the IASB's effort in developing a robust standard for insurance contracts, EFRAG, in addition to its usual analysis and due process, has organised field-testing activities in cooperation with the National Standard Setters of Germany (ASCG), France (ANC), Italy (OIC) and the United Kingdom (FRC), and the IASB with participants from the insurance and reinsurance industry and has attended outreach events conducted by the IASB in co-operation with European National Standard Setters. 13 companies have taken part in the field-testing exercise and EFRAG Staff has attended 6 outreach events. The preliminary results of the field-test activities have been shared with EFRAG's Technical Expert Group, National Standard Setters ANC, ASCG, FRC, the OIC and IASB staff during the finalisation stage of EFRAG's final comment letter. The field-test report will be finalised after EFRAG's final comment letter and will be communicated separately.

We note that there are still some key aspects where the IASB needs to focus on in the coming months. However, EFRAG remains fully supportive of the objective that the Board is attempting to fulfil the project in the near term, which will be of great benefit to investors and will improve financial reporting given the lack of an IFRS in this area.

Our detailed responses to the questions in the ED are set out in the Appendix 1. The remarks focus on the specific questions raised in the ED. Appendix 2 includes additional comments for the IASB's consideration.

If you would like to discuss our comments further, please do not hesitate to contact Ralitza Ilieva, Sapna Heeralall or me.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Françoise Flores', with a small horizontal line underneath.

Françoise Flores

**EFRAG Chairman**

## APPENDIX 1 – Responses to the questions in the ED

### EFRAG's responses to the questions raised in the Exposure Draft

#### Adjusting the contractual service margin

##### Question 1

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if:

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

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

#### EFRAG's response

**EFRAG believes that the contractual service margin should represent the unearned profit in an insurance contract, as it considers that this results in decision-useful information.**

**EFRAG therefore agrees with adjusting the contractual service margin for differences between the current and previous estimates of cash flows that relate to future coverage or services that will affect the future profitability of the contracts. Such accounting would also avoid counterintuitive results of immediate recognition of adverse changes in estimates in profit or loss when contracts are profitable or early recognition of profits that might reverse over time, and thus bring consistency with how the margin is determined at inception.**

**However, considering that the contractual service margin represents the unearned profit in an insurance contract, EFRAG believes that it should also be adjusted to reflect changes in the estimates of the risk adjustment associated with future coverage.**

**EFRAG's comments on the contractual service margin for contracts with assets dependent cash flows are provided in the response to Question 2.**

*Contracts accounted for using the general measurement requirements in the ED*

#### Changes in estimates of the present value of future cash flows

- 2 In its comment letter in response to the 2010 Exposure Draft, EFRAG highlighted as a main concern that under those proposals the contractual service margin did not represent the unearned profit that entities would recognise by providing services even though such an approach would provide the most useful information. EFRAG therefore agrees with the proposal in the ED that differences between current and previous estimates of the present value of future cash flows should be added to, or deducted from, the contractual service margin if those

changes relate to future coverage or services, provided that the margin does not become negative.

- 3 In our view, adjusting the contractual service margin for such changes in estimates would provide a faithful representation of the remaining unearned profit as those changes affect the future profitability of the contracts. More particularly, we agree with the rationale in paragraph BC31 of the ED that this measurement would avoid counterintuitive results of immediate recognition of adverse changes in estimates when contracts are profitable, while it would bring consistency between the initial and subsequent measurement of the contractual service margin.
- 4 EFRAG acknowledges that the distinction between differences in estimates that relate to (i) future coverage and other future services under the contract and (ii) experience adjustments relating to past coverage, may lead to complexity in practice, as entities would need to identify separately the cash flows that would adjust the contractual service margin and those that would be recognised immediately in profit or loss. However, we believe that this increase in complexity would be outweighed by the more transparent and relevant information on the effects of changes in estimates in the notes.

#### Changes in the risk adjustment

- 5 Considering EFRAG's view that adjusting the contractual service margin would provide relevant information about the effect of changes in estimates after initial recognition, we do not agree with the IASB's proposal that the effect of changes in the risk adjustment should be fully recognised in profit or loss in the period of the change.
- 6 The IASB argues in paragraph BC32 (e) of the ED that changes in the risk adjustment do not affect the amount of unearned profit because those changes unwind over time. However, as noted in paragraph BC36 of the ED, changes in the risk adjustment contain three components: (i) a release from risk as the coverage period expires, (ii) changes in risk that relate to future coverage, and (iii) changes in risk that relate to incurred claims.
- 7 Considering that the contractual service margin represents the unearned profit, EFRAG believes that it should also be adjusted to reflect changes in the estimates of the risk adjustment associated with future coverage. We understand that one of the reasons why the IASB did not propose to adjust the contractual service margin is the difficulty inherent in the disaggregation between components in each reporting period. However, EFRAG believes that such split would be more consistent with the principles underlying the general measurement model and would not require additional efforts by preparers. In particular, EFRAG understands that insurers are used to determine separately the part of the risk adjustment that relates to a particular reporting period and the part that refers to future coverage.

#### Recognition in profit or loss of the contractual service margin

- 8 EFRAG agrees with the proposals in the ED that the contractual service margin should be recognised over the coverage period in a pattern that reflects the provision of services as required by the contract, as we believe that insurance coverage would be the primary service provided once entities would have identified and accounted for separately any distinct investment components and goods and services embedded in the contracts. If the premiums charged to policyholders include payments for other services not accounted for separately,

like asset management, we still believe that entities should recognise the contractual service margin over the coverage period, because this is the period over which entities would provide the insurance coverage and other services promised in the insurance contracts.

- 9 We acknowledge that insurance coverage terminates at the end of the coverage period. However, there are activities such as claims settlement that can be performed after the coverage period has ended. We agree with the IASB's view that the settlement of insurance liabilities should not be considered as a service that is promised in the insurance contract. In effect, the definition of an insurance contract focuses on the transfer of significant insurance risk rather than on the provision of services necessary to settle the obligations arising from the insured events. We further note here that the risk adjustment that entities would recognise for bearing risk would be recognised in profit or loss as and when they are released from risk in both the coverage and settlement period, as there is still uncertainty in the amount and timing of the cash flows beyond the coverage period.

#### Accretion of interest on the contractual service margin

- 10 Except when the cash flows in the insurance contract are asset dependent (see Question 2), the ED requires the contractual service margin to be adjusted for the time value of money through accretion of interest using the interest rate determined at the inception of the contract. We understand that the main objective of accreting interest is to reflect the change in value that occurs when the premium is received before the related services are provided, rather than reflecting the current price that the entity would charge at the reporting date to provide the remaining services.
- 11 EFRAG agrees that interest should be accreted on the contractual service margin because the margin is the difference at inception of the various components that are all discounted. Furthermore, we believe that this would convey more useful information about the entity's progression on providing the promised services under the contract. We note that if interest was not accreted on the contractual service margin, the amount recognised as income in future periods would be understated, in particular for long-term insurance contracts.
- 12 For contracts with assets dependent cash flows, EFRAG believes that the discount rate for the accretion of interest on the contractual service margin should be unlocked and not locked-in at inception of the contracts. For our comments on the contractual service margin for contracts with assets dependent cash flows, please refer to our response to Question 2.

