Mr. Russell G. Golden  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5166  
Norwalk, CT 06856-5116  

30 November 2010  

Re: Discussion Paper, “Preliminary View on Insurance Contracts” (File Reference No. 1870-100)  

Dear Mr. Golden:  

We appreciate the opportunity to comment on the Financial Accounting Standards Board’s (FASB or Board) Discussion Paper, “Preliminary Views on Insurance Contracts” (DP).  

As previously stated, we strongly support a single set of high quality global accounting and financial reporting standards and strongly support the convergence of IFRS and US GAAP as a step toward realization of that goal. A converged accounting model for insurance contracts is an important milestone in the convergence process, particularly given the diversity in practice under IFRS for insurance contracts.  

We agree with the fundamental objective articulated in the DP to estimate insurance contract liabilities based on a fulfillment value. However, we have significant concerns about some of the features of the proposed measurement model in the ED and believe these must be resolved before a standard on insurance contracts can be finalized. Therefore, we propose a measurement model that:  

- Would be dynamic and not lock-in any assumptions over the life of the insurance contract  
- Would include the present value of probability-weighted cash flows, a risk adjustment and an adjusted residual margin until that margin is reduced to zero  
- Would require all assumptions to be updated at each reporting date  
  - Changes relating to non-market assumptions such as, mortality, morbidity and general insurance claims would be recognized in the residual margin  
  - Changes in market assumptions would be immediately recognized in earnings  
  - Adjustments to the residual margin would be amortized on a prospective basis
For non-linked contracts, the insurance liability would, as a short-term practical expedient, be discounted using a high-quality corporate bond rate instead of a risk-free rate plus a liquidity adjustment.

Insurers would be permitted the option to present volume amounts (e.g., premiums, benefits or claims) on the face of the statement of income.

This suggested model is just one possible solution and we understand others will suggest or have recently suggested different solutions. The evaluation of a measurement model for insurance contracts requires considerable effort. We are aware of the other proposed models and currently we are reviewing them. As part of our evaluation we will give consideration to the consistency in the concepts used in the accounting for insurance contracts on one hand and other accounting literature (e.g., accounting for financial instruments) on the other. We hope that the Board will keep an open mind with regard to these suggestions and we are willing to work with the FASB staff to assess these alternatives as the Board moves forward with this project.

With regard to the modified measurement model referenced by the Board, our conceptual preference is that the Board should not introduce a modified measurement model for short-duration contracts. However, there are indications that the cost to obtain that pre-claim information under the basic model will exceed the limited benefits of applying that model to short-duration contracts. In that case, we agree that the Board should diverge from their overall objective to have one measurement model and allow a modified measurement model for short-duration contracts. We also believe if the modified measurement model is used the onerous contract test should be simplified.

Although we support the Boards efforts to create a converged insurance contracts standard, we believe that if the Boards are unable to agree on key aspects of a converged standard than the FASB should not issue a new insurance contracts standard for US GAAP that either represents a fundamental change or minor improvements to current insurance accounting. We believe that it would be unduly burdensome for US preparers to implement a new measurement model for insurance contracts that does not align with the IASB’s measurement model or to make changes to US GAAP, only to potentially convert to IFRS in the future. However, if the Boards agree on a converged standard that is not substantially consistent with our proposed model, we will assess the appropriateness of that proposed measurement model to US GAAP when the FASB issues an exposure draft on that converged model.

We have attached our comment letter to the IASB on their Exposure Draft: Insurance Contracts (ED) to this letter. In the appendix to this letter, as well as in our comment letter to the IASB, we have outlined in detail our recommendations.

If our approach were adopted, we believe it would result in a measurement model that could be consistently applied by insurers and provide decision useful information to financial statement users. Our most significant recommendations are further discussed below.
Discount rate

The selection of an appropriate discount rate is likely the single most difficult issue that the FASB must resolve to achieve global convergence for the accounting for insurance contracts. The discount rate selected needs to achieve a balance between providing a measurement model that fairly represents the economic relationship between the insurer and the policyholder and at the same time produces a liability amount that reflects the current expected value to fulfill the insurer’s obligations. Such a rate also must provide meaningful performance measures and be consistent with the economics of the business.

Although we agree with the Board that insurance liabilities should reflect the time value of money, we acknowledge that there are concerns in the insurance industry that the discount rate proposed in the measurement model will result in volatility in reported earnings that, in some cases may not reflect the overall economic relationship between the insurer and the policyholder. We understand and agree with the Board’s desire to use a discount rate that is based on the characteristics of the liability, rather than the assets used to fund that liability, to provide a more consistent measurement among entities. However, we do not believe the use of the risk-free rate plus a liquidity adjustment is consistent with the fulfillment measurement objective as it can be seen to have more similarities to a fair value measurement. We also believe that an asset earning rate is not inconsistent with the objective of the DP to measure insurance liabilities at a fulfillment value. However, using an asset earning rate would compromise comparability among insurers with different investment strategies. We therefore suggest, as a short-term practical solution to improve comparability among insurers, that the Board propose that non-linked contracts (i.e., non-participating contracts) be discounted using a high-quality corporate bond rate, similar to the requirement of Accounting Standards Codification Topic 715, Compensation - Retirement Benefits.

We also note that both IFRS and US GAAP use various discount rates to reflect the time value of money. While we have proposed a short-term practical solution to the discount rate, the Board should consider undertaking a comprehensive study of all discount rates used throughout the accounting literature. The objective of that study should be to develop a framework to select discount rates that will result in the most relevant information to users given the nature of the item being measured.

Risk adjustment and residual margin versus composite margin

The proposed measurement model would lock the residual margin or composite margin at inception with changes in expected cash flows and risk adjustment being recognized immediately in earnings. That requirement is inconsistent with the revenue recognition model as similar changes in expected costs in that model are absorbed into the expected profit margin (until the margin is reduced to zero). We believe that changes in the estimated cash flows of insurance contracts should be recognized in a manner similar to changes in estimated costs to fulfill performance obligations in the proposed revenue recognition model.

Based on the foregoing, we recommend that the Board select an adjusted margin approach and that approach should include a risk adjustment and residual margin. As noted in our response to Question 4, we do not support an adjusted composite margin approach. Although we support adjusting the residual margin, we believe that the residual margin should only be adjusted for certain changes in
expected cash flows and related changes to the risk adjustment. Specifically, we believe that only non-market changes related to items such as mortality, morbidity, and general insurance claims should be absorbed into the residual margin. We believe that a current measurement model, or any model that the Board ultimately selects, should require market-related assumption changes to flow through to earnings.

While we recommend the risk adjustment and residual margin approach, we have some concerns with the calculation and reliability of the risk adjustment. We have described those concerns in our response to Question 9.

**Presentation**

We believe that a margin presentation approach will not provide more useful information to all users of financial statements because it will not convey adequate information about an insurer’s operations. Therefore, we encourage the Board to allow insurers to include volume information on the statement of income. We believe the Board can achieve this result by integrating some of the disclosure items into the statement of income. Allowing insurers the option to present volume amounts will eliminate financial reporting difficulties incurred by insurers that may be subject to two different presentation models.

**Transition**

The transition provisions for any new measurement model for insurance contracts will have a significant long term effect on some insurance companies' results as existing contracts may stay in force for 20 to 30 years. Therefore, the Board should carefully consider the transition provisions of this standard. Although the DP does not address transition, the IASB’s ED proposes a transition approach that would not adequately present the future profits on in-force business. We have explored alternative approaches and have identified three different approaches the Board should consider: retrospective application, fair value and current pricing. We acknowledge that none of these approaches completely solves the transition issue but may allow a more appropriate recognition of future profits on in-force business. Further explanation of each approach is included in our response to question 17 of the IASB’s ED.

Very truly yours,

Ernst & Young LLP
Appendix A - Responses to specific questions raised in the Discussion Paper, “Preliminary Views on Insurance Contracts”

Definition and Scope

Question 1

Are the proposed definitions of insurance contract and insurance risk (including the related guidance) understandable and operational?

We agree with the definition of an insurance contract but have concerns with the definition of insurance risk. We question whether extremely unlikely scenarios should be considered when determining if significant insurance risk exists. If the Board removes extremely unlikely scenarios from the definition of insurance risk then specific guidance for fixed premium policies that cover unlikely events, for example, catastrophe covers, will be required.

Question 2

If the scope of the proposed guidance on insurance contracts is based on the definition of an insurance contract rather than on the type of entity issuing the contract, would financial reporting be improved?

We believe that financial reporting would be improved if the scope of the proposed guidance on insurance contracts is based on the definition of an insurance contract rather than on the type of entity issuing the contract, except as discussed in our response to Question 4. We generally believe that the type of contract and economics of the contract should drive the accounting instead of the type of entity.

Question 3

Do you agree with the proposed scope exclusions? Why or why not?

