Please note that the comments expressed herein are solely my personal views.

Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Chris Barnard
Actuary

03 November 2010

File Reference No. 1870-100
Discussion Paper, Preliminary Views on Insurance Contracts

Dear Sir.

Thank you for giving us the opportunity to comment on your Discussion Paper, Preliminary Views on Insurance Contracts.

I will make some comments here on the main concepts raised in your paper, and the differences to the IASB’s proposed approach. The enclosed appendix contains the comment letter which I submitted to the IASB on their exposure draft ED/2010/8 Insurance Contracts. This covers most of the remaining issues and questions raised in your paper.

Accounting principle and definition of insurance contract (questions 1-5, 18)

I would strongly recommend that the FASB adopt one accounting model for insurance contracts¹, whether long- or short-term, and independently of the entity issuing the contract. I prefer substance over form, and support the proposed definition of insurance contract in your paragraph 22. This will surely provide more meaningful information to users of financial statements, and would be a big improvement compared to the current US Gaap models for insurance contracts, which have been developed in a piecemeal fashion over many years.

¹ This would include financial instruments with DPFs, and health insurance provided by an employer.
Please note that the comments expressed herein are solely my personal views.

Risk adjustment and residual margin (questions 8, 15)

I would recommend that the FASB also adopt the risk adjustment and residual margin approach proposed by the IASB. I believe this approach better depicts the financial and risk drivers under insurance contracts, and provides more meaningful information to users.

Remeasurement of residual margin

I would further recommend that the residual margin is remeasured at each reporting date. This would then represent a current value, which is consistent with its measurement at initial recognition. It would also be more market consistent, which is surely more appropriate than traditional deferral-and-matching techniques.

Transitional arrangements

I would recommend a consistent treatment of pre- and post-transition contracts.

Yours faithfully

Chris Barnard
APPENDIX

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

Chris Barnard
Actuary

31 October 2010

Dear Sir.

Thank you for giving us the opportunity to comment on your exposure draft Insurance Contracts.

I will first address some general comments on the ED here, and then provide more detailed comments to the specific questions raised by the IASB. Throughout, I will compare and contrast the ED proposals with existing and developing economic valuation standards and principles, particularly those underlying market consistent embedded value (MCEV)\(^1\) and Solvency II (SII)\(^2\), which represent widely used and accepted economic measurement standards. To this end I also provide a summary comparison between the proposed IFRS Phase II, MCEV and SII.

Purpose of the ED proposals

It is not clear to me what is the purpose of the ED proposals. It is not to control cash generation and distribution, nor does it represent a solvency standard. The

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\(^1\) Exemplified by the latest CFO Forum’s MCEV Principles published October 2009.

\(^2\) According to the European Union’s QIS 5 Technical Specifications published 5 July 2010.
purpose must surely be to allow users of financial statements (users) to measure the performance of an entity during the reporting period. In this sense the ED proposals initially fail, as the requirement to calibrate the insurance liability valuation to the premium at issue does not allow the recognition of profits at inception.

Analyses of insurance company products worldwide shows that a significant proportion of the margin generated from insurance contracts is paid out to distribution, and the remainder is left for the entity’s profit.\(^3\) This indicates the importance of selling to the entity (it is often said that insurance is “sold”, it is not “bought”). Therefore it could be argued that a large part of the service which an insurance entity provides is the process by which an insurance contract is sold, including the fact-find, advisory and actual selling process. To ignore this, by arbitrarily calibrating the insurance liability valuation to the premium at issue, would be expected to lead to the continuation of supplementary reporting, such as MCEV, which is often demanded and used by analysts and investors.

Despite this, your proposal to split the calibration of the insurance liability valuation to the premium at issue into two parts, a risk margin and a residual margin, could be useful. At initial recognition, the residual margin is similar to a value of new business\(^4\) (VNB) under general embedded value (EV) methodology, which is a number often used by analysts and investors when analysing the performance of insurance entities. However, this would not provide a fully realistic assessment of the profitability of new business, as your proposals would exclude overheads and non-incremental acquisition expenses from the measurement. But this is a step in the right direction.