#### Options and guarantees that are closely related to the insurance component

- 13 The treatment of changes in the value of options and guarantees is unclear in the ED. Under the general measurement requirements (i.e. when the mirroring approach, discussed in Question 2, is not applicable), the ED does not separate – for the purposes of subsequent measurement – the cash flows arising from embedded options and guarantees from the total expected cash inflows and outflows. Although the ED is not explicit on the issue, EFRAG understands that subsequent changes in the intrinsic and time value of options and guarantees would be recognised:
- (a) In profit or loss as changes in cash flows, provided that the options and guarantees do not relate to future coverage or other future services provided

under the contract (in which case the changes in their value would adjust the contractual service margin), and

(b) In other comprehensive income to reflect the effect of changes in the discount rate in the intrinsic and time value of these options and guarantees.

- 14 Paragraph BC127(b) of the ED explains that there would be an inconsistent presentation of changes in the value of options and guarantees embedded in insurance contracts depending on whether the options and guarantees are embedded in a contract that requires the entity to hold underlying items and specifies a link to returns on those underlying items.
- 15 EFRAG believes that the IASB has not sufficiently considered the treatment of options and guarantees that are closely related to the insurance component. EFRAG's view is that changes in the value of options and guarantees should be treated consistently with all other elements of the insurance liability. This means that changes in the value of options and guarantees are recognised based on the nature of the change and the measurement application followed for other elements of the insurance liability (i.e. in the contractual service margin, the statement of profit or loss, or the statement of other comprehensive income).

Re-establishing an exhausted contractual service margin after a favourable change in cash flows

- 16 EFRAG believes that favourable changes subsequent to an exhausted contractual service margin should be treated by first recognising reversal of past losses within profit or loss until such a time that all prior losses have been fully offset. Subsequent to this, a contractual service margin can then be re-established at its equivalent historical value. EFRAG believes that this would be more consistent with the definition of the contractual service margin as the expected unearned profit. Additionally, EFRAG believes that the benefits of this approach outweigh the cost and additional complexity of tracking these losses.

Unit of account

- 17 Although the ED does not specify a unit of account for adjusting the contractual service margin, paragraph BCA113 of the ED implies that the unit of account would be at a lower granular level than the portfolio level and this would cause considerable operational complexity that increases costs without clear benefits. Therefore, EFRAG supports the consistent use of the portfolio as the unit of account, also for the release of the contractual service margin.

*Contractual service margin for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items*

- 18 As explained in our answer to Question 2 below, EFRAG has some concerns about the measurement and presentation exception that the IASB is proposing for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items.

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

**Question 2**

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 (i.e. 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?

### EFRAG's response

**EFRAG appreciates the IASB's efforts to address the accounting mismatch issue for contracts with asset dependent cash flows. However, EFRAG does not support the proposed 'mirroring approach', because:**

- **The proposed measurement and presentation exception will only apply to limited types of contracts;**
- **It increases the complexity because of the arbitrary decomposition of cash flows;**
- **Part of the insurance liability will be measured on a basis different from the present value of the fulfilment cash flows;**
- **Any adjustment to solve the accounting mismatch issue should, in our view, start from the liabilities side and not from the assets side;**
- **It allows only for a limited unlocking of the contractual service margin which contradicts the definition of the contractual service margin as the unearned profit; and**
- **Presenting the effects of changes in the discount rate partly in the statement**

**of profit or loss and partly in the statement of other comprehensive income would make financial statements difficult to understand and would impair comparability of contracts with similar economic features.**

**EFRAG has in the past months considered the key principles and mechanics of an insurance industry alternative approach. We believe that it can address some of the above concerns. Therefore, EFRAG supports the key principles of the insurance industry alternative approach. However, we believe that there are still some aspects in this alternative approach that need to be further developed. We note that the same applies for the IASB approach, although aspects may be different**

**EFRAG believes that the IASB should allow sufficient time for testing any alternative proposal to ensure that the application mechanisms work appropriately for various products under different economic scenarios.**

- 19 EFRAG appreciates the IASB's efforts to address the accounting mismatch issue for contracts with asset dependent cash flows. However, EFRAG does not support the proposed 'mirroring approach', because:
- (a) The proposed measurement and presentation exception will only apply to limited types of contracts;
  - (b) It increases the complexity because of the arbitrary decomposition of cash flows;
  - (c) Part of the insurance liability will be measured on a basis different from the present value of the fulfilment cash flows;
  - (d) Any adjustment to solve the accounting mismatch issue should, in our view, start from the liabilities side and not from the assets side;
  - (e) It allows only for a limited unlocking of the contractual service margin which contradicts the definition of the contractual service margin as the unearned profit; and
  - (f) Presenting the effects of changes in the discount rate partly in the statement of profit or loss and partly in the statement of other comprehensive income would make financial statements difficult to understand and would impair comparability of contracts with similar economic features.

#### Scope

- 20 The ED proposes to eliminate any accounting mismatches in measurement and presentation when there is no possibility of economic mismatches. More specifically, the ED notes that there is no possibility of economic mismatch if the contract:
- (a) Requires the entity to hold the underlying items; and
  - (b) Specifies a link between the payments to the policyholder and the returns on those underlying items.
- 21 We agree that when the above two criteria are met, or when the insurer voluntarily holds the underlying assets, insurers will not suffer any economic mismatches. However, EFRAG believes that the IASB's proposals will apply to a very limited

set of contracts and leave unresolved the mismatch issue in many other situations that are economically quite similar.

- 22 The field-testing activities that EFRAG performed jointly with the IASB, ANC, ASCG, FRC and OIC reveal that there are many types of participating contracts for which the cash flows depend on the asset returns. While for some of these contracts there is a contractual link, others do not have such a contractual link and may not require the entity to hold the underlying items. Even for some unit-linked contracts there is no requirement for the entity to hold the underlying items. Thus, similar economic features will be treated differently because some of them will meet the measurement and presentation exception criteria and others not. EFRAG does not support this consequence of the IASB's approach and believes there is no need for different measurement models for participating and non-participating contracts. The general building block approach should be applied to all types of insurance contracts.
- 23 We note that the IASB has already taken into account the asset dependency in the general building block approach by introducing the requirement in paragraph 26(a) of the ED where the insurance contract liability is dependent on underlying items (e.g. asset returns). In such case, the entity should take that dependence into account when determining the discount rate used to present interest expense in profit or loss.
- 24 In our view, a measurement and presentation approach for contracts with a performance-sharing mechanism should work for any type of insurance contract and not only for contracts (e.g. unit-linked types of contracts) where all of the benefits delivered to the policyholder are directly determined by value of the underlying items (e.g. the price of units in an internal or external investment fund). Therefore, not having a separate model for certain asset dependent insurance contracts provides principle-based accounting for insurance contracts and allows for similar accounting to be applied to economically similar contracts.