We agree with the scope exclusions in paragraph 28 except for the exclusion in paragraph 28(e) of fixed-fee service contracts. Paragraph 28(e) states that “an insurer would apply the proposed guidance to insurance contracts in which the insurer provides goods or services to the policyholder to compensate the policyholder for insured events.” This indicates that fixed fee service contracts will be accounted for differently according to whether they are issued by an insurer or not. Because the objective of the standard is to apply to insurance contracts instead of insurance entities, we do not understand why fixed-fee service contracts issued by insurers should be in the scope of the insurance contracts standard while fixed-fee service contracts issued by non-insurers are out of the scope. We believe those entities that issue fixed-fee service contracts should, based on an assessment of the predominante features of the contract, account for those types of contracts using either the standard on insurance contracts or revenue recognition.
We agree that financial guarantee contracts where the policyholder holds the underlying instrument should be in the scope of an IFRS on insurance contracts. However, we are concerned that for banks and similar businesses that loan funds it may be operationally burdensome for those entities to implement the insurance contracts standard for financial guarantee contracts that they issue. Specifically, we are concerned because those entities will be required to introduce complex new processes to measure impairment of loans and the insurance model may require different processes for similar risks. Further, it may be confusing for users of their financial statements if similar risks (e.g., non-performance) are measured on different bases.

Question 4

Should benefits that an employer provides to its employees that otherwise meet the definition of an insurance contract be within the scope of the proposed guidance? Why or why not?

We believe the benefits an employer provides to its employees that otherwise meet the definition of an insurance contract should not be within the scope of the proposed standard.

Question 5

The Board’s preliminary view is that participating investment contracts should not be accounted for within the proposed model for insurance contracts but, rather, should be included in the scope of the proposed model for accounting for financial instruments. Do you agree? Why or why not?

We agree with the Board’s objective to create an insurance contracts standard instead of a standard for the insurance industry. Therefore, we agree with the Board’s preliminary view that participating investment contracts should be included in the scope of the proposed model for accounting for financial instruments. However, before these contracts are scoped into the financial instruments standard the Board will need to re-address the accounting for them, because we believe that the financial instruments standard does not provide guidance on the accounting for the unique aspects of these types of contracts. If the Board decides that it will not specifically address the accounting for these contracts in the financial instruments standard, then the Board should include them in the insurance contracts standard.

Question 6

Do you support the approach for determining when noninsurance components of contracts should be unbundled? Why or why not?

The unbundling principle requires an insurer to separate all components that are not closely related to the insurance coverage specified in a contract. Conceptually, we agree with unbundling for those aspects of an insurance contract that are clearly separable components (e.g., financing or servicing). Notwithstanding that we agree with the concept of unbundling, the unbundling principle in the DP is difficult to interpret because the DP does not specifically define what closely related means and the DP does not include sufficient guidance.
Although the DP provides examples of common components that are not closely related to the insurance coverage, we believe that the examples are generic and can be interpreted differently. For example, the DP indicates that an account balance should be unbundled if the account balance is credited with an explicit return and that crediting rate is based on a general account pool of investment for universal life contracts. To a casual reader it appears that most universal life contracts should be unbundled. However, once the detail of contract terms are analyzed almost all universal life contracts fail to meet the criteria that all investment performance should be passed onto the policyholder. Therefore, the example in the DP seems problematic as most universal life contracts would not meet the criteria to be unbundled.

Recognition and Measurement

Question 7

Do you agree with the use of the probability-weighted estimate of net cash flows to measure insurance contracts? Does that approach faithfully represent the economics of insurance contracts? Is it an improvement over existing U.S. GAAP?

We agree with the Board that one component of an insurance liability should be the probability-weighted estimate of future cash flows. We also recognize that in any calculation the views of management will influence the selection of expected cash flows and the related probability of those cash flows. We believe that the use of the term “unbiased” is intended to prevent unduly optimistic or pessimistic assumptions (i.e., neutral). We recommend that the Board remove the notion of “unbiased” from the ED and provide robust guidance on the objective of the calculation of the present value of probability-weighted cash flows.

We agree that the probability-weighted estimate of net cash flows faithfully represents one component of an insurance contract.

We agree that the reduction or elimination of multiple models in using estimates to measure insurance liabilities would be an improvement to existing US GAAP as long as the model selected provides relevant information.

Question 8

Do you think that an entity’s estimate of the net cash flows should include a risk adjustment margin?

The proposed measurement model would lock the residual margin or composite margin at inception with changes in expected cash flows and risk adjustment being recognized immediately in the statement of income. That requirement is inconsistent with the revenue recognition model as similar changes in expected costs in that model are absorbed by the expected profit margin until that margin is reduced to zero. We think that changes in the estimated cash flows of insurance contracts should be recognized in a manner similar to changes in estimated costs to fulfill performance obligations in the proposed revenue recognition model.
Based on the foregoing, we recommend that the Board select an adjusted margin approach and that approach should include a risk adjustment and residual margin. We would not support an adjusted composite margin approach because under that approach the composite margin could be reduced to zero and the remaining insurance liability would only be the present value of probability weighted average of cash flows. We believe that amount does not properly represent the liability because it does not reflect the risk and uncertainty in those cash flows.

Although, we support adjusting the residual margin, we believe that the residual margin should only be adjusted for certain changes in expected cash flows and related changes to the risk adjustment. Specifically, it should cover only non-market changes related to items such as mortality, morbidity, and general insurance claims. We believe that a current measurement model, or any model that the Board ultimately selects, should require market-related assumption changes to flow through to earnings because that approach would better represent how companies manage their asset/liability risk (considering that certain assets may be recognized at fair value with changes in fair value recognized in earnings under either IFRS 9 or the FASB’s recent proposals).

While we recommend the risk adjustment and residual margin approach, we have some concerns with the calculation and reliability of the risk adjustment. We have described those concerns in our response to Question 9. We encourage the Board to continue to discuss the objective of the risk adjustment and provide further guidance to promote consistent and reliable application by insurers.

In the event that the Board selects an unadjusted margin approach, we believe that the composite margin approach would be a better choice. Under that approach we prefer the composite margin because we believe that changes in the risk adjustment would be very difficult to estimate and would result in further volatility and complexity without providing substantially better information.

**Question 9**

Is the objective of the risk adjustment margin understandable? If so, do you think that the techniques for estimating the risk adjustment margin (see paragraph 52(b)), faithfully represent the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected?

We do not agree that the risk adjustment, if used, should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected. We believe that the risk adjustment should represent the amount, if any, an insurer would rationally expect to pay to relieve itself of the risk that the ultimate fulfillment cash flows exceed those expected.

Because the measurement model requires the base cash flows to be unbiased probability-weighted estimates (i.e., the mean), we agree that the measurement model should provide for the uncertainty that management perceives is inherent in such estimates. However, we are concerned that the DP restricts the method management may use to make that estimate as it will allow only one of three methods. More sophisticated techniques may be developed in the future that better meet the objective for including a risk adjustment in the liability measurement. These techniques should not be excluded from use. We believe that the accounting standard should clearly describe the objective that
the measurement should represent, and then management should develop their estimate of that amount using an appropriate model of their choice. Also, the Board should consider issuing educational materials and illustrative examples about expected present value techniques, illustrating how the risk adjustment is determined and included in the present value of the fulfillment cash flows.

Question 10

Do you think that the risk adjustment margin would be comparable for entities that are exposed to similar risks?

If the Board provides a clear definition of the objective of a risk adjustment and requires specific disclosures around the techniques used and assumptions made when calculating the risk adjustment, then we believe that the risk adjustment would be reasonably comparable among companies. More transparency around the calculation would help users of financial statements to compare insurers’ exposure to risk and make informed decisions.

Questions 11

Do you agree with the description of cash flows that should be included in the measurement of an insurance contract? Is the proposed guidance operational?

We believe that the guidance in the DP is too general. We prefer the more detailed guidance that the IASB provided in its ED. While we prefer the IASB’s guidance we have the follow comments on that guidance.

The application guidance indicates that the starting point for an estimate of cash flows is a range of scenarios that reflects the full range of possible outcomes (i.e., all possible scenarios). However, in paragraphs B38 and B39 it appears that the ED provides insurers with some relief from the requirement to use all scenarios. We believe that insurers should not be required to use all scenarios. Instead, insurers should be required to use a sufficient number of scenarios to reasonably calculate the probability-weighted cash flows.

Paragraph B62(f) indicates that costs that do not relate directly to the contract or contract activities, such as general overhead, should not be included in the cash flows to calculate an insurance liability. We have received feedback indicating that this is not sufficient guidance. For example, some have questioned whether third-party investment management fees should be included in the contract liability as these fees are related to the insurance contracts, while others have questioned whether costs related to information systems. Should be included in the cash flows. While we do not believe that the Boards intended these costs to be included in the liability measurement, additional guidance would be helpful in reducing the potential for diversity in practice.

In paragraph B64, the ED indicates that in some cases depreciation can be considered in the cash flows for the determination of the fulfillment value. We do not agree that non-cash items should be part of the expected cash flows.
The draft application guidance does not provide guidance with respect to policy loans. For example, should they be treated as part of the cash flows? If that is not the intent then we suggest policy loans be explicitly excluded from the scope of the standard.

Question 12

Do you agree that the carrying amount of all insurance contracts should be discounted if the effect is material? Do you agree with the proposed guidance on the discount rate that should be used to measure the carrying amount of insurance contracts? If not, which discount rate should be used?