**Risk adjustment**

It is clearly appropriate to calculate a separate risk adjustment as part of the insurance liability. Under any economic measurement, the insurance liability can be split into a best estimate, and a risk margin associated with the variability of the cash flows under the contract. In your 2007 discussion paper\(^5\) you defined the risk

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\(^3\) See O’Keefe and Sharp (1998), International Measures of Profit for Life Assurance Companies. Also an analysis of insurers’ accounts shows that commissions paid are typically 2-3 times bigger than the shareholders’ income before taxes.

\(^4\) The additional value to shareholders created through the activity of writing new business.

Please note that the comments expressed herein are solely my personal views

margin as "...an explicit and unbiased estimate of the margin that market participants require for bearing risk". Now, in your basis for conclusions, paragraph BC110, you specifically state that the "...risk adjustment should not represent the compensation a market participant would require for bearing the risk associated with the contract". In fact your current proposed definition in paragraph 35 is: "the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected". This definition is wholly subjective, is not market consistent and should probably be rewritten. The problem with the proposed risk adjustment is that there is no robust or reliable way of calculating it. We are dealing here with tail events, events which are by definition rare and extreme. This is one area where more guidance should be provided, otherwise the financial statements could not be considered reliable.

For example, the IASB could consider the proposals specified under SII, which mandate the cost of capital approach, with a cost of capital rate (under QIS 5) of 6%. We can debate how theoretically correct this approach is, but at least this provides an objective and comparable methodology to entities. I'm afraid that the current ED proposals, with their subjective definition, choice of three completely different methodologies and subjective parameterisations, are not only unreliable, but will lead to incomparable reporting as well.

The residual margin

The residual margin eliminates any gain at inception of the contract, by calibrating the insurance liability valuation to the premium at issue. The residual margin is then amortised over the remaining coverage period at the cohort level. I will comment on this in more detail later, but as a minimum, I would strongly recommend that the residual margin is remeasured at each reporting date, so that this represents a current value in line with the rest of the measurement model.

Differences between the IASB and the FASB

I am not happy with the inconsistencies and differences between the IASB and the FASB, in particular concerning the risk adjustment plus residual margin proposed by the IASB, and the composite margin proposed by the FASB. This will lead to incomparable reporting between the regimes in the measurement of the insurance
liability, and performance reporting thereafter. It is not good that the FASB are proposing a weaker insurance contracts standard, and one which is more likely to lead to problems during volatile economic and financial periods in the future.

The discount rate

This is one of the most fundamental, and should be one of the most objective and transparent inputs to the measurement model. However, the ED does not give guidance on how an entity should determine the discount rate. The term "observable current market prices" could refer to Swap rates, the yield on high quality corporate bonds, government bond rates or something else. Also, what adjustment could be reasonably and objectively made for illiquidity? The ED provides no guidance here, and there is also no consensus on how this should be done.\(^6\) I do not accept paragraph BC101 at all. Yes, I prefer principles-based accounting to arbitrary rules, but the ED is full of rules, and some detailed guidance. Rules are okay, as long as they are reasonable, rational, consistent and are not arbitrary.

I anticipate that European domiciled insurers will probably adopt a pragmatic approach consistent with SII, which mandates the risk free curves and illiquidity premium. At least paragraph 90 explicitly requires disclosure of the methods and inputs used to estimate the discount rates, and a measurement uncertainty analysis thereon, which is a push towards consistency and comparability here.

Measurement uncertainty analysis

I commend the IASB on paragraph 90 (d). I would always recommend that the disclosure requirements include sensitivity and scenario testing on the significant judgments, estimates and assumptions, where relevant. This would provide meaningful information to users of financial statements. I do not believe that such disclosures would be onerous for preparers of financial statements (preparers). I would argue that having a good understanding of your business and risk drivers, including their dependencies, is vital to managing the business and its risks. It is a

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Please note that the comments expressed herein are solely my personal views.

pity that such a broad measurement uncertainty analysis was not proposed in ED/2010/3 - Defined Benefit Plans: Proposed amendments to IAS 19.