*Segregation of cash flows arising from insurance contracts*

- 25 EFRAG understands that the IASB proposed splitting cash flows in order to eliminate accounting mismatches to the maximum extent possible and perform the split in a way that matches the economic features of the insurance liability with the economic features of the underlying items. However, we have serious concerns about this requirement.
- 26 The results from the field-test reveal that the IASB's proposal is highly complex for preparers and the requirements in the ED are unclear even for a simple insurance contract. There are a number of interpretations as to how the cash flows could be bifurcated, with each interpretation resulting in a different measurement of the insurance contract liability. Furthermore, most participants in the field-test note that the split is not consistent with the way contracts with asset dependent cash flows are assessed and managed. Another difficulty is the necessary assignment of assets to liabilities.
- 27 EFRAG questions 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. For our comments and views on treatment of options and guarantees closely related to the other cash flows, please see our response to Question 1.
- 28 EFRAG also believes that the split of the cash flows is not consistent with the key assumption that the entity should measure the insurance contract in a way that

portrays a current assessment of the combined package of cash inflows and cash outflows generated by both financial and service elements.

Measuring the liabilities on a consistent basis and addressing the accounting mismatch from the liabilities side

- 29 Applying the split will result in part of the insurance liability being measured on a basis different from the present value of the fulfilment cash flows that an entity expects to pay to the policyholder and hence might not represent the true estimate of the ultimate probability-weighted expected cash flows. When the underlying items are not measured on a fair value basis but the entity is required (or chooses) to disclose their fair value, the ED requires the entity to disclose the extent to which the differences between the fair value and the carrying amount of the underlying items would be passed on to policyholders. Such disclosure would be useful to inform users of financial statements that the policyholders have an economic interest in the difference between the fair value of the underlying items and their carrying amount. However, such disclosures would not be required if disclosure of the fair value of the underlying items is not required (e.g. deferred tax or goodwill).
- 30 EFRAG believes that for all types of contract (including contracts with cash flows that depend on the returns of underlying items), the present value of the fulfilment cash flows that an entity expects to pay to the policyholder would more faithfully represent the entity's contractual obligations and rights. This would also convey more useful information about the amounts, timing and uncertainty of the cash flows generated by those obligations and rights. Therefore, EFRAG believes that all contracts should be measured using the present value of fulfilment cash flows.

Contractual service margin for contracts with asset dependent cash flows

- 31 Another key concern relates to the limited unlocking of the contractual service margin for changes in underlying items for participating contracts. As is noted in our response to Question 1, EFRAG believes that the contractual service margin should always reflect the unearned profit arising from the insurance contracts. For participating contracts, an intrinsic element of the unearned profit is the investment return arising from the contracts; EFRAG believes it is appropriate to account for the effect of changes in investment returns in the contractual service margin. The sharing of investment returns between shareholders and policyholders is a key feature of participating contracts. Consequently, we consider this treatment to be more consistent with the definition of the contractual service margin as the unearned profit for providing services under the insurance contract.

Presentation of interest expense in profit or loss for cash flows that are expected to vary directly with returns on underlying items

- 32 Although EFRAG understands the underlying reasoning for the suggested approach for presenting interest expense, we are concerned about the complexity, which would reduce the usefulness of the financial statements. The proposals would require the effects of changes in the discount rates for similar contracts or even for the same contract – due to the split in the cash flows – to be recognised partly in the statement of profit or loss and partly in the statement of other comprehensive income. This would be difficult to understand and would impair comparability of contracts with similar economic features (e.g. contracts with asset dependent cash flows). Additionally, this would distort the presentation of insurers' performance of participating contracts, including reflecting in profit or loss considerable volatility arising from changes in asset values that may have no

relationship with the returns that the insurer earns by providing services under these contracts.

- 33 The split would also distort performance reporting in general. Investors will find this difficult to understand, particularly with regards to what has changed and where that change has been recorded. Therefore, we have doubts as to the decision usefulness of the decomposition proposals for users of financial statements.

Alternative approach

- 34 EFRAG understands that the insurance industry is developing an alternative to the IASB's 'mirroring approach', which is based on the present value of the fulfilment cash flows for all insurance contracts and would result in one consistent approach regarding the measurement of insurance liabilities. This approach has now been published in several comment letters to the IASB on the ED (e.g. the letter submitted by the European CFO Forum/Insurance Europe).

- 35 EFRAG has considered the key principles and mechanics of this alternative approach and believes that it could address some of the concerns which EFRAG expresses in respect of the 'mirroring approach' proposed by the IASB.

- 36 EFRAG supports the following key principles of the insurance industry proposal:

- (a) No exception for the measurement of participating contracts. Instead, the industry proposal defines how to apply the general principles of the ED to all contracts with a link to underlying items;
- (b) All insurance contract liabilities would be measured at current fulfilment value on the face of the balance sheet without the bifurcation of cash flows. By removing the need to bifurcate cash flows, the industry proposal will increase the consistency in the measurement of participating contracts between insurers, thereby aiding comparability;
- (c) The contractual service margin should always reflect the unearned profit arising from the insurance contracts and be determined on a fully unlocked basis. For participating contracts, an intrinsic element of the unearned profit is the investment return arising from the contracts; EFRAG believes it is appropriate to account for the effect of changes in investment returns in the contractual service margin. The sharing of investment returns between shareholders and policyholders is a key feature of participating contracts. Consequently, we consider this treatment to be more consistent with the definition of the contractual service margin as the unearned profit for providing services under the insurance contract;
- (d) Profit would be recognised in accordance with the fulfilment of the contract as services are provided, similar to the general revenue recognition principles.

- 37 The insurance industry approach puts forward an Asset-Liability Management approach that EFRAG supports. In addition, the alternative approach can accommodate both fair value through other comprehensive income and fair value through profit or loss approaches for presenting the effect of changes in the discount rate for both the asset and liability side, which will reduce the frequency and severity of accounting mismatches. This in turn, makes the financial statements more meaningful. EFRAG also believes that the alternative approach would be less complex than the IASB's mirroring approach as there would be no

bifurcation of cash flows and the building block model would apply to these contracts as well.

- 38 Below are some aspects in the insurance industry alternative approach, which EFRAG believes should be further developed:
- (a) More guidance is needed to determine the contracts that should be classified as participating contracts and, therefore, have to reflect the asset dependence using an asset-based discount rate.
  - (b) More guidance should be developed regarding the discount rate used for the calculation of the asset dependent cash flows.
  - (c) The alternative should be developed in a way that it is applicable to all asset classes including equities and real estate. It is important that accounting for changes in (financial) assumptions should be consistent for the financial assets and real estate, and for the insurance liabilities.
  - (d) 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.
  - (e) Profit should be recognised in accordance with the fulfilment of the contract as services are provided, similar to the general revenue recognition principles. However, in order to determine the pattern of release of the contractual service margin for contracts with asset dependent cash flows, it would be necessary to analyse the nature of the relevant services provided for those contracts (e.g. asset management, risk management) that drive profit recognition.
- 39 Although EFRAG believes that there are still some aspects that need to be further developed in the insurance industry alternative approach, the same applies to the IASB approach, even if aspects may be different.
- 40 EFRAG believes that the IASB should allow sufficient time for testing any alternative proposal to ensure that the application mechanisms work appropriately for various products under different economic scenarios and also to consider the information provided being more useful and informative.