The selection of an appropriate discount rate is most likely the single most difficult issue that the FASB needs to resolve to achieve global convergence for the accounting for insurance contracts. The discount rate selected needs to achieve a balance between providing a measurement model that fairly represents the economic relationship between the insurer and the policyholder and at the same time produces a liability amount that reflects the current expected value to fulfill the insurer's obligations. Such a rate also must provide meaningful performance measures and be consistent with the economics of the business.

Although, we agree with the Board that insurance liabilities should reflect the time value of money, we acknowledge that there are concerns in the insurance industry that the discount rate proposed in the measurement model will result in volatility in reported profit and loss that, in some cases may not reflect the economic relationship between the insurer and the policyholder. We understand and agree with the Board's desire to use a discount rate that is based on the characteristics of the liability, rather than the assets used to fund the liability, to provide a more consistent measurement among entities. However, we do not believe the use of the risk free rate plus a liquidity adjustment is consistent with the fulfillment measurement objective as it appears to have more similarities to a fair value measurement. We also believe that an asset earning rate is not inconsistent with the objective of the DP to measure insurance liabilities at a fulfillment value. However, using an asset earning rate would compromise comparability among insurers with different investment strategies. We therefore suggest, as a short-term practical solution to improve comparability among insurers, that the Board propose that non-linked contracts be discounted using a high-quality corporate bond rate similar to the requirement of Accounting Standards Codification Topic 715, Compensation - Retirement Benefits.

We also note that both IFRS and US GAAP use various discount rates to reflect the time value of money. While we have proposed a short-term practical solution to the discount rate, the Board should consider undertaking a comprehensive study of all discount rates used throughout the accounting literature. The objective of that study should be to develop a framework to select discount rates that will result in the most relevant information to users given the nature of the item being measured.

If the Board decides to continue with a standard on insurance contracts that discounts insurance liabilities at risk-free rate plus a liquidity adjustment, it should establish a clear principle explaining how a liquidity adjustment should be calculated. We believe that the ED does not adequately articulate the underlying rationale and objective of a liquidity adjustment. This lack of clear rationale and objective, likely will result in inconsistent application by insurers. Also, as indicated in the Basis for Conclusions in paragraph 100 of the IASB's ED, there is not yet a consensus on how best to measure a liquidity adjustment, for example how to separate liquidity effects from credit effects. We question
why the Board would recommend that a measurement include a component that is not reliably measurable.

Question 13

Do you think that acquisition costs should be included as one of the cash flows relating to the contract? If not, how would you account for acquisition costs?

We agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows.

Question 14

Do you agree that acquisition costs included in the cash flows used in the measurement of the insurance contract should be limited to those that are incremental at the individual contract level? If not, which acquisition costs, if any, would you include in the measurement of the insurance contract?

We agree that acquisition costs included in the cash flows used in the measurement of the insurance contract should be limited to those that are incremental at the individual contract level.

Question 15

Do you agree with the use of either the composite margin approach or two-margin approach to measure the net insurance contract? Does either approach faithfully represent the economics of insurance contracts? Is either approach an improvement over the measurement used in current U.S. GAAP?

See our response to question 8.

We believe that with the proper enhancements to the risk adjustment and residual margin, the two-margin approach would faithfully represent the economics of an insurance contract.

We believe that the two-margin approach may be an improvement to US GAAP for most long-duration contracts because it will eliminate multiple methods currently being applied today. However, with regard to short-duration contracts, the two margin approach may only result in limited improvements to US GAAP and the cost of implementing that approach could exceed the benefits.

Question 16

Do you think that the composite margin should be recognized in earnings in subsequent periods using the ratio described in paragraph B3? If not, how would you recognize the composite margin in earnings?

If the composite margin is used, we agree that it should be recognized in earnings in subsequent period using the ratio described in the DP.
Question 17
Do you agree that interest should not be accreted on the composite margin? Why or why not?

We agree that interest should not be accreted on the composite margin as it represents a deferred profit amount and not a cash flow.

Question 18
Do you think that all insurance contracts should be recognized and measured using one approach or that some insurance contracts should be recognized and measured using an alternative approach (for example, the modified approach)? Why or why not?

Conceptually, insurance contracts should be recognized and measured using one single measurement model. However, if the Board decides that the cost to use the single measurement model for short-duration contracts in the pre-claim period exceeds the benefits, then insurers should be permitted to use an alternative approach for those contracts, provided that the onerous contract test is simplified.

Question 19
If an alternate approach is required for some insurance contracts, what recognition, measurement, and presentation provisions should be applied (including those items noted in paragraph 106)?

If an alternate approach is required for some insurance contracts for recognition, measurement and presentation, then we believe that the US GAAP short-duration unearned premium approach should be used in the pre-claim period, provided that the onerous contract test is simplified, and the present value of the fulfillment cash flows in the post-claim period.

Question 20
Do both the building-block approach and the modified approach (with the latter approach applied only to certain short-duration contracts) produce relevant and decision-useful information? Why or why not?

We do not believe that the proposed building-block approach will produce relevant and decision-useful information. However, with our proposed changes we believe that the proposed building-block approach would produce relevant and decision-useful information.

Also, we believe that an alternate approach (i.e., unearned premium) currently provides relevant and decision-useful information for short duration contracts at a reasonable cost.

Question 21
How should the scope of insurance products for each approach be defined (for example, duration of coverage period, duration of claims payment period, or type of insurance)?
Notwithstanding the fact that we believe one single measurement model for all insurance contracts would be preferable, if the Board decides to proceed with an alternative approach, we do not agree that an arbitrary cut-off period of coverage is appropriate to determine those contracts that should be measured under the modified measurement model. Having such a test creates the potential for arbitrage, with contracts being designed or modified to achieve an accounting outcome rather than for a commercial purpose. We recommend that the Board should consider retaining the definition of short-duration contracts and long-duration contracts in US GAAP. This definition is well-known and has been applied by insurers consistently for many years. If the Board does not accept the US GAAP definition then we propose that the Board expand the arbitrary cut-off period to three years. This time period would then be substantially consistent with the definition of short-duration that is used currently in practice and in US GAAP.

Question 22

Are there specific types of insurance contracts for which the approaches would not provide decision-useful information?

See our responses to questions 19 and 20.

Question 23

What are the implications of the recent U.S. healthcare reform to the application of the proposed contract boundary principle, including whether health insurance contracts written under the new reforms would meet the conditions in the proposed guidance to be accounted for under the modified approach?

The recent US healthcare reform would not appear to allow many health insurance companies to account for individual health contracts using the modified measurement model, as insurers will not be able to re-underwrite individual health insurance policies. However, if the Board allows an insurer to use a modified model if the insurer re-underwrites individual policies as a group then we believe these contracts would meet the conditions to be accounted for under the modified approach.

Question 24

What other changes should be considered to both improve and simplify U.S. GAAP for short- and long-duration insurance contracts?

See our cover letter for additional recommendations.

Question 25

What are the incremental costs of adopting the alternatives described in this Discussion Paper? Please separately describe one-time costs and ongoing costs.
Many companies, both insurance and non-insurance, will be affected by the standard and will be required to adjust their systems and processes to comply with the new standard. However, we believe preparers are better positioned to respond to the specifics of this question.

Reinsurance

Question 26

The scope of the proposed guidance includes reinsurance contracts that an insurer issues or acquires. However, insurance contracts held directly by other policyholders would be excluded from the scope of the proposed guidance. Do you agree with this exclusion? Why or why not?

We agree that the accounting by policyholders should not be included in the scope of a standard on insurance contracts.

Question 27

Should there be symmetry between the recognition and measurement of reinsurance contracts and the underlying contract ceded?

We believe that there should be symmetry between the recognition and measurement of reinsurance contracts and the underlying contract ceded, except that at the inception of a reinsurance contract a gain should be recognized (if applicable), for the reasons cited in the Basis for Conclusion paragraph 236 of the IASB’s ED. Reinsurance contracts are essentially insurance contracts written by the reinsurer to protect the insurance company against specified insured losses on written insurance contracts. Therefore, reinsurance contracts would meet the definition of an insurance contract in the DP and should be measured using the same measurement model as insurance contracts.

Overall, we do not believe that the Board has spent sufficient time discussing all the issues surrounding reinsurance. During the outreach program, roundtables and field testing the Board should consider specifically gathering information about the issues relating to reinsurance (e.g., risk transfer, contract boundaries and risk adjustment calculation). We expect that several improvements will be required as the Board becomes more knowledgeable on this topic.

Presentation and Disclosure

Question 28

The margin presentation approach highlights the changes in the insurance liability, rather than the current approach in U.S. GAAP, which presents, among other items, premium revenues, benefits paid, operating costs, and changes in loss estimates. Would this change improve your understanding of the performance of an entity that provides insurance (for some types of insurance or for all)? Please explain.

We believe that a margin presentation approach will not provide enough information to be more useful to all users of financial statements because it will not convey adequate information about an insurer’s
operations. For example, for some insurance contracts earned premiums are a measure of the consideration paid by the policyholder to the company. The earning of that consideration over the coverage period represents the revenue of the entity and should be presented in the statement of income. We encourage the Board to include volume information on the statement of income. We believe the Board can achieve this by integrating some of the proposed disclosure items into the statement of income. Allowing insurers to present some volume amounts (e.g., revenues, benefits or claims) will eliminate financial reporting difficulties for insurers that issue both life and property and casualty insurance contracts that, under the IASB's ED, would be subject to two different presentation models. Furthermore, permitting insurers to present all relevant information on the statement of income will reduce the use of supplemental non-GAAP measures, which we believe would be likely if the Board were to retain the proposed presentation requirements.