Summary comparison between IFRS Phase II, MCEV and Solvency II

<table>
<thead>
<tr>
<th></th>
<th>IFRS Phase II</th>
<th>MCEV</th>
<th>Solvency II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope of liabilities</td>
<td>All insurance + Investment with DPF</td>
<td>Covered business</td>
<td>All</td>
</tr>
<tr>
<td>Market value for all assets</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>MC financial assumptions driving best-estimate liability</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Liquidity premium included</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Own credit risk in valuation</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Entity-specific demographic / expense assumptions</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Current, not locked-in, assumptions</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Overheads included</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Liability includes a risk margin above financial BEL</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Reflect best estimate renewal premiums</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Contract boundary</td>
<td>Repricing, contract level</td>
<td>Expected premiums</td>
<td>Repricing, portfolio level</td>
</tr>
<tr>
<td>Reflect best estimate renewal premiums</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Calibrate insurance liability valuation to premium at issue</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Diversification across portfolios considered</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Discounted tax assets and liabilities</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Treatment of reinsurance</td>
<td>No offsetting</td>
<td>Net of outward reinsurance</td>
<td>Gross with separate calculation</td>
</tr>
<tr>
<td>Short-duration contracts – pre-claim</td>
<td>Premiums less acq costs allocated over coverage period + loss recognition test</td>
<td>PV cash flows</td>
<td>PV cash flows</td>
</tr>
</tbody>
</table>

1870-100
Comment Letter No. 3
Answers to specific questions raised by the IASB

Question 1 – Relevant information for users (paragraphs BC13–BC50)

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

The proposed measurement model is a vast improvement over IFRS 4, which still allowed unrealistic cost and deferral-and-matching approaches. In principle, the measurement model is a market consistent valuation, which allows for all cash flows under the insurance contract, and also values options and guarantees. It is also closer in methodology to MCEV and SII, which are widely used, if still developing, market consistent valuation standards. However, I have some reservations concerning some of the proposals. There is still some work to do to improve the measurement model, and its presentation and related disclosures, to make it more objective, reliable and relevant to users. I will comment more on this below.

Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)

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

Yes. In the absence of a deep and liquid market for insurance liabilities, or their components such as expenses, mortality, disability and other claims and decrements, policyholder and management behaviour and so on, we cannot fully mark-to-market. This “mark-to-model” methodology is the only credible, realistic and reliable approach to replicate a market consistent or economic valuation.
Please note that the comments expressed herein are solely my personal views.

It is appropriate to include future cash outflows (obligations) and future cash inflows (rights) in the measurement. This is also consistent with your revenue recognition proposals, which combine obligations and rights into a single contract asset or liability.\(^7\)

My only concern is that some cash flows, e.g. general overheads and non-incremental acquisition costs, are not included in the measurement model, but are allowed to emerge in the future as “losses”. I recommend that you include these particular cash flows in the measurement, which would be more prudent, and align more closely with MCEV and SII.

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

Yes. This is generally well explained and put together.

**Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)**

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

Yes. This is absolutely necessary. The use of asset-based discount rates is not prudent, market consistent, or realistic, and leads to the well known results that an entity can reduce a liability by simply switching from e.g. bonds to equities, and thus anticipating a higher return. Risk premia should be accounted for as they are earned, and not anticipated in advance.

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

*In principle yes. However I would hardly call the contents of paragraphs 30(a), 31 and 34 “guidance”. I would advise the board to include more comprehensive guidance on how to set any liquidity premium. It is very important.*

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\(^7\) See ED/2010/6, Revenue from Contracts with Customers.
Please note that the comments expressed herein are solely my personal views

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

No. I would suggest that those who are using an alternative methodology, including asset-based discount rates, allowance for own credit risk or arbitrary risk premia, are already misrepresenting the economic substance of some long-duration insurance contracts, usually by undervaluing them.