### **Presentation of insurance contract revenue and expense**

#### **Question 3**

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?

#### **EFRAG's response**

**EFRAG believes that the earned premium approach, which recognises revenue as services are provided, offers the promise of significant advantages.**

**However, based on the results of our consultation process and field-test, we are**

**concerned that revenue figure that would result is not an indicator that is currently used in the life insurance industry today and the costs of implementing such an approach might outweigh the benefits.**

**Presentation of revenue and expenses also differs depending on whether the entities apply the simplified approach.**

**EFRAG believes that for entities applying the simplified approach, the proposed earned premium approach is suitable as traditional numbers would continue to be disclosed.**

**However, for companies not applying the simplified approach, EFRAG is supportive of a summarised margin presentation with volume information disclosed in the notes to the financial statements.**

**EFRAG does not support the proposed disaggregation of investment components.**

41 In its comment letter in response to the 2010 Exposure Draft, EFRAG was in favour of a summarised margin presentation combined with volume information on the face of the statement of comprehensive income. That is, EFRAG considered that volume information, such as premiums written, claims expenses, and claims handling expenses, should be presented on the face of the statement of comprehensive income for all insurance contracts together with the underwriting margins.

42 After issuing EFRAG's comment letter on the 2010 Exposure Draft, EFRAG staff explored different presentations for the statement of comprehensive income to combine volume and margin information, which were shared with the IASB staff. In this regard, we appreciate the IASB's effort in considering those alternatives throughout the re-deliberation process. The resulting proposals in the ED, however, are different from EFRAG's proposals, and our view on the ED is discussed in more detail in paragraphs 47 to 54.

43 The feedback we received from constituents shows that the difficulty to have one revenue number for all types of insurance contracts comes from the differences between life and non-life insurance contracts. While entities that issue mainly non-life contracts tend to accept the proposed definition of insurance contract revenue, this is not the case for those that issue life contracts. Arguments also differ between generalist users and insurance specialist users. Generalist users support the earned premium proposed by the IASB because of the comparability with other industries, while insurance specialist users do not believe it produces a useful number and seem to prefer the summarised margin presentation.

44 In the following paragraphs, we note some of the arguments for and against the IASB's earned premium approach.

*Arguments for and against the Exposure Draft proposals for revenue and expense presentation*

45 In EFRAG's view, the arguments in favour of the ED proposals are the following:

- (a) The proposals will provide comparability between insurers and entities in other industries which provide services, because the revenue will be recognised when the services are provided;
- (b) The proposals are similar to the presentation of revenue and expenses for other long-term construction contracts which is also based on a notional allocation methodology;

- (c) The understandability of the financial statements will be improved as measures of the activity undertaken by an organisation will be based on commonly understood notions of revenue and expenses;
- (d) Comparability would be provided between insurers and other deposit-taking institutions because the investment components would be disaggregated and excluded from the revenue number. There would also be comparability between the 'simplified approach' and the approach under the general measurement requirements;
- (e) The proposals will also provide useful information about the revenue and expense split between the insurance coverage provided and investment activities undertaken for policyholders;
- (f) The proposals are conceptually sounder than the previous summarised margin presentation because revenue is measured as the change in the insurance liability over the financial reporting period, while the previous proposals did not measure revenue on this basis;
- (g) Many respondents to the 2010 Exposure Draft stated that margin information was useful, but could be presented in the notes and not necessarily on the face of the financial statements;
- (h) The summarised margin presentation does not faithfully represent the extent to which services are provided under an insurance contract while the proposals do;
- (i) The proposals, unlike the summarised margin presentation, provide a gross measure of performance that is consistent with the principles of measuring revenue from contracts and has been requested by those who report and use financial measures;
- (j) Many respondents to the 2010 Exposure Draft have indicated that the information from the measurement model discussed in (j) above would be useful and the IASB has concluded that the benefits of the information provided would outweigh the costs involved.

46 On the other hand, the arguments against the ED proposals are the following:

- (a) The proposals of projecting all expected future premiums over time is based on a theoretical notional allocation of the insurance liability and therefore the revenue generated from these insurance liabilities is also based on a theoretical notional concept;
- (b) The proposals seem to be an accounting construct, which provide artificial comparability of information, instead of providing a useful number to the users of the financial statements;
- (c) The proposals would result in information that is very different from that currently used in the insurance industry and provided to the users of financial statements;
- (d) A fundamental concern with the proposals is that the principle of accounting for an insurance contract as a single transaction is not considered, especially when taking into account that different components are packaged and priced together. Therefore, some believe there is a disconnect between the measurement model and the revenue number;

- (e) The proposals result in the presentation of information that is similar to revenue and expenses for other long-term contracts; however, such information is currently not used as key information by management of entities with insurance activities;
- (f) The proposals do not meet the cost/benefit criteria and the information would be burdensome to calculate in practice, while the tracking of different components making up the revenue measure will add complexity for preparers and may be costly to implement.

*EFRAG's view*

- 47 EFRAG believes that the earned premium approach, which recognises revenue as services are provided, offers the promise of significant advantages including the comparability of revenues from insurance companies with other industries providing services.
- 48 However, EFRAG notes that the majority of the participants in its field-test expect medium to high implementation costs of the proposals. The expected implementation costs were mainly related to changes in IT systems, identifying the non-distinct investment components, adjusting the operating model for actuarial analysis and that implementation was considered to be time-consuming. Therefore EFRAG believes that the costs to be incurred would not outweigh the benefits.
- 49 The need of users for relevant and comparable information and should be balanced against the costs for preparers. EFRAG thinks that a less conceptually pure approach could be used that provides similar information usefulness to users. Therefore, EFRAG believes that for companies applying the simplified approach, the proposed earned premium approach is suitable. However, for companies not applying the simplified approach, we, on balance, support summarised margin presentation with volume information disclosed in the notes to the financial statements.
- 50 The Basis for Conclusions of the ED discussed two other possible alternative views that the IASB does not support, namely:
  - (a) Current industry practice of showing premium revenue as the written premiums for the period. This view is not supported by EFRAG either, as it is a measure of the new business written rather than a measure of the revenue as determined using the general measurement approach which measures the change in the insurance liability during the period; and
  - (b) Premiums due presentation which allocates the total expected insurance contract revenue to periods in which the premiums become unconditionally due to the entity. EFRAG also does not support this view as it is not consistent with commonly understood concepts of revenue and uncertainty would be reflected in claims and benefits presented.

*Disaggregation of investment components*

- 51 The IASB's proposals for revenue and expense presentation would exclude investment components from insurance contract revenue and incurred claims, even though they are not unbundled because they are not distinct and are highly interrelated with the insurance component.
- 52 The investment component amounts excluded from revenue and expenses represents the amount that is built up over time and is owed to the policyholder

For example, an investment component might be repaid if the policy lapses or might be included in the benefit paid upon death of the policyholder. The amount included in this death benefit could then be calculated as the amount that is due to the policyholder if he did not die, but rather surrendered the insurance policy.