Question 29

Should insurance contracts measured under the building-block approach be presented using a margin presentation approach or a premium presentation approach that would require a true-up amount as described in paragraph 119 (for example, the written allocation presentation approach or the allocated premium presentation approach)?

See our response to question 28.

Question 30

Should short- and long-duration (or nonlife and life) contracts be presented in a similar manner even if such contracts are measured under different approaches?

See our response to question 28.

Question 31

Do you agree with the proposed disclosures in the IASB’s Exposure Draft? Why or why not? If not, what would you recommend and why?

The disclosure information required by the IASB’ ED is largely based on the existing requirements of IFRS 4, except for certain reconciliations for new elements in the liability introduced by the ED. We do not believe that the IASB devoted adequate time to develop disclosure objectives to complement the information presented when using the summarized margin approach. The disclosure principles and requirements should be tailored to the new measurement and recognition requirements of the proposed measurement model in the ED.

Notwithstanding the fact that the disclosures could be aggregated, we believe that they would have to be presented at the level of a portfolio of insurance contracts. Therefore, we believe it could result in voluminous disclosures, and those disclosures could become a series of account balance roll-forward amounts with generic commentary as to causes of changes in estimates. We also believe that the proposed changes will so fundamental that detailed illustrations of the types of disclosures will be
necessary. This will help avoid years of inconsistencies in the disclosures provided by different insurers (similar to the inconsistencies in initial disclosures of embedded value reporting).

We believe that the FASBs project to establish a framework for disclosures and rationalize existing disclosure requirements is critical to effective financial reporting. We believe that a disclosure framework should be developed concurrent with the completion of significant projects given the volume of additional disclosures proposed by the Boards in these areas. That framework might help the Board to focus on those disclosures that provide the greatest benefit to users at the least cost to preparers, which we do not believe has been the case for this and other major projects (e.g., revenue recognition and leases).

Additional Question for Respondents

Question 32

After considering your views on the specific issues contained in this Discussion Paper and the IASB's Exposure Draft, what do you think would represent the most appropriate improvement to U.S. GAAP?

a. Pursue an approach based on the IASB's Exposure Draft?

b. Pursue an approach based on the IASB’s Exposure Draft with some changes? Please explain those changes.

c. Pursue an approach based on the Board's preliminary views in this Discussion Paper?

d. Pursue an approach based on the Board’s preliminary views in this Discussion Paper with some changes? Please explain those changes.

e. Make targeted changes to address specific concerns about current U.S. GAAP (for example, items included in paragraph 7)? Please describe those changes.

See our cover letter.

Additional Response - Initial Recognition of an Insurance Contract

We agree that an insurer is exposed to some risk when an offer (e.g., binder) is made to a potential policyholder and the insurer is unable to rescind the offer even if the risks change before the effective date. Current accounting models followed by insurers do not require these binders to be recognized at the offer date. As a result, insurance companies generally do not track these offers and companies initially recognize these contracts only when the policyholder completes the transaction and agrees to the terms. If the Board decides to have companies recognize offers at the binder dates then we understand that significant system changes will be required. Because the likelihood that material changes will occur between the time an offer is made and the offer is accepted is very low, we do not believe that companies should begin the accounting for these contracts at the offer date. We believe
that the Board should require that an insurance contract be initially recognized when both parties have legally agreed to the arrangement not when the insurer makes an offer.
Appendix B

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

30 November 2010

Invitation to comment – Exposure Draft – Insurance Contracts

Dear IASB Members:

The global organisation of Ernst & Young is pleased to respond to the Exposure Draft, Insurance Contracts (ED). Our responses to the specific questions for respondents are set out in the appendix to this cover letter. We highlight below some of the broader issues raised in our responses.

As previously stated, we strongly support a single set of high quality global accounting and financial reporting standards and strongly support the convergence of IFRS and US GAAP as a step toward realisation of that goal. A converged accounting model for insurance contracts is an important milestone in the convergence process, particularly given the diversity in practice under IFRS for insurance contracts.

In this regard, we are concerned that the IASB’s and FASB’s decisions on this joint project are not completely converged. We understand that the IASB may feel greater urgency to issue an insurance standard given the current state of IFRS 4, Insurance Contracts. Conversely, the FASB may feel less pressure to issue a new insurance standard given that, whilst there are opportunities for improvement in US GAAP, current US GAAP for insurance contracts is reasonably robust, is applied relatively consistently and enjoys the general support of users, regulators and preparers. Notwithstanding these differing pressures, to achieve a converged standard we believe that the Boards need to operate on the same timeline and make their decisions jointly, even if that process slightly delays issuance of a final standard beyond the date targeted by the IASB. We do not believe that it is in the best interests of the insurance industry if a major market like the US does not adopt the same rules at the same time as the rest of the world. However, if the Boards are unable to agree on the key aspects of a converged standard then the IASB should move forward and issue a new insurance contracts standard as soon as possible.

We agree with the fundamental objective articulated in the ED to estimate insurance contract liabilities based on a fulfilment value. However, we have significant concerns about some of the features of the proposed measurement model in the ED and believe these must be resolved before a standard on insurance contracts can be finalised. Therefore, we propose a measurement model that:

Would be dynamic and not lock-in any assumptions over the life of the insurance contract
Would include the present value of probability-weighted cash flows, a risk adjustment and an adjusted residual margin until that margin is reduced to zero.

Would require all assumptions to be updated at each reporting date

- Changes relating to non-market assumptions such as, mortality, morbidity and general insurance claims would be recognised in the residual margin
- Changes in market assumptions would be immediately recognised in profit or loss.

Adjustments to the residual margin would be amortised on a prospective basis.

For non-linked contracts, the insurance liability would, as a short-term practical expedient, be discounted using a high-quality corporate bond rate instead of a risk-free rate plus a liquidity adjustment.

Insurers would be permitted the option to present volume amounts (e.g., premiums, benefits or claims) on the face of the statement of comprehensive income.

This suggested model is just one possible solution and we understand others will suggest or have recently suggested different solutions. The evaluation of a measurement model for insurance contracts requires considerable effort. We are aware of the other proposed models and currently we are reviewing them. As part of our evaluation we will give consideration to the consistency in the concepts used in the accounting for insurance contracts on one hand and other accounting literature (e.g., accounting for financial instruments) on the other. We hope that the Board will keep an open mind with regard to these suggestions and we are willing to work with the IASB staff to assess these alternatives as the Board moves forward with this project.

With regard to the modified measurement model proposed by the Board, our conceptual preference is that the Board should not introduce a modified measurement model for short-duration contracts. However, there are indications that the cost to obtain that pre-claim information under the basic model will exceed the limited benefits of applying that model to short-duration contracts. In that case, we agree that the Board should diverge from their overall objective to have one measurement model and allow a modified measurement model for short-duration contracts. We also believe if the modified measurement model is used the onerous contract test should be simplified.

In the appendix to this letter we have outlined in detail our recommendations. If our approach were adopted, we believe it would result in a measurement model that could be consistently applied by insurers and provide decision-useful information to financial statement users. Our most significant recommendations are further discussed below.

**Discount rate**

The selection of an appropriate discount rate is likely the single most difficult issue that the IASB must resolve to achieve global convergence for the accounting for insurance contracts. The discount rate selected needs to achieve a balance between providing a measurement model that fairly represents the economic relationship between the insurer and the policyholder and at the
same time produces a liability amount that reflects the current expected value to fulfil the insurer’s obligations. Such a rate also must provide meaningful performance measures and be consistent with the economics of the business.

Although we agree with the Board that insurance liabilities should reflect the time value of money, we acknowledge that there are concerns in the insurance industry that the discount rate proposed in the measurement model will result in volatility in reported profit or loss, that in some cases may not reflect the overall economic relationship between the insurer and the policyholder. We understand and agree with the Board’s desire to use a discount rate that is based on the characteristics of the liability, rather than the assets used to fund that liability, to provide a more consistent measurement among entities. However, we do not believe the use of the risk-free rate plus a liquidity adjustment is consistent with the fulfilment measurement objective as it can be seen to have more similarities to a fair value measurement. We also believe that an asset earning rate is not inconsistent with the objective of the ED to measure insurance liabilities at a fulfilment value. However, using an asset earning rate would compromise comparability among insurers with different investment strategies. We therefore suggest, as a short-term practical solution to improve comparability among insurers, that the Board propose that non-linked contracts (i.e., non-participating contracts) be discounted using a high-quality corporate bond rate, similar to the requirement of IAS 19 Employee Benefits.

We also note that both IFRS and US GAAP use various discount rates to reflect the time value of money. Whilst we have proposed a short-term practical solution to the discount rate, the Board should consider undertaking a comprehensive study of all discount rates used throughout the accounting literature. The objective of that study should be to develop a framework to select discount rates that will result in the most relevant information to users given the nature of the item being measured.