No. The board should maintain its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer.

Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)

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

I support using a risk adjustment and a residual margin (the IASB proposal). This better reflects the economics and business of insurers, which is selling and managing risk, and is consistent - in principle - with market pricing of tradeable instruments. It is also consistent - in principle - with IAS 37, fair value methodology,\(^6\) MCEV and SII. However I totally reject your rationale given in paragraph BC112 (b) that the risk margin “reduces the amount that needs to be released to income using the inherently somewhat arbitrary mechanisms used to release the composite or residual margin”. This is itself arbitrary, and I can think of far simpler ways of doing this.

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\(^6\) Fair value, exit value, entry value.
Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)

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

Yes, in principle. However, this may not be practicable. I agree with AV2. It is not possible to objectively determine the risk adjustment under the proposals, as it depends on each entity’s subjective views and price/risk tolerance. Different entity’s results will not be comparable. However, all is not lost. The board could consider a SII type of proposal, which mandates a simple cost of capital approach, which is fairly easy to calculate. In this case, rather than mandating the confidence level, or actual cost of capital rate, entities would reflect their risk assessment in their own confidence level or cost of capital rate assumption. At least the methodology would be consistent, and results would be much more comparable.

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

Please see my response to (a) above. An alternative approach is to allow entities to use any generally accepted method. Why restrict the choice to three techniques? This is just a half-way house, and also negates the use of more sophisticated techniques in the future. I understand the board’s aim of reducing “diversity in practice”, but this will not help, as the risk adjustment is itself so poorly defined.

In any case, the technique chosen should be implementable at reasonable cost and should provide concise and informative information to enable performance benchmarking.

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9 SII also mandates the cost of capital rate under QIS 5, at 6%.
10 Consider also the latest CFO Forum’s MCEV principles, which state that: “Regardless of the methodology used to determine the allowance for the cost of residual non hedgeable risks, it should be presented as an equivalent average cost of capital charge”.
Please note that the comments expressed herein are solely my personal views.

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

In principle yes, as this will aid consistency of reporting, and comparability of results.

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

Yes. Insurers assemble portfolios of contracts and price the contracts on the basis that there is diversification within the portfolio. There is limited evidence that insurers allow for diversification across portfolios and lines of business, when pricing their contracts.\textsuperscript{11} Measuring the risk adjustment at portfolio level is also more prudent than at entity level. However, this is not consistent with SII, which assumes that the risk margin “reflects the level of diversification of the original undertaking. In particular, it takes into account the diversification between lines of business.”\textsuperscript{12} SII assumes transfer of the entity as a whole, rather than the transfer of individual portfolios. But SII also assumes that the entity is free to transfer assets between portfolios, which may not be the case.

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

In principle yes. The application guidance, and basis for conclusions provide a good level of information and guidance on the risk adjustment. However, the guidance is not definitive, and still leaves a lot of subjectivity around the choice of method. I have made a short summary of the three techniques allowed for estimating the risk adjustment below, according to the characteristics stated in paragraph B72 (a) – (e):

\textsuperscript{11} See Diversification Benefits of the Variable Annuities and Equity-Indexed Annuities Mixture, Guanghua Cao, 2006; Natural hedging of life and annuity mortality risks, Cox and Lin, 2005.
\textsuperscript{12} See QIS 5 Technical Specifications, TP.5.6.
Please note that the comments expressed herein are solely my personal views.