- 53 Under the ED, an investment component that is not unbundled should be excluded from the premiums and claims presented in the statement of profit and loss. In contrast, there is no requirement for the investment component part of the insurance liability to be calculated and disclosed separately in the opening or closing balance sheet at the financial reporting date.
- 54 Although EFRAG understands the underlying conceptual reasoning for disaggregating the non-distinct investment components from premiums and claims, we have two key concerns in relation to this requirement. First, this is inconsistent with the ED's proposal not to unbundle non-distinct elements of an insurance contract. Second, we are concerned that the requirement to disaggregate 'non-distinct' investment components from the earned premium revenue number will be unduly costly to implement as the data required are not readily available and inherently difficult to obtain. The allocation of some of these components would be arbitrary and would not provide useful or comparable information.

#### Interest expense in profit or loss

##### Question 4

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?

## EFRAG's response

**EFRAG does not support the mandatory use of other comprehensive income to report the impact of changes in the discount rate of the insurance liabilities. EFRAG believes that avoiding mismatches calls for alignment of measurement of assets that are backing insurance liabilities.**

**EFRAG recommends the IASB to identify a third 'liability-driven' long term investment business model as stated in our letter of 25 October 2013 based on the feedback in the 'Long-term investing activities business model consultation'. On that basis, entities would need to make an accounting policy choice at an entity level whether to report the impact of changes in the discount rate of the insurance liabilities in the statement of profit or loss or the statement of other comprehensive income. However, if an entity elects the latter, it should be eligible, for portfolios managed on a fair value through profit or loss basis, to report the impact in profit or loss.**

**In case our preferred approach is not adopted, we believe that insurers should have the option to make an accounting policy choice at portfolio level to report the impact of changes in the discount rate of the insurance liabilities in the statement of profit or loss or the statement of other comprehensive income. Without such flexibility insurers would not be able to eliminate accounting mismatches to an acceptable extent.**

**EFRAG recommends including insurance liabilities in the scope of the macro hedging project to address accounting mismatches that may result from measuring at fair value through profit or loss derivatives held as part of hedging strategies when the fair value through other comprehensive income is selected.**

### *Putting our response in context: the limited amendments to IFRS 9*

- 55 In November 2012, the IASB issued the Exposure Draft *Limited Amendments to IFRS 9: Classification and measurement* (limited amendments to IFRS 9). One of the objectives of that Exposure Draft was to take into account the interaction of the classification and measurement model for financial assets with the IASB's project on insurance contracts. In this context, the IASB proposed to introduce a mandatory fair value through other comprehensive income measurement category for financial assets (i) whose contractual cash flows are solely payments of principal and interest, and (ii) that were held within a business model in which financial assets are managed both in order to collect contractual cash flows and for sale.
- 56 Under the fair value through other comprehensive income model, interest revenue, credit impairment and any gain or loss on derecognition would be recognised in profit or loss, while all other gains and losses (i.e. the difference between these items and the total change in fair value) would be recognised in other comprehensive income. Interest income and credit impairment would be computed and recognised in the same manner as for financial assets measured at amortised cost. Cumulative gains or losses recognised in other comprehensive income would be reclassified to profit or loss when the financial asset is derecognised. That would result in amortised cost information being provided in profit or loss and fair value information in the statement of financial position. The outcome of this approach would be that the same amounts are reported in the statement of profit or loss, both if the assets are measured at amortised cost and at fair value.

- 57 In addition, the IASB proposed that the existing fair value option in IFRS 9 should be available for financial assets that would otherwise be mandatorily measured at fair value through other comprehensive income. That is, the Exposure Draft proposed that an entity would be permitted to designate such a financial asset as measured at fair value through profit or loss if, and only if, such designation eliminates or significantly reduces an accounting mismatch. Such designation would be performed at initial recognition and would be irrevocable.
- 58 In its April 2013 response to the limited amendments to IFRS 9, EFRAG expressed its appreciation of the IASB's efforts to consider its request to address accounting mismatches that might arise from the application of different measurement models to financial assets and insurance liabilities.
- 59 However, we also expressed a number of concerns, in particular that the proposals to modify the characteristics assessment did not go far enough (more assets should be eligible for amortised cost or fair value through other comprehensive income), and that the proposals did not fully address the concerns raised by insurance companies, which was one of the reasons for reopening the classification and measurement requirements in IFRS 9. Furthermore, we stated that the proposal failed to clearly identify the business model underlying fair value through other comprehensive income.
- 60 Overall, EFRAG believed that measurement of financial assets at fair value through other comprehensive income is necessary to address insurers' concerns about accounting mismatches and performance reporting. However, EFRAG noted that:
- (a) If fair value through other comprehensive income measurement were to be introduced as a mandatory measurement category, it would not fully address these concerns, since certain asset portfolios might not have sufficient turnover to meet the criteria for the fair value through other comprehensive income measurement category, derivatives would not qualify, and portfolios that fail to meet the contractual cash flow characteristics assessment and investment properties would not qualify for fair value through other comprehensive income measurement.
  - (b) If fair value through other comprehensive income measurement were to be introduced as an option to eliminate or reduce accounting mismatches, it would require significant changes in the current approach in IFRS 9. It would be necessary to define explicitly the business model underlying fair value through profit or loss measurement.
  - (c) If fair value through other comprehensive income measurement were to be introduced as an unrestricted option for all types of entities, it would impair comparability.

*Putting our response in context: the long-term investing activities business models*

- 61 In the context of these concerns and observations, and considering the European Commission's green paper on long-term investment,<sup>1</sup> EFRAG launched in June 2013 a public consultation on whether there was a need for specific financial

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<sup>1</sup> Green paper *Long-term financing of the European economy*, European Commission, COM (2013) 150 final, 25 March 2013.

reporting for long-term investing activities business models. The findings of this public consultation and EFRAG's recommendations have been provided in a letter to the IASB dated 25 October 2013.