Risk adjustment and residual margin versus composite margin

The proposed measurement model would lock the residual margin or composite margin at inception with changes in expected cash flows and risk adjustment being recognised immediately in profit or loss. That requirement is inconsistent with the revenue recognition model as similar changes in expected costs in that model are absorbed into the expected profit margin (until the margin is reduced to zero). We believe that changes in the estimated cash flows of insurance contracts should be recognized in a manner similar to changes in estimated costs to fulfil performance obligations in the proposed revenue recognition model.

Based on the foregoing, we recommend that the Board select an adjusted margin approach and that approach should include a risk adjustment and residual margin. As noted in our response to Question 4, we do not support an adjusted composite margin approach. Although we support adjusting the residual margin, we believe that the residual margin should only be adjusted for certain changes in expected cash flows and related changes to the risk adjustment. Specifically, we believe that only non-market changes related to items such as mortality, morbidity, and general insurance claims should be absorbed into the residual margin. We believe that a current measurement model, or any model that the Board ultimately selects, should require market-related assumption changes to flow through the profit or loss.
Whilst we recommend the risk adjustment and residual margin approach, we have some concerns with the calculation and reliability of the risk adjustment. We have described those concerns in our response to Question 5.

Financial instruments with discretionary participation features

We agree with the Board's objective to create an insurance contracts standard instead of a standard for the insurance industry. Therefore, we do not understand why the Board decided that financial instruments with discretionary participation features, that have no insurance attributes, should be included in the scope of the insurance contracts standard. These contracts on a theoretical basis should be in the scope of IFRS 9, Financial Instruments, (IFRS 9) rather than in the scope of the insurance contracts standard. However, before these contracts are scoped into IFRS 9 the Board will need to re-address the accounting for them, because we believe that the guidance in IFRS 9 does not consider the unique aspects of these types of contracts. This could result in an amendment to IFRS 9. If the Board decides that it will not specifically address the accounting for these contracts in IFRS 9, then the Board would be justified to include them in the insurance contracts standard as a default because IFRS 9 does not address their accounting.

Financial guarantee contracts

We agree that financial guarantee contracts where the policyholder holds the underlying instrument should be in the scope of an IFRS on insurance contracts. However, we are concerned that for banks and similar businesses that loan funds it may be operationally burdensome to implement the insurance contracts standard for financial guarantee contracts that they issue. Specifically, we are concerned because those entities will be required to introduce complex new processes to measure impairment of loans as a consequence of IFRS 9 and the insurance model may require different processes for similar risks. Further, it may be confusing for users of their financial statements if similar risks (e.g., non-performance) are measured on different bases.

If the final standard on insurance contracts is sufficiently similar to the expected cash flows approach being developed under IFRS 9, then including financial guarantee contracts in the insurance contracts standard may not be operationally burdensome for banks and similar businesses. In any event, the IASB should consider performing additional field testing in this area so that the Board understands the effects its decisions will have on these companies. The Board's decision on whether to keep these contracts in or out of a standard on insurance contracts should depend on how different the treatment would be compared to that of loans and how significant the costs would be to implement the approach for these entities.

Presentation

We believe that a summarised margin presentation will not provide more useful information to all users of financial statements because it will not convey adequate information about an insurer's operations. Therefore, we encourage the Board to allow insurers to include volume information on the statement of comprehensive income. We believe the Board can achieve this result by integrating some of the disclosure items into the statement of comprehensive income. Allowing insurers the option to present volume amounts will eliminate financial reporting difficulties incurred by insurers that may be subject to two different presentation models.
Transition

We are concerned with the transition provisions in the ED because insurers will not adequately present the future profitability on in-force business in profit or loss. We have explored alternative approaches and have identified three different approaches the Board should consider: retrospective application, fair value and current pricing. We acknowledge that none of these approaches completely solves the transition issue but may allow a more appropriate recognition of future profits on in-force business. Further explanation of each approach is included in our response to Question 17.

If our suggested amendments are accepted by the Board, additional due process would nevertheless be warranted to provide stakeholders with an opportunity to appropriately and fully consider the revised proposal and to comment on them. Joint deliberations with the FASB leading to the re-exposure of the insurance contracts proposal are essential. Jointly deliberating the issues and reaching converged solutions will take time, and the Boards should take the necessary time to ensure that their standard in this important area is well developed, understood and supported by the various stakeholders.

Should you wish to discuss the contents of this letter with us, please contact Richard Lynch at +1 212 773 5601.

Yours faithfully

Ernst & Young
Responses to specific questions raised in the Exposure Draft, 
*Insurance Contracts*

**Measurement (paragraphs 16–53 and BC45-BC144)**

1. **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?

   **Comments:**

   Fundamentally, we agree with the Board’s objective of measuring insurance contract liabilities based on a fulfilment value. However, we have observed that there are many different views on how that amount should be calculated, including the discount rate that should be used, because the ED lacks a clear definition of the concept of fulfilment value. Therefore, the Board should provide a clearer definition of fulfilment value other than to indicate that it represents the cash flows needed to fulfill the insurance contract.

   We are concerned with several aspects of the proposed measurement model in the ED. Therefore, we do not believe the measurement model proposed in the ED would help users of an insurer’s financial statements to make economic decisions and have developed an alternative measurement model for your consideration. The measurement model we propose would be dynamic and not lock in any assumptions over the life of the insurance contract. Our proposed measurement model would include the present value of probability-weighted cash flows, a risk adjustment and an adjusted residual margin. Insurers would update all assumptions at each reporting date and changes relating to non-market assumptions, such as mortality, longevity and general insurance claims, would be recognised in the residual margin. And changes in market assumptions would be immediately recognised in profit or loss. The updated residual margin would be amortised prospectively. We believe that prospective application is consistent with the principles of a change in accounting estimate in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, and would be simpler for all insurers to apply. Also, the model we propose for non-linked contracts would use a high-quality corporate bond rate to discount the insurance liability instead of a risk-free rate plus a liquidity adjustment. Our proposed model is discussed further in the detailed responses in the following questions.

2. **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?

   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?
Comments:

(a) We 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. Taking into account all expected cash flows of an insurance contract will best reflect the economic relationship between the insurer and policyholder.

(b) We believe that the draft application guidance on estimates of future cash flows, for most of the items, is at the right level of detail. However, there are some areas where the application guidance does not provide sufficient detail to promote consistency. For example:

We agree with the Board that one component of an insurance liability should be the probability-weighted estimate of future cash flows. We also recognise that in any calculation the views of management will influence the selection of expected cash flows and the related probability of those cash flows. We believe that the use of the term "unbiased" is intended to prevent unduly optimistic or pessimistic assumptions (i.e., neutral). We recommend that the Board remove the notion of "unbiased" from the ED and provide robust guidance on the objective of the calculation of the present value of probability-weighted cash flows.

The application guidance indicates that the starting point for an estimate of cash flows is a range of scenarios that reflects the full range of possible outcomes (i.e., all possible scenarios). However, in paragraphs B38 and B39 it appears that the ED provides insurers with some relief from the requirement to use all scenarios. We believe that insurers should not be required to use all scenarios. Instead, insurers should be required to use a sufficient number of scenarios to reasonably calculate the probability-weighted cash flows.

Paragraph B62(f) indicates that costs that do not relate directly to the contract or contract activities, such as general overhead, should not be included in the cash flows to calculate an insurance liability. We have received feedback indicating that this is not sufficient guidance. For example, some have questioned whether third-party investment management fees should be included in the contract liability as these fees are related to the insurance contracts, whilst others have questioned whether costs related to information systems should be included in the cash flows. While we do not believe that the Boards intended these costs to be included in the liability measurement, additional guidance would be helpful in reducing the potential for diversity in practice.

In paragraph B64, the ED indicates that in some cases depreciation can be considered in the cash flows for the determination of the fulfilment value. We do not agree that non-cash items should be part of the expected cash flows.

The draft application guidance does not provide guidance with respect to policy loans. For example, should they be treated as part of the cash flows? If that is not the intent then we suggest policy loans be explicitly excluded from the scope of the standard.
Question 3 – Discount rate (paragraphs 30-34 and BC88-BC104)

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

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

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

Comments:

(a) We agree that the discount rate used by the insurer for non-linked contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing the liability, unless there is a direct linkage to the assets. We believe that if two companies happened to have non-linked contracts with the same exact characteristics, then the discount rate of those liabilities should be the same; they should not differ due to the investment strategies of the companies.

(b) The selection of an appropriate discount rate is most likely the single most difficult issue that the IASB needs to resolve to achieve global convergence for the accounting for insurance contracts. The discount rate selected needs to achieve a balance between providing a measurement model that fairly represents the economic relationship between the insurer and the policyholder and at the same time produces a liability amount that reflects the current expected value to fulfil the insurer’s obligations. Such a rate also must provide meaningful performance measures and be consistent with the economics of the business.