<table>
<thead>
<tr>
<th>Characteristic (para B72 (a) – (e))</th>
<th>Confidence level (CL)</th>
<th>CTE</th>
<th>Cost of Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Skewed distribution</td>
<td>(a)</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Contract duration</td>
<td>(b)</td>
<td>can do</td>
<td>can do</td>
</tr>
<tr>
<td>Width of probability distn</td>
<td>(c)</td>
<td>if widening within CL</td>
<td>yes</td>
</tr>
<tr>
<td>Uncertainty of estimates</td>
<td>(d)</td>
<td>if CL is set higher</td>
<td>if CL is set higher</td>
</tr>
<tr>
<td>Emerging experience</td>
<td>(e)</td>
<td>yes</td>
<td>yes</td>
</tr>
</tbody>
</table>

Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

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

If the purpose of the ED proposals is for users to be able to quantify the performance of an entity during a reporting period, then I do not agree. The value of new business published by insurers is widely used by analysts and investors when measuring insurers’ performance, and is usually a very significant part of the valuation of the insurer. However, this criticism is mitigated if we are able to use the residual margin at initial recognition as a proxy for the value of new business. Therefore we should modify the definition of residual margin so that it is more consistent with a VNB under a market consistent valuation, at least by including general overheads and non-incremental acquisition costs in its measurement.

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

Yes. This is entirely appropriate.
Please note that the comments expressed herein are solely my personal views.

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

Potentially. Given that you propose that the residual margin is amortised over the coverage period, it is appropriate to estimate the residual margin at the cohort level of aggregation. However, this brings some complexities, as the risk adjustment is measured at portfolio level of aggregation, whilst the residual margin is estimated at the lower cohort level of aggregation. The residual margin calibrates the insurance liability valuation to the premium at issue – it is a balancing item.

I interpret the ED proposals to mean that the entity should measure the risk adjustment at portfolio level, somehow allocate this down to the cohort level, and thus estimate the residual margin thereon. But this seems rather arbitrary. I would rather recommend that, as the residual margin is derived from elements measured at the portfolio level of aggregation, then it makes sense in principle to determine the residual margin at the same level of aggregation i.e. the portfolio level.

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

The current proposed method represents something akin to historic deferral-and-matching approaches, which are hardly market consistent. It is counterintuitive to remeasure the fulfilment cash flows and risk adjustment at each reporting period, whilst arbitrarily fixing the residual margin. This leads to some bizarre results. For example, an adverse change in the measurement of the fulfilment cash flows, or risk adjustment, leads to an immediate loss being reported in profit or loss, whilst a profit will continue to be recognised from the release of the associated residual margin.

I would strongly recommend that the board instead proposes that the residual margin is remeasured at each reporting date, a view recognised in paragraph AV3. This would therefore reflect a current estimate of the residual margin, which is consistent with its determination at initial recognition, and is surely appropriate.
Please note that the comments expressed herein are solely my personal views.

The residual margin should therefore represent as closely as possible the expected present value of future profitability for insurance contracts at each reporting date.

Remeasuring the residual margin at each reporting date would also help to mitigate any accounting mismatch caused by measuring some assets at amortised cost under IFRS 9, and liabilities at current fulfilment value.\textsuperscript{13}

If this recommendation is not accepted, then I would support the proposed method(s) of releasing the residual margin, as the best of a bad methodology.

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

I trust that the board will not adopt this approach. If it does, then I would recommend that the board proposes instead that the composite margin is remeasured at each reporting date. The current proposal is as bad as the current proposal for releasing the residual margin, only worse.

Again, if this recommendation is not accepted, then I would support instead the proposed method(s) of releasing the composite margin as the best of a bad methodology.

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

Under the current ED proposals, it would be appropriate to accrete interest on the residual margin, for consistency with the measurement of the fulfilment cash flows and risk adjustment. Under my recommendation above in 6 (d), it would not be appropriate.
Please note that the comments expressed herein are solely my personal views

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)

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

Yes. To the extent that the premium includes a loading for acquisition costs, then this is consistent with the measurement of fulfilment cash flows. This consistency is desirable. The alternative of expensing the acquisition costs at initial recognition would usually lead to a day one loss, the curse of old-fashioned statutory accounting for profitable insurance contracts, only mitigated by the arbitrary setting up of DACs, Zillimerisation etc.