- 62 EFRAG's public consultation revealed that common characteristics of any long-term investment business model are the relationship of the investing activities with long-term liabilities, and the objective to achieve a long-term return. 'Asset-liability consistency' is the foundation of any long-term investment business model.
- 63 Insurers' long-term investing business model is 'liability-driven' as their investment strategy is driven by the economic objective of matching their long-term liabilities and generating returns, to cover interest cost and generate profit. The asset-liability management that supports the business model is quite dynamic to deliver optimised matching and highest yields. However, it does not exclude assets held to maturity.
- 64 Based on the findings from its public consultation, EFRAG believes that an appropriate accounting regime for a 'liability-driven' business model should reflect the effects of the asset-liability management in aligning the measurement of assets with the measurement of liabilities that they are intended to back. Hence, accounting would help provide transparent information on potential economic mismatches in the balance sheet. Moreover, changes in assets and liabilities should be presented in the statement of comprehensive income with the objective of best portraying the long-term return that is generated from the asset in accordance with the entity's business model.
- 65 We have learned from our consultation that many entities with a long-term investment liability-driven business model, including insurers, wish to see the impact of both the changes in interest rate on the liability and the changes in outstanding gains (or losses) on the asset presented in the statement of other comprehensive income, with the statement of profit or loss reflecting the primary measure of performance (i.e. it is not impacted by short-term changes, except when impairment losses are incurred).
- 66 However, those constituents who already report both assets and liabilities on the basis of current values and report in the statement of profit or loss all short-term changes, are firmly opposed to showing those short-term changes in other comprehensive income. Their experience brings evidence that the use of current values is not impeding the assessment of their financial position (and performance) by investors, even though short-term changes are not isolated outside profit or loss.
- 67 EFRAG observed in its letter that discussions have shown that there is support for both views in Europe, and that there may, therefore, be a need to grant an option for all changes to be shown through profit or loss. In this event, EFRAG believes there should be disaggregation requirements to ensure that insurers using fair value through profit or loss provide the same information as insurers using fair value through other comprehensive income on the face of the statement of comprehensive income to the extent possible and in the notes for the remaining information. This should ensure that users are able to compare the performance of insurers, irrespective of whether short-term changes are reported in the statement of other comprehensive income or in the statement of profit or loss.
- 68 Finally, EFRAG noted that when an entity preferred to select the option of reporting all short-term current value changes in the statement of other comprehensive income rather than in the statement of profit or loss, there might be

certain portfolios of contracts for which reporting through profit or loss would provide better information nevertheless.

*Our response to Question 4 – our preferred approach*

- 69 Consistent with these earlier positions, the starting point for EFRAG's views is the need, under a long-term investment liability-driven business model, for accounting requirements that do not ignore the interaction between the liabilities and related assets when selecting measurement bases and defining performance requirements. A symmetrical treatment of the changes in assets and liabilities is necessary to faithfully represent the financial position and performance of a long-term investor, including an insurance company. Accounting mismatches should be eliminated or reduced as much as possible.
- 70 As related assets include more than financial instruments that are eligible for fair value through other comprehensive income measurement, this measurement approach (including recycling) should be available to other assets as well, including other fixed-income financial instruments, equities, and investment properties. EFRAG recognises that this will require changes in several standards dealing with assets.
- 71 EFRAG acknowledges that a decision to extend the use of other comprehensive income (with recycling) to a broader set of asset classes – in particular, debt instruments that do not meet the contractual cash flow characteristics assessment, and investments in equities – would require the development of an appropriate impairment model. EFRAG aims to discuss the impairment model in the coming months and has at this stage not formalised a recommendation as to what this model should be.
- 72 If an extended use of fair value through other comprehensive income (with recycling) is introduced, EFRAG supports the proposal to recognise, in profit or loss, interest expense using the discount rates that applied at the date that the contract was initially recognised, and to recognise the impact of changes in the discount rate in other comprehensive income, unless the cash flows of the insurance contract are asset dependent, in which case the discount rate should be unlocked. This would align the measurement bases of liabilities and related assets (i.e. eliminate or significantly reduce accounting mismatches), and create a consistent presentation of performance of the insurer in the statement of profit or loss and in the statement of other comprehensive income. The use of other comprehensive income helps distinguishing between short-term volatility and long-term trends and thereby aids in understanding the performance of an insurer and reflecting the long-term nature of the insurance business.
- 73 However, EFRAG also recognises, as noted above, that there are insurers who firmly oppose the use of fair value through other comprehensive income for their assets and liabilities, and want to continue reporting all short-term and long-term changes in profit or loss. The field-test reveals that there are insurance contracts, such as unit-linked contracts or variable annuities, which are managed on a fair value through profit or loss basis.
- 74 Considering the findings above, EFRAG believes that the insurance liability accounting model should enable entities to report using a fair value through other comprehensive income approach, a fair value through profit or loss approach, or both, if they meet the objective of avoiding accounting mismatches in the statements of financial position, profit or loss, and other comprehensive income.

Insurers should be allowed to make an accounting policy choice at the level of the reporting entity.

- 75 If an insurer elects fair value through other comprehensive income, it should have the option, on a portfolio basis, to report the impact of changes in the discount rate of the liability in profit or loss, if the assets and liabilities are managed on a fair value basis.
- 76 EFRAG is not aware of any circumstances under which an insurer that elects to report the impact in the statement of profit or loss would need an option, on a portfolio level, to report this impact in the statement of other comprehensive income. Since, however, it does not rule out that such circumstances exist; EFRAG encourages the IASB to perform outreach on this issue.
- 77 If insurers already report (part of) their business under a fair value through profit and loss approach, their information systems, generally, do not store the discount rates at the inception of an insurance contract, and, therefore, do not provide the information necessary to use the fair value through other comprehensive income approach. To avoid significant investments in system changes and reconstructing historical data, EFRAG believes these insurers should not be required to separately present a lock-in discount rate and the impact of changes in the discount rate, for the assets and the liabilities, in the statement of comprehensive income, since the benefits would not outweigh the cost.
- 78 Based on the considerations above, EFRAG does not support the proposed mandatory use of other comprehensive income.
- 79 EFRAG notes that the IASB is currently debating a proposal to supplement the existing application guidance on the business model in IFRS 9. The proposal is to clarify that an entity's business model for managing financial assets is often observable through particular activities that are undertaken to achieve the objectives of that business model. These business activities usually reflect the way in which the performance of the business model and underlying financial assets in that business model are evaluated and reported (i.e. key performance indicators) as well as the risks that typically impact the performance of the business model.
- 80 Under this approach, the business model assessment should allocate financial assets to the measurement attribute that will provide the most relevant and useful information about how activities and risks are managed to create value.
- 81 According to the proposal, a change in the business model, and consequential changes in the policy choice, would occur only when an entity has either stopped or started doing something on a level that is significant to the entity's operations and thus demonstrable to both internal and external stakeholders.
- 82 EFRAG notes that, under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, a policy can only be changed if the change results in the financial statements providing reliable and relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.
- 83 EFRAG believes that these requirements would adequately address concerns from users of financial statements about the potential for opportunistic reclassifications, and the consistency and rigour with which the reclassification requirements would be applied.

*Our response to Question 4 – our alternative approach*

- 84 As noted in paragraph 70 above, EFRAG believes that the best way to eliminate or significantly reduce accounting mismatches in the financial statements of insurers is to widen the scope of assets eligible for fair value through other comprehensive income.
- 85 However, if the IASB were not to follow this recommendation, EFRAG believes that insurers should have an accounting policy option at portfolio level to report the impact of the changes in the discount rate of the insurance liabilities in the statement of profit or loss or the statement of other comprehensive income.

*Our response to Question 4 – macro hedging*

- 86 Finally, EFRAG believes that macro hedging should enable insurers to reflect asset-liability management and asset portfolio hedging strategies. Therefore, we recommend the Board to include insurance liabilities in the scope of the macro hedge project. This should help to address accounting mismatches in respect of derivatives covering insurance liabilities.

**Effective date and transition**

**Question 5**

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?