Although we agree with the Board that insurance liabilities should reflect the time value of money, we acknowledge that there are concerns in the insurance industry that the discount rate proposed in the measurement model will result in volatility in reported profit or loss that, in some cases may not reflect the economic relationship between the insurer and the policyholder. We understand and agree with the Board’s desire to use a discount rate that is based on the characteristics of the liability, rather than the assets used to fund the liability, to provide a more consistent measurement among entities. However, we do not believe the use of the risk-free rate plus a liquidity adjustment is consistent with the fulfilment measurement objective as it can be seen to have more similarities to a fair value measurement. We also believe that an asset earning rate is not inconsistent with the objective of the ED to measure insurance liabilities at a fulfilment value. However, using an asset earning rate would compromise comparability among insurers with different investment strategies. We therefore suggest, as a short-term practical solution to improve comparability among insurers, that the Board propose that non-linked contracts be discounted using a high-quality corporate bond rate similar to the requirement of IAS 19, Employee Benefits.
Discounting of liabilities under various existing or proposed IFRS standards is applied differently depending on the topic. For example:

- IAS 19 requires an entity to determine the discount rate by reference to market yields at the end of the reporting period on high-quality corporate bonds,
- The proposed discount rate for IAS 37 liabilities is a risk-free rate,
- The proposed discount rate for the new leases standard is either the lessee’s incremental borrowing rate or the rate implicit in the lease,
- IFRS 9 requires financial liabilities to be reported at amortised cost,
- The proposed discount rate for insurance liabilities is the risk-free rate plus a liquidity adjustment.

We believe that there should be consistency on how the time value of money is applied throughout all IFRS standards provided that the measurement attribute is the same. Accordingly, we believe that the Board has to develop a long-term solution to the selection of a discount rate and that will require a comprehensive review.

If the Board decides to continue with a standard on insurance contracts that discounts insurance liabilities at a risk-free rate plus a liquidity adjustment, it should establish a clear principle explaining how a liquidity adjustment should be calculated. The ED does not adequately articulate the underlying rationale and objective of a liquidity adjustment. This lack of clear rationale and objective, likely will result in inconsistent application by insurers. As indicated in the Basis for Conclusions in paragraph 100 of the ED, there is not yet a consensus on how best to measure a liquidity adjustment, for example how to separate liquidity effects from credit effects. We question why the Board would recommend that a measurement accounting standard include a component that is not reliably measureable.

(c) We acknowledge that many life insurers currently price many of their products to reflect the asset return they are expecting from a mix of assets they intend to buy over the life of an insurance contract. Therefore, the expected cash outflows (i.e., benefits or claims) that an insurer assumes will occur usually are based on a rate higher than the risk-free rate. These insurers have expressed a desire for a discount rate that is consistent with the expected investment performance of the assets over the life of the insurance contract to avoid having to recognise a loss at inception of a contract. Recognising a loss at inception could be viewed by these insurers as misrepresenting the transaction, as the insurer generally will not credit a rate in excess of the return that is achieved on the assets that support the insurance obligations over the entire life of the contract. We believe that these insurers have a valid concern if they will be required to record a loss at contract inception when they believe that they do not have a loss.

We agree that the insurer’s own risk of non-performance should be excluded from the discount rate.
Question 4 - Risk adjustment versus composite margin (paragraphs BC105-BC115)

4. 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.

Comments:

The proposed measurement model would lock the residual margin or composite margin at inception with changes in expected cash flows and risk adjustment being recognised immediately in profit or loss. That requirement is inconsistent with the revenue recognition model as similar changes in expected costs in that model are absorbed by the expected profit margin until that margin is reduced to zero. We think that changes in the estimated cash flows of insurance contracts should be recognized in a manner similar to changes in estimated costs to fulfill performance obligations in the proposed revenue recognition model.

Based on the foregoing, we recommend that the Board select an adjusted margin approach and that approach should include a risk adjustment and residual margin. We would not support an adjusted composite margin approach because under that approach the composite margin could be reduced to zero and the remaining insurance liability would only be the present value of probability weighted average of cash flows. We believe that amount does not properly represent the liability because it does not reflect the risk and uncertainty in those cash flows.

Although we support adjusting the residual margin, we believe that the residual margin should only be adjusted for certain changes in expected cash flows and related changes to the risk adjustment. Specifically, it should cover only non-market changes related to items such as mortality, morbidity and general insurance claims. We believe that a current measurement model, or any model that the Board ultimately selects, should require market-related assumption changes to flow through the profit or loss because that approach would better represent how companies manage their asset/liability risk (considering that certain assets may be recognized at fair value with changes in fair value recognized in earnings under either IFRS 9 or the FASB’s recent proposals).

Whilst we recommend the risk adjustment and residual margin approach, we have some concerns with the calculation and reliability of the risk adjustment. We have described those concerns in our response to Question 5. We encourage the Board to continue to discuss the objective of the risk adjustment and provide further guidance to promote consistent and reliable application by insurers.

In the event that the Board selects an unadjusted margin approach we believe that the composite margin approach would be a better choice. Under that approach we prefer the composite margin because we believe that changes in the risk adjustment would be very difficult to estimate and would result in further volatility and complexity without providing substantially better information.
Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105-BC123)

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

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

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

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

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

Comments:

(a) We do not agree that the risk adjustment, if used, should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. We believe that the risk adjustment should represent the amount, if any, an insurer would rationally expect to pay to relieve itself of the risk that the ultimate fulfilment cash flows exceed those expected. This objective is consistent with the objective of the proposed risk adjustment in the Exposure Draft on IAS 37, Provisions, Contingent Liabilities and Contingent Assets (IAS 37). Therefore, we believe the Board should carry over the definition of a risk adjustment in IAS 37 to the final standard on insurance contracts so that the risk adjustment is defined consistently in all IFRS.

(b) Because the measurement model requires the base cash flows to be unbiased probability-weighted estimates (i.e., the mean), we agree that the measurement model should provide for the uncertainty that management perceives is inherent in such estimates. However, we are concerned that the ED restricts the method management may use to make that estimate as it will allow only one of three methods. More sophisticated techniques may be developed in the future that better meet the objective for including a risk adjustment in the liability measurement. These techniques should not be excluded from use. We believe that the accounting standard should clearly describe the objective that the measurement should represent, and then management should develop their estimate of that amount using an appropriate model of their choice. Also, the Board should consider issuing educational materials and illustrative examples about expected present value techniques, illustrating how the risk adjustment is determined and included in the present value of the fulfilment cash flows.
(c) We do not agree that the insurer should have to disclose the confidence level if their estimation model does not generate one. We believe better disclosure with regard to the risk adjustment would be achieved by providing sufficient detail of the assumptions management used to estimate the risk adjustment. With sufficient detail, users could then evaluate an individual entity's risk adjustment and compare them with those of other entities.

(d) We recognise that diversification (e.g., longevity vs. mortality) can be important to the overall entity-wide risk management. At the same time, we understand the Board's concerns regarding the practical challenges around estimating the diversification benefits that may exist beyond the portfolio level. However, the proposal to limit diversification between certain portfolios will not reflect how those risks are managed and may not reflect the economics. We believe that the Board should re-evaluate whether to limit diversification and consider permitting insurers to pool certain risks for determining the risk adjustments when they are managed together.

(e) We believe the application guidance is not at the right level of detail. We believe that the application guidance should provide sufficient guidance to ensure consistent application by insurers.

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

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

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

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

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

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

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

(a) We believe a gain at inception should not be recognised. However, if the Board decides in either the revenue recognition or the financial instruments projects that gains at inception are allowed, then gains should also be permitted for insurance contracts.

(b) We 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.

(c) We agree that the proposed unit of account for the residual margin is at an appropriate level. However, we are aware that the Board continues to perform field testing and that testing may indicate that another unit of account would be equally reasonable. Therefore, we encourage the Board to use the responses to the ED along with the field testing in determining the most appropriate unit of account for the residual margin.

(d) We believe that the proposed method for releasing the residual margin should be based on the economic relationship between the insurer and the policyholder. The release of the residual margin in profit or loss should be consistent with the revenue recognition project. Therefore, the IASB should articulate why the proposal to release the residual margin over the coverage period is consistent with the revenue recognition exposure draft, since we are aware that many insurance contracts have significant service elements after the coverage period.

Also, we do not understand the principle in paragraph 53 that the residual margin should be adjusted when there are fewer contracts in force and should not be adjusted when there are more contracts in force. We believe the residual margin should be adjusted for unexpected levels of in-force insurance contracts at the end of each reporting period. If the residual margin is updated each reporting period, then the final standard on insurance contracts should indicate that the change should be accounted for as a change in an accounting estimate in accordance with IAS 8.

(e) The ED’s description of the amortisation of the composite margin is not consistent with the proposed method of releasing the composite margin in the FASB’s DP. In the FASB’s DP, the margin is amortised as claims and benefits are paid, rather than when incurred. We agree with the DP’s method for amortising the composite margin, provided that additional guidance is included regarding how premiums would be allocated.

(f) We disagree that interest should be accreted on the residual margin as it represents a deferred profit amount and not a cash flow.

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

7. 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?

Comments:
We agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows.

We agree that all non-incremental acquisition costs should be recognised as expenses when incurred.

We recommend that the application guidance address the accounting treatment for costs incurred prior to the contract being recognised. We believe that these costs should be expensed.