I do not support the proposal that non-incremental acquisition costs should be recognised as expenses when incurred. We price insurance contracts to recoup all acquisition costs and overheads. If we didn’t, then we would achieve losses (or reduced profits) continually over time. Again, to the extent that we allow for all acquisition costs when we price (load) the premiums, then we should allow for all acquisition costs consistently in the measurement of fulfilment cash flows.

As a minimum, I would propose that the assessment of acquisition cost should be made at the portfolio level, to be consistent with the measurement of the fulfilment cash flows, the risk margin, and also my recommendation for the residual margin in 6 (c).

Question 8 – Premium allocation approach

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

I recommend that the board does not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts. Whilst I am sympathetic to the views that preparers and users are happy with the simpler,

\[13\] Such accounting mismatch could also be mitigated by using the fair value option for assets.
current accounting approaches for short-duration contracts, I would prefer to see a single, consistent measurement model for all insurance contracts. It is true that the premium allocation approach is consistent with the customer consideration approach proposed in the Revenue Recognition ED, but it is inconsistent with SII, which mandates a unified approach for all insurance contracts.

In any event, the modified approach seems to be as complicated as the full measurement model, as the present value of fulfilment cash flows needs to be determined, by portfolio, for the purposes of carrying out the onerous contracts test, and to account for post-claims liabilities.

If the board does introduce the modified measurement approach, then at least it should not require it. The board should then permit but not require the approach and allow insurers to apply the full measurement model to all insurance contracts.

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

I do not support the approach. If the approach is adopted, then I would recommend that the pre-claims liability should not accrete interest.

**Question 9 – Contract boundary principle**

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

Yes. I fully agree with your proposed boundary principle. It reflects well the distinction between in-force and new business.

Paragraph 27 (b) states that the boundary of an insurance contract is triggered when the insurer “…has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.” Importantly, the pricing reassessment has to apply to “the particular policyholder”, rather than a portfolio, for the contract boundary to be triggered. This means that for many unit-linked or variable style contracts with variable expense, mortality or
other charges applied at portfolio level, depending on emerging experience, the contract boundary would still be the full term of the contract.

I note also that the proposed definition of contract boundary differs from the SII definition. The SII definition is similar, but the point referring to pricing reassessment applies at portfolio level under SII. This could lead to a significant difference in the measurement of insurance liabilities, and therefore on the balance sheet, between the ED proposals and SII. The ED proposals also differ from the simpler, more common sense, but less objective definition under MCEV, which refer the contract boundary to “expected premiums”. For completeness I have compared contract boundaries for sample contract types under the current ED proposal, and SII, in the table below:

<table>
<thead>
<tr>
<th>Contract</th>
<th>Boundary under proposed IFRS</th>
<th>Boundary under SII</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most non-life e.g. annual motor</td>
<td>One year</td>
<td>One year</td>
</tr>
<tr>
<td>Annual contract with future renewals including “no claims discounts”</td>
<td>One year</td>
<td>One year</td>
</tr>
<tr>
<td>Most group life/PHI etc</td>
<td>One year</td>
<td>One year</td>
</tr>
<tr>
<td>Risk cover with n year premium guarantee</td>
<td>Full term</td>
<td>Until end of premium guarantee</td>
</tr>
<tr>
<td>Unit-linked with variable charges</td>
<td>Full term</td>
<td>One year</td>
</tr>
<tr>
<td>Universal life, without guarantees, with annually set expense and mortality charges</td>
<td>Full term</td>
<td>One year</td>
</tr>
<tr>
<td>Most variable annuity contracts</td>
<td>Full term</td>
<td>Full term</td>
</tr>
<tr>
<td>Annually renewable at current premium rates</td>
<td>Full term</td>
<td>One year</td>
</tr>
<tr>
<td>Contracts where premiums each year are based on current market premiums</td>
<td>Full term</td>
<td>One year</td>
</tr>
<tr>
<td>Deferred annuity with GAO</td>
<td>Full term including annuity</td>
<td>Full term including annuity</td>
</tr>
<tr>
<td>Pension-style savings with OMO annuity</td>
<td>Full term excluding annuity</td>
<td>Full term excluding annuity</td>
</tr>
<tr>
<td>Contracts with automatic indexation</td>
<td>Full term</td>
<td>Full term</td>
</tr>
<tr>
<td>Participating contract with ability to amend discretionary benefits</td>
<td>Full term</td>
<td>Full term</td>
</tr>
</tbody>
</table>