**EFRAG's response**

**EFRAG agrees with the proposed modified retrospective approach for transition as we understand that in many circumstances entities would be able to make a reasonable estimation of the remaining contractual service margin based on historic information about portfolios.**

**If the IASB were to require IFRS 9 to be effective before the new insurance contracts standard, EFRAG would recommend that for all entities where insurance forms a significant part of the entities' activities:**

- **The effective date of IFRS 9 should be deferred until the effective date of the new insurance contracts standard. In our view, early application of both IFRS 9 and the new insurance contracts standard should be permitted, so as to facilitate the concomitant application of IFRS 9 and the future standard on insurance contracts at the earliest possible date; and**
- **However, if IFRS 9 is not deferred to align with the effective date of the future insurance standard, EFRAG believes that entities should be permitted to reconsider designations (of hedges and the fair value option) and classifications of investment portfolios accounted for under IFRS 9 when they first apply the new insurance contracts standard.**

**EFRAG further recommends a three year implementation period from the date of publication of the new insurance contracts standard.**

- 87 In its comment letter in response to the 2010 Exposure Draft, EFRAG's two main concerns were that:

- (a) The residual margin (now called the contractual service margin) for contracts in-force at transition would be set to zero instead of requiring retrospective application in accordance with IAS 8; and
- (b) In order to minimise the operational burden it would be crucial that insurance companies have the opportunity to apply IFRS 9 and the final insurance contracts standard at the same time. The ability to redesignate financial assets at the time of adoption of the new standard on insurance contracts was less preferable but it should be allowed.

88 EFRAG believes that our concern expressed in paragraph 87(a) has been addressed in the ED; however, we are still concerned about the interaction between IFRS 9 and the future standard on insurance contracts as explained in paragraph 87(b).

#### *Retrospective application*

89 EFRAG supports the proposed modified retrospective approach that would require entities to estimate the contractual service margin on transition using specified simplifications, as entities would apply retrospective application when required by IAS 8. Such an approach would allow insurers to report a potentially significant part of the profits on existing contracts through profit or loss and it would enhance comparability between the results of existing and new business.

90 Retrospective application is also supported by users. It would facilitate their analysis of the margin balance and on earnings trends over time. It would also allow them to project future earnings in a consistent way for all contracts and to compare entities that previously used different accounting models.

#### *Balance between comparability and verifiability*

91 EFRAG is aware of the subjectivity inherent in the estimations when retrospective application is impracticable due to the use of hindsight. For contracts issued long ago, retrospective application would normally be considered impracticable because it would require significant estimates that are not based solely on objective information.

92 As a consequence, entities would have to estimate what the contractual service margin would have been had they been able to apply the new standard retrospectively. In such cases, the ED states that entities would not need to undertake exhaustive efforts to obtain objective information but should take into account all objective information that is reasonably available.

93 We note here that in the re-deliberation process the IASB asked its staff to consider developing a constraint or set of constraints on the estimated amount of the residual margin. However, as noted in paragraph BC173 of the ED, the IASB concluded that there is no need to constrain the amount of contractual service margin because the proposed requirements to use all of the available information to approximate retrospective application would be sufficient to ensure that the contractual service margin is not overstated.

94 EFRAG understands that in many circumstances entities would be able to make a reasonable estimation of the remaining contractual service margin based on historic information about the various portfolios (e.g. embedded value calculations and actuarial assumptions specified in the technical descriptions of the insurance contracts). Therefore, we would expect this information to provide enough evidence to regulators and auditors when verifying the estimates made by entities.

*Effective dates of IFRS 9 and the insurance contracts standard*

- 95 EFRAG is aware of the high level of complexity that arises from the interaction between (i) IFRS 9, including the limited amendments to the classification and measurement requirements which are currently being re-deliberated by the IASB, and the future insurance contracts standard, and (ii) their respective mandatory effective dates.
- 96 EFRAG believes that entities that issue insurance contracts need to be able to make accounting policy decisions on insurance liabilities and designations of financial instruments simultaneously to enhance the relevance and comparability of their financial statements. Both IFRS 9 and the insurance contracts standard will have a significant impact on the way entities with insurance activities report the performance of their core business with a pervasive effect on the financial statements. In addition, the implementation of these standards in two separate rounds would lead to significant one-off costs and would be operationally burdensome.
- 97 However, EFRAG notes that the impact on comparability and relevance of the financial statements and the costs for preparers depends on the activities undertaken. Those effects depend on whether or not insurance forms a significant part of the entities' activities.
- 98 Therefore, if the IASB were to require different effective dates for IFRS 9 and the insurance contracts standard and IFRS 9 would be effective earlier, EFRAG recommends that for entities where insurance forms a significant part of an entity's activities the effective date of IFRS 9 should be deferred until the effective date of the new insurance contracts standard. In our view, early application of both IFRS 9 and the future insurance contracts standard should be permitted, to facilitate the concomitant application of IFRS 9 and the future standard on insurance contracts at the earliest possible date.
- 99 However, if IFRS 9 is not deferred to align with the effective date of the future insurance contracts standard, EFRAG believes that entities for whom insurance forms a significant part of their activities should be permitted to reconsider designations (of hedges and the fair value option) and classifications of investment portfolios accounted for under IFRS 9 when they first apply the new insurance contracts standard. EFRAG disagrees with the IASB's proposal not to permit full redesignation and reclassification under IFRS 9 as this could lead to significant accounting mismatches.
- 100 EFRAG recommends that entities should be allowed a three year implementation period from the date of publication of the new insurance contracts standard.

*Time required prior to finalisation of the standard*

- 101 We believe that sufficient time should be given to perform extensive testing, prior to the finalisation of IFRS 9 and the future insurance contracts standard. As the proposals represent a fundamental change in accounting for insurance companies, it is essential that a comprehensive understanding of the proposals is gained. In addition, we also urge the IASB to make a review draft available and to set up an implementation group, which would enable amending the final text of the standard.

## The likely effects of a standard for insurance contracts

### Question 6

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.

### EFRAG's response

**EFRAG believes that the costs of implementing the proposals will be significant, and the IASB needs to ensure that the benefits are sufficient to justify these costs.**

- 102 The joint field-test provides evidence that the costs of implementing the proposals will be significant. These significant costs would be required both to initially implement the standard and also to comply on an on-going basis.
- 103 EFRAG believes that the proposals will increase transparency and comparability for insurance contracts, but believes that the IASB also needs to be mindful of its responsibility to ensure that the benefits that accrue from the final standard are sufficient to justify these costs.
- 104 Particular areas that the field-testing and EFRAG's public due process identified as being costly to implement were:
- (a) The requirement to calculate and disclose a confidence interval for the risk adjustment, even if the risk adjustment is calculated on another basis;
  - (b) The bifurcation of cash flows and disaggregation of investment components;
  - (c) The requirements for participating contracts;
  - (d) The requirement to use other comprehensive income;
  - (e) A lower unit of account for unlocking the contractual service margin than is used to manage insurance contracts;
  - (f) The requirements to present premium revenue as defined by the IASB;
  - (g) The use of a locked-in discount rate for the accretion of interest in the premium allocation approach; and
  - (h) Disclosure requirements.