We note that there is a difference in the accounting treatment of transaction costs between this ED and the Revenue Recognition Exposure Draft. The ED requires that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows. Also, the Leases Exposure Draft allows capitalisation of the costs of obtaining and negotiating contracts. However, the Revenue Recognition Exposure Draft requires the costs of obtaining a contract to be expensed as incurred.

Question 8 – Premium allocation approach

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

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

Comments:

(a) We agree with the Board's original objective to create one consistent measurement model for all insurance contracts. Therefore, we do not understand why the Board has deviated from that objective to require that certain short-duration contracts apply a modified measurement model that will not produce substantially the same results as the basic measurement model over the life of the insurance contract.

The ED requires certain short-duration contracts (i.e., those with a coverage period of approximately 12 months and no embedded options) to use a modified measurement model during the pre-claim period. However, the ED requires that the present value of the fulfilment cash flows be used after a claim has occurred. Therefore, any perceived benefit from being able to apply the modified measurement approach in the pre-claim period (e.g., not having to perform cash flow modelling) is limited. Furthermore, the modified measurement model requires an onerous contract test to be performed and that test is based on performing cash flow modelling to calculate the present value of the fulfilment cash flows. Therefore, we do not believe that the Board has provided a basis to deviate from the objective to provide one measurement model for all insurance contracts.

In addition, the modified model was introduced as a practical accommodation, as it is a reasonable proxy for the present value of the fulfilment cash flows plus a residual margin. Given that management's expectation of the future cash flows are built into their pricing of
insurance contracts, we do not understand why a practical accommodation is necessary. Further, we believe the expected claim information could be produced for the pre-claims liability. Therefore, our initial preference is that the Board should not introduce a modified measurement approach for short-duration contracts. However, there are indications that the cost to obtain that pre-claim information under the basic model will exceed the limited benefits of applying that model to short-duration contracts. In that case, we agree that the Board should diverge from their overall objective to have one measurement model and allow a modified measurement model for short-duration contracts. We also believe if the modified measurement model is used the onerous contract test should be simplified.

Also, we believe that volume indicators are important to users for short-duration contracts and a presentation model that eliminates those indicators is not appropriate. Our response to presentation of insurance contracts is further discussed in question 13.

(b) Notwithstanding the fact that we believe a modified measurement model should not be allowed, if the Board decides to proceed with a modified measurement model, we do not agree that an arbitrary cut-off period of coverage is appropriate to determine those contracts that should be measured under the modified measurement model. Having such a test creates the potential for arbitrage, with contracts being designed or modified to achieve an accounting outcome rather than for a commercial purpose. We recommend that the Board consider adopting the definition of short-duration contracts and long-duration contracts in US GAAP. This definition is well-known and has been applied by insurers consistently for many years. If the Board does not accept the US GAAP definition then we propose that the Board expand the arbitrary cut-off period to three years. This time period would then be substantially consistent with the definition of short-duration that is used currently in practice and in US GAAP.

Cash flows that arise from future premium (paragraphs 26-29 and BC53-BC66)

Question 9 – Contract boundary principle

9. 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?

Comments:

We believe that the Board needs to improve the application guidance for contract boundaries by elaborating on what is considered re-pricing a contract. Also, the application guidance should include more guidance on which cash flows should be included in the initial insurance liability, such as those cash flows related to instances where an insurer has the ability to partially re-underwrite a contract but does not have the ability to fully re-underwrite it. Also, there needs to be more guidance for when a regulatory or governmental agency places restrictions on when an insurer is able to re-price an individual policy or a group of policies. We believe that limitations placed on an insurer by a regulatory or governmental agency should not automatically cause a contract to fail the re-pricing criteria.
In addition, the ED does not address the contract boundary for a reinsurance agreement. Some have questioned whether the contract boundary for a reinsurance agreement is the end of the reinsurance agreement or the end of the coverage period of the underlying insurance contract.


**Question 10 – Participating features**

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

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

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

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

**Comments:**

(a) Participation features, whether contractual obligations or not, are considered in the pricing of contracts. Therefore, we agree that the measurement of insurance contracts should include participating benefits on an expected present value basis.

(b) We agree with the Board’s objective to create an insurance contracts standard instead of a standard for the insurance industry. Therefore, we do not understand why the Board decided that financial instruments with discretionary participation features, that have no insurance attributes, should be included in the scope of the insurance contracts standard. These contracts on a theoretical basis should be in the scope of IFRS 9 rather than in the scope of the insurance contracts standard. However, before these contracts are scoped into IFRS 9 the Board will need to re-address the accounting for them, because we believe that IFRS 9 does not provide guidance on the accounting for the unique aspects of these types of contracts. This could result in an amendment to IFRS 9. If the Board decides that it will not specifically address the accounting for these contracts in IFRS 9, then the Board should include them in the insurance contracts standard.

(c) If the Board decides to include financial instruments with discretionary participation features in the insurance contracts standard then they should be defined separately in the standard.
(d) Since we do not believe that financial instruments with discretionary participation features should be in the scope of the IFRS on insurance contracts we believe that these paragraphs are not necessary. However, if the Board decides to include financial instruments with discretionary participation features in the insurance contracts standard then we agree with these paragraphs.

Definition and scope (paragraphs 2-7, B2-B33 and BC188-BC209)

Question 11 – Definition and scope

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

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

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

Comments:

(a) We agree with the definition of an insurance contract, including the two changes summarised in paragraph BC191. However, we question whether extremely unlikely scenarios should be considered when determining if significant insurance risk exists. If the Board removes extremely unlikely scenarios from the definition of insurance risk then specific guidance for fixed premium policies that cover unlikely events, for example, catastrophe covers, will be required.

(b) We agree with the scope exclusions in paragraph 4 except for the exclusion in paragraph 4(e) of fixed-fee service contracts. Paragraph 4(e) states that “an insurer shall apply this IFRS to insurance contracts in which the insurer provides goods or services to the policyholder to compensate the policyholder for insured events.” Also, the application guidance specifically includes in the scope of the standard insurers that use their own hospitals and medical staff to provide medical services covered by the insurance contract. This indicates that fixed fee service contracts will be accounted for differently according to whether they are issued by an insurer or not. Because the objective of the standard is to apply to insurance contracts instead of insurance entities, we do not understand why fixed-fee service contracts issued by insurers should be in the scope of the insurance contracts standard whilst fixed-fee service contracts issued by non-insurers are out of the scope. We believe those entities that issue fixed-fee service contracts should, based on an assessment of the predominant features of the contract, account for those types of contracts using either the standard on insurance contracts or revenue recognition.

(c) We agree that financial guarantee contracts where the policyholder holds the underlying instrument should be in the scope of an IFRS on insurance contracts. However, we are concerned that for banks and similar businesses that loan funds it may be operationally burdensome for those entities to implement the insurance contracts standard for financial guarantee contracts that they issue. Specifically, we are concerned because
those entities will be required to introduce complex new processes to measure impairment of loans as a consequence of IFRS 9 and the insurance model may require different processes for similar risks. Further, it may be confusing for users of their financial statements if similar risks (e.g., non-performance) are measured on different bases.

If the final standard on insurance contracts is sufficiently similar to the expected cash flows approach being developed under IFRS 9 then including financial guarantee contracts in the insurance contracts standard may not be operationally burdensome for banks and similar businesses. In any event, the IASB should consider performing additional field testing in this area so that the Board understands the effects its decisions will have on these companies. The Board’s decision on whether to keep these contracts in or out of a standard on insurance contracts should depend on how different the treatment would be compared to that of loans and how significant the costs would be to implement the approach for these entities.

**Unbundling (paragraphs 8-12 and BC210-BC225)**

**Question 12 - Unbundling**

12. 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?

Comments:

The unbundling principle requires an insurer to separate all components that are *not closely related* to the insurance coverage specified in a contract. Conceptually, we agree with unbundling for those aspects of an insurance contract that are clearly separable components (e.g., financing or servicing). Notwithstanding that we agree with the concept of unbundling, the unbundling principle in the ED is difficult to interpret because the ED does not specifically define what *closely related* means and the ED does not include sufficient application guidance.

Although the ED provides examples of common components that are not closely related to the insurance coverage, we believe that the examples are generic and can be interpreted differently. For example, the ED indicates that an account balance should be unbundled if the account balance is credited with an explicit return and that crediting rate is based on a general account pool of investment for universal life contracts. To a casual reader it appears that most universal life contracts should be unbundled. However, once the detail of contract terms are analysed almost all universal life contracts fail to meet the criteria that all investment performance should be passed onto the policyholder. Therefore, the example in the ED seems problematic as most universal life contracts would not meet the criteria to be unbundled.

In addition, the unbundling example relating to unit-linked investments in the ED contradicts the existing guidance in IAS 39.AG33(g) relating to closely related unit-linked features.
Presentation (paragraphs 69-78 and BC150-BC183)

Question 13 – Presentation

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

(b) Do you 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?