14 According to the latest QIS 5 specifications.
15 According to the latest CFO Forum's MCEV principles.
Question 10 – Participating features

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

Yes. This is fully consistent with the proposed measurement model, SII and MCEV. Participating benefits are integral to the rationale (and sale) of many insurance contracts, and their generation, management and distribution are constrained by custom and practice, including policyholders’ reasonable expectations, regulatory, legal and constructive obligations. Therefore I disagree with Mr Smith in AV8.

The ED only explicitly refers to discretionary participation features (DPFs) relating to financial instruments (investment contracts), in paragraphs 62-66. The ED also implicitly refers to DPFs relating to insurance contracts in paragraph 23.

Interestingly the ED also refers in paragraph B61 (j) to “…payments to current or future policyholders as a result of a contractual participation feature…”. Firstly the reference to “future” policyholders should instead refer to “potential future” policyholders. Secondly this statement also flatly contradicts paragraph 23 (e) which states that the future cash flows “…include only those cash flows that arise from existing contracts…”.

I assume that you include the reference to future policyholders in order to somehow capture the unallocated surplus or “estate” that may have built up within participating businesses. However this ambiguity raises some important questions:

- how should unallocated surplus be divided between equity and liability?
- Is special treatment required for mutual entities?
- How should unallocated surplus be divided between existing and potential future policyholders?

These are not trivial questions\textsuperscript{16}, and I would recommend that you include wording or proposals to clear up the ambiguity raised in B61 (j).

Please note that the comments expressed herein are solely my personal views.

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

Yes. Financial instruments with DPFs are very similar to insurance contracts with DPFs, and they are often (though not always) managed together in the same pool of assets. Furthermore, the provisions of IAS 39 and IFRS 9 are not well suited to financial instruments with DPFs.

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

No. I do not support the additional condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity. I prefer substance over form, and this condition seems rather arbitrary.

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

Yes. Given that financial instruments with DPFs do not contain significant insurance risk, then their contract boundary cannot refer to this. The proposal that the contract boundary for financial instruments with DPFs is the point at which the contract holder no longer has a contractual right to receive benefits arising from the DPF is reasonable, and appropriate. It is also consistent in principle to the definition of contract boundary for an insurance contract.

See also my recommendation in 6 (d) above. If this is not accepted, then I would support the proposal that the release of the residual margin reflects the asset management services, as asset management services are the “profit” or “service” carrier for financial instruments with DPFs. This would be the best of a bad methodology.
Question 11 – Definition and scope

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

Yes. I agree with the definition of an insurance contract and related guidance. I also agree with the changes summarised in BC191. Clearly an insurer should consider the time value of money in assessing whether additional benefits are significant.

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

Yes. However, I would recommend that the board provides more clarity as to which types of fixed-fee service contracts are excluded from scope (see paragraph 4 (e)).

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

Yes. I prefer substance over form, so it is appropriate that financial guarantee contracts be brought within the scope of the IFRS on insurance contracts.

Question 12 – Unbundling

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

In principle yes, is this would provide more meaningful information to users.

In your 2007 discussion paper Preliminary Views on Insurance Contracts, components should be unbundled if they are not “interdependent”. The current ED proposes that a component should be unbundled if it is not “closely related” to the
Please note that the comments expressed herein are solely my personal views.

Insurance coverage specified in a contract. I prefer the current ED proposal, as it is more principles-based. However, this may lead to contradictory and misleading information being provided. For example, policyholder behaviour would be expected to be different in a contract consisting of a bundle of components, compared to the individual components if unbundled. Furthermore, it does not make sense to unbundle components where the insurer has priced the contract as a whole, or manages the contract as a whole, i.e. as consisting of a bundle of components.