*Calculating and disclosing a confidence interval for the risk adjustment*

- 105 The proposals do not prescribe a method for calculating the risk adjustment and recognise that a confidence interval approach may not always be appropriate for measuring the liability. The required disclosure of a confidence interval for the risk adjustment may give a false impression of comparability between insurers. EFRAG's field-testing and due process provided evidence that it was relatively burdensome to calculate a confidence interval for the risk adjustment.
- 106 Given that the disclosure does not assist, and may in fact hinder, in achieving comparability or transparency, and that field-testing has identified it as burdensome, EFRAG does not support this requirement.

*The unbundling of cash flows and disaggregation of investment components*

- 107 EFRAG's field-testing and due process provided evidence that these requirements required significant effort due to their complexity.

*The requirements for participating contracts*

- 108 The requirements for participating contracts were identified as particularly complex. This was due to the mirroring requirements, a lack of clarity on what contracts were covered and arbitrary allocations (such as whether certain assets are linked to these liabilities) that may have performance presentation implications.

*The requirement to use other comprehensive income*

- 109 It was noted that the requirement to use other comprehensive income would result in significant additional record keeping and calculations because it would require the retention and application of more than one discount rate within a single portfolio. This was identified as a particular issue for contracts with multi-year portfolios and particularly at transition.

*The unit of account for unlocking the contractual service margin*

- 110 Paragraph BCA113 of the ED implies that the unit of account for unlocking the contractual service margin would be lower than is used to manage their contracts in practice. This would increase operational complexity without any clear benefit. Please see our comment on this issue in response to Question 1.

*Premium revenue as defined by the IASB*

- 111 The calculation of premium revenue as defined by the IASB may be costly, both due to initial implementation costs – particularly distinguishing the investment component on existing contracts – and on an on-going basis due to the increased level of skills required.

*Locked-in discount rate for the accretion of interest in the premium allocation approach*

- 112 We understand that separate systems are often used for tracking insurance contracts and claims on contracts for which the premium allocation approach would be expected to be used. The use of a locked-in discount rate at contract inception for accreting interest, including on claims, therefore presents a significant operational complexity. Further comments on this issue are provided in Appendix 2.

*Disclosure requirements*

- 113 The disclosure requirements in general were identified as burdensome and inconsistent with a principles-based standard. We recommend the IASB

reassesses its tentative decisions on disclosures in the light of the current development of a disclosure framework.

**Clarity of drafting**

**Question 7**

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?

**EFRAG's response**

114 Based on its analysis of the ED, field-test and due process, EFRAG has identified a number of areas where the drafting of the standard has resulted in inconsistent interpretation of requirements or is unclear. EFRAG will provide these to the IASB staff separately.

## **APPENDIX 2 – Additional comments**

### **Change from a top-down to a bottom-up discount rate**

- 1 EFRAG believes that a change from a top-down approach to a bottom-up approach is a change in an accounting estimate rather than a change in an accounting policy. The accounting policy is to apply a discount rate to the measurement of insurance liabilities while the estimate is how to calculate the discount rate using either a top-down approach or a bottom-up approach. The change in the calculation of the discount rate will not provide more relevant information relating to the measurement of the insurance company's financial position, performance or cash flows.
- 2 EFRAG believes that the IASB should provide guidance in the final standard explaining that such a change in the discount rate is to be treated as a change in an accounting estimate rather than a change in an accounting policy.

### **Interest expense in profit or loss for the liability for the incurred claims for contracts under the premium allocation approach**

- 3 EFRAG understands that the premium allocation approach represents an approximation of the general building block model. Accordingly, using the same discount rate for the liability for remaining coverage and the liability for incurred claims is meaningful. However, in certain circumstances, such as when a claim is discovered after the coverage period, the use of the rate when the claim is discovered, rather than the rate at the inception of the contract, would provide more useful information for contracts under the premium-allocation approach. Furthermore, the field-testing exercise reveals that the 'lock-in' of the discount rate for the liability for incurred claims under the simplified approach would introduce unnecessary complexity as companies would need to track the yield-curve at contract inception, which is information which companies currently do not keep in their systems.
- 4 As noted in our response to Question 6 in Appendix 1, we understand that separate systems are often used for tracking insurance contracts and claims on contracts for which the premium allocation approach would be expected to be used. The use of a locked-in discount rate at contract inception for accreting interest, including on claims, therefore presents a significant operational complexity. Therefore, EFRAG recommends that the final standard requires the liability for incurred claims to be discounted/accreted using the discount rate when the claim is discovered and not the discount rate at inception of the contract.

### **Accounting treatment for reinsurance contracts held**

- 5 EFRAG is aware that representatives from the insurance industry argue that the IASB's proposals on measurement of the reinsurance contractual service margin do not fully reflect the economics of certain reinsurance transactions and could potentially result in accounting arbitrage. These constituents believe that day one gains and losses from reinsurance contracts should be recognised immediately in profit or loss. Also, several respondents noted that the ED's proposals for reinsurance contracts on an individual loss basis did not depict appropriately the economic relationship between the reinsurance contract and the underlying insurance contract. In particular, the high dependence of the reinsurance contract on the underlying insurance contract was not taken into consideration adequately.
- 6 EFRAG recommends the IASB to explore these issues further.

### **The specifics of mutual entities**

- 7 EFRAG understands that some aspects of the proposed 'mirroring approach' as proposed by the IASB are supported by mutual entities. Those entities see no reason why assets and liabilities would not be measured using the same measurement principles in those cases in which existing or future policyholders receive, ultimately, 100% of the results of the mutual entity. EFRAG urges the IASB to consider those specifics as in some jurisdictions those entities prepare financial statements under IFRS and represent a significant part of the insurance market. EFRAG will perform further work on those specifics to improve its understanding of all issues in respect of mutual entities and assist the IASB.

### **Disclosures of minimum capital requirements**

- 8 EFRAG agrees with the rationale underlying paragraph BCA232 of the ED that disclosures about the effects of the regulatory frameworks in which an entity operates should be applied consistently for all entities operating in a regulated environment and should not be developed separately in a project on accounting for insurance contracts. Such disclosures should be part of the IASB's work on disclosures more generally.
- 9 However, EFRAG has some concerns on the requirement in the ED that entities should disclose the effect of minimum capital requirements to which the entity is subject. EFRAG notes that a similar requirement was proposed when IFRS 7 *Financial Instruments: Disclosures* was developed and was implemented through the requirements of paragraph 135(d) of IAS 1 *Presentation of Financial Statements*. This requires information whether or not the entity complied with any externally imposed capital requirements to which it is subject. EFRAG believes that IAS 1 already covers the issue of disclosures of externally imposed capital requirements. EFRAG also notes that disclosures about minimum capital requirements may be prohibited in certain situations by law or local regulation, creating a situation where an entity would be considered as not complying with the requirements in IFRS. Thus, EFRAG recommends that the requirement for disclosure of the minimum capital requirements is deleted in the final standard. However, this should not prevent the IASB to consider such requirement as part of the IASB's work on disclosures more generally to secure consistency with entities operating in a regulated environment.