Comments:

(a) We believe that a summarised margin presentation will not provide enough information to be more useful to all users of financial statements because it will not convey adequate information about an insurer’s operations. For example, for some insurance contracts earned premiums are a measure of the consideration paid by the policyholder to the company. The earning of that consideration over the coverage period represents the revenue of the entity and should be presented in the statement of comprehensive income. We encourage the Board to include volume information on the statement of comprehensive income. We believe the Board can achieve this by integrating some of the proposed disclosure items into the statement of comprehensive income. Allowing insurers to present some volume amounts (e.g., revenues, benefits or claims) will eliminate financial reporting difficulties for insurers that issue both life and property and casualty insurance contracts that, under the ED, would be subject to two different presentation models. Furthermore, permitting insurers to present all relevant information on the statement of comprehensive income will reduce the use of supplemental non-GAAP measures, which we believe would be likely if the Board were to retain the proposed presentation requirements.

(b) We agree with the proposed requirement that all income and expenses arising from insurance contracts should be presented in profit or loss.

Disclosures (paragraphs 79-97 and BC242 and BC243)

Question 14 – Disclosures

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

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

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

(a) The disclosure information required by the ED is largely based on the existing requirements of IFRS 4, except for certain reconciliations for new elements in the liability introduced by the ED. We do not believe that the Board devoted adequate time to develop disclosure objectives to complement the information presented when using the summarised margin approach. The disclosure principles and requirements should be tailored to the new measurement and recognition requirements of the proposed measurement model in the ED.

Notwithstanding the fact that the disclosures could be aggregated, we believe that they would have to be presented at the level of a portfolio of insurance contracts. Therefore, we believe it could result in voluminous disclosures, and those disclosures could become a series of account balance roll-forward amounts with generic commentary as to causes of changes in estimates. We also believe that the proposed changes will be so fundamental that detailed illustrations of the types of disclosures will be necessary. This will help avoid years of inconsistencies in the disclosures provided by different insurers (similar to the inconsistencies in initial disclosures of embedded value reporting).

(b) See response to (a).

(c) We are not aware of any additional disclosures that should be required.

Unit-linked contracts (paragraphs 8(a)(i), 71 and 78, Appendix C, and paragraphs BC153-BC155 and BC184-BC187)

Question 15 – Unit-linked contracts

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

Comments:

We do not agree that the accounting for non-insurance assets should be within the scope of this standard. Therefore, we believe that the appropriate standard for all financial assets, including assets held to support unit-linked contracts, is IFRS 9. Therefore, the Board should consider moving the proposed guidance for how to account for unit-linked assets in the ED to IFRS 9.

In Appendix C the Board introduced a requirement to recognise and measure at fair value through profit or loss shares issued by an insurer and held as part of a pool of assets underlying unit-linked contracts. We understand that insurers sometimes have to hold their own shares to comply with the terms of their insurance contracts. In those circumstances the insurer may not have any discretion whether to purchase or not purchase its own shares. We agree with the Board that insurers should treat these shares as assets when the insurer is required by the terms of the insurance contract to hold these shares. However, if the insurer has discretion as to the investments it can hold to fulfil its obligation then shares purchased under those conditions should not be recognised as assets.
We believe that unit-linked liabilities will be unbundled from insurance contracts and accounted for in accordance with IFRS 9.

Reinsurance (paragraphs 43-46 and BC230-BC241)

Question 16 – Reinsurance

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

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

Comments:

(a) We believe that reinsurance assets should use the same expected loss model included in IFRS 9. However, in our comment letter to the IASB, we disagreed with the proposed expected loss model and presented an alternative model.

(b) The reinsurance principle allows an insurer to recognise a gain if the present value of the fulfillment cash flows for the reinsurance contract is greater than zero (that is, the present value of the fulfillment cash flows of the insurance contracts is more than the reinsurance premium). We agree with the Board that an insurer should be able to recognise a gain in a reinsurance contract if the insurer has already recognised the underlying contracts covered by the reinsurance contract. We believe that if an insurer is able to transfer the risk in insurance contracts to eliminate the uncertainty risk at a price lower than the liability, then recognition of a gain is reasonable.

We believe that the contract boundaries defined in the ED are not always applicable to reinsurance arrangements. Therefore, a significant disconnect will exist between a reinsurance arrangement and the underlying insurance contracts. For example, many reinsurance arrangements are designed to reinsure insurance contracts that will be issued in the future. Therefore, the ED would require that the reinsurance company record an insurance liability on insurance contracts that have not been issued whilst the cedant does not recognise an insurance liability until it issues the insurance contract.

Overall, we do not believe that the Board has spent sufficient time discussing all the issues surrounding reinsurance. During the outreach program, roundtables and field testing the Board should consider specifically gathering information about the issues relating to reinsurance (e.g., risk transfer, contract boundaries and risk adjustment calculation). We expect that several improvements will be required as the Board becomes more knowledgeable on this topic. Also, we recommend that the Board develop a reinsurance workshop to assist the Board during the deliberation period so reinsurance issues are properly addressed.
Transition and effective date (paragraphs 98-102 and BC244-BC257)

Question 17 – Transition and effective date

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

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

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

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

Comments:

(a) The ED requires that an insurer should measure its existing insurance contracts at the present value of the fulfilment cash flows at transition date. If that amount is more or less than the previous accounting balance, the difference is recorded in retained earnings. This could result in the risk adjustment being the only margin released on business in-force after transition because the residual margin on the in-force insurance contracts has already been recognised in retained earnings. This will be a major issue for life insurance companies because they issue insurance contracts that are in force for many years (e.g., 20 or 30 years). Therefore, these entities will have to measure similar types of contracts using two different models depending on whether the insurance contract was issued before or after transition (i.e., existing in-force business versus new business) and the resulting financial statements will not be useful to investors. We have explored alternative approaches and have identified three different approaches the Board may want to consider in its re-deliberations:

   Retrospective application – some insurers have indicated that they can obtain the required information necessary to apply the proposed measurement model retrospectively. Although insurers may have certain data available for contracts originated many years ago, it seems unlikely that many insurers would be able to calculate a risk adjustment for contracts entered into 10 or 20 years ago without the use of hindsight. We believe that this would be a difficult task for many insurance companies, especially those that have grown through acquisitions or otherwise had systems change over the years. Also, we believe that retrospective application would be costly to many insurers and require a significant amount of time to complete.

   Fair value – we believe that the Board should consider an alternative approach where insurers calculate the fair value of insurance contracts at transition. This approach would be understandable and would retain the profit emergence of long-duration contracts. If the fair value of the insurance contracts is higher than the present value of cash flows the difference should be allocated to the residual margin. This approach provides a somewhat easier method of calculating an amount that is close to the
present value of the fulfilment cash flows without having to apply the model retroactively. Also, the approach retains the margin in the balance sheet for long-duration contracts and allows the company to release it into earnings over time.

Retrospective application using current pricing – we believe that our approach to adjust the residual margin each reporting period provides a solution at transition. The same measurement model could be used for in-force contracts at transition. By indexing movements in financial factors; the original premium charged for a cohort of business could be expressed at a current price and then compared to current estimates of costs. The resulting margin could be attributed across the life of the contract and the opening balance sheet margin thereby established. If the Board is unwilling to adjust the margin, this approach should still be considered and allowed as an approximate transitional method where full retrospective application is impractical. This at least uses consistent measurement principles for the opening balance sheet and, with disclosure, is preferable in our view to the elimination of residual margins altogether as proposed by IASB.

Also, the transition provisions selected for insurers to implement the new measurement model should be included in IFRS 1 for insurers who later adopt IFRS for the first time.

(b) Although the FASB's DP does not address transition, the ED provides a proposal that would require a risk adjustment to be used to approximate the composite margin. We think that using a risk adjustment for the in-force contracts is inconsistent with the measurement basis of the composite margin. Accordingly, if the composite margin is used then further deliberations will be required as the liability will need to be greater than just the present value of expected cash flows.

(c) We believe that the effective date for entities that are required to follow the new IFRS on insurance contracts should align with their effective date for IFRS 9. Therefore, if the effective date of IFRS 9 and the final standard on insurance contracts are different then there should be a temporary entity-based exemption for these companies required to apply the new insurance contracts standard. However, if the Board does not provide an exemption then we believe insurers should, as currently proposed in the ED, be allowed to re-designate assets upon adoption of the new IFRS on insurance contracts.

(d) We believe that, at a minimum, two years will be needed.

Other comments

Question 18 – Other comments

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

Comments:
Recognition

We agree that an insurer is exposed to some risk when an offer (e.g., binder) is made to a potential policyholder and the insurer is unable to rescind the offer even if the risks change before the effective date. Current accounting models followed by insurers do not require these binders to be recognised at the offer date. As a result, insurance companies generally do not track these offers and companies initially recognise these contracts only when the policyholder completes the transaction and agrees to the terms. If the Board decides to have companies recognise offers at the binder dates then we understand that significant system changes will be required. Because the likelihood that material changes will occur between the time an offer is made and the offer is accepted is very low, we do not believe that companies should begin the accounting for these contracts at the offer date. We believe that the Board should require that an insurance contract be initially recognised when both parties have legally agreed to the arrangement not when the insurer makes an offer.

Question 19 – Benefits and costs

19. 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.

Comments:

We agree that if the Board moves to a more comparable IFRS standard it would improve financial reporting of most insurance contracts at a reasonable cost. With regards to short duration contracts, the cost may exceed the benefits to obtain the required information, see response to question 8.