I would therefore recommend that components are not unbundled where the insurer prices or manages the contract as a whole.

**Question 13 – Presentation**

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

Yes. This clearly shows the contributions from the main business and risk drivers. It is also more consistent with the methodology used to present embedded value type information. However, I would recommend that volume information, such as premiums and claims expenses are also shown in the statement of comprehensive income (SOCI). This would provide more meaningful information to users.

I agree in principle with the proposed net presentation of the insurance contracts' rights and obligations in the statement of financial position, given that this would be consistent with your revenue recognition proposals. However, it might provide more meaningful information if the risk adjustment and residual margin were separately presented here.

Paragraph 73 concerning interest rates and discount rates is very vague. Please would you clarify what you expect from this?

(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?
Subject to my previous comments concerning remeasuring the residual margin, yes.

Question 14 – Disclosures

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

Yes. However, analysts and investors are very interested in the free cash flow position of insurers, and the amount of cash generated by writing insurance business. This has become more important since the financial crisis. I would recommend some more thought on how this can be communicated through presentation and disclosure. An example would be to disclose the expected distributable profits by calendar year, or even the expected cash flows by calendar year, split by broad line of business, and broad type e.g. premiums, claims, administration and maintenance expenses, acquisition expenses etc. I would recommend this disclosure separately for in-force and new business.

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

Yes. But see my comments to 14 (a). Furthermore, the wording of paragraph 81 is very broad, and this could lead to a reduction in comparability between entities.

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

See my comments to 14 (a). I would also prefer to see some disclosure of profit margins on new business and internal rates of return generated by new business.

I fully support the disclosure of "Methods and inputs used to develop the measurements" proposed in paragraph 90, in particular the measurement uncertainty analysis therein. Given that the measurement model involves significant judgement and use of estimates, it is important to allow users to make there own sensitivity and scenario analyses of the financial position of an insurer.
Comment Letter No. 3

Please note that the comments expressed herein are solely my personal views.

**Question 15 – Unit-linked contracts**

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

Yes. *This is entirely appropriate.*

**Question 16 – Reinsurance**

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

Yes. *I support the proposals. I agree that the cedant should consider the non-performance risk of the reinsurer when measuring the present value of the fulfilment cash flows.*

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

*I find it odd that paragraph 45 allows the recognition of a gain at initial recognition of the reinsurance contract, but day one gains are not allowed for insurance contracts.*

**Question 17 – Transition and effective date**

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

No. *The proposal to exclude the residual margin at transition, and subsequently, appears to be arbitrary. This proposal implies that part of the in-force embedded value on pre-transition contracts would re-allocate to retained earnings, and there would be no subsequent release as income in profit or loss. This is totally inconsistent with the proposed treatment for post-transition contracts. I would recommend a consistent treatment of pre- and post-transition contracts, and more thought should be given on how we can achieve this, for example by requiring full retrospective application in accordance with IAS8.*
Please note that the comments expressed herein are solely my personal views.

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

No. This seems even more arbitrary than the board’s proposed transition requirements.

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

This would make sense in practical and economic terms.

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

This depends on the individual insurer. Many insurers are already reporting embedded value type information, and many European insurers (including their worldwide subsidiaries), are preparing for SII implementation. These entities will find the transition easier compared with other insurers who would have to apply present value and probability weighted techniques to cash flows for the first time.

Question 18 – Other comments

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

No.

Question 19 – Benefits and costs

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

Yes.
Summary of my main recommendations to the board:

- Include general overheads and non-incremental acquisition costs in the measurement of the fulfilment cash flows
- Adopt the risk adjustment and residual margin approach
- Define more objectively the risk adjustment
- Estimate the residual margin at the portfolio level
- Remeasure the residual margin at each reporting date
- Do not introduce a modified measurement approach
- Do not unbundle where the insurer prices or manages contracts as a whole
- Adopt consistent treatment for pre- and post-transition contracts

Yours faithfully

Chris Barnard