Technical Director
File Reference No. 1870-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 51166
Norwalk, CT 06856-5116

Dear Sir/Madam:

Re: Discussion Paper – Preliminary Views on Insurance Contracts

The Canadian Bankers Association (CBA) would like to thank you for the opportunity to comment on the FASB Discussion Paper (DP) Preliminary Views on Insurance Contracts.

We appreciate that FASB and IASB are working together to develop a high-quality, compatible insurance accounting standard for insurance contracts and have undertaken this project as a joint project. We strongly support the FASB in continuing to work with the IASB to issue converged standards and encourage the two boards to resolve any differences in their proposal for insurance contracts in finalizing their views. With globalization in financial markets, the FASB and the IASB should work towards developing a single set of high quality global accounting standards, rather than making targeted improvements to existing U.S. GAAP in isolation.

Our primary concern is the proposed use of a discount rate for contract liabilities that is determined independently from the assets supporting the insurance contract, since this results in a methodology that will fail to accurately reflect the true economics of the insurance contract. As indicated in our letter to the IASB, delinking the liability-side from the asset-side ignores the correlation that is critical to an insurer’s pricing, product design and asset-liability matching activities, particularly in long term life products. In determining the appropriate pricing for an insurance product, the insurer takes into account the expected returns from invested assets that support the contract’s obligation. This link between assets and liabilities is also reflected in the use of the Canadian Asset Liability Method for life insurers in Canada. In essence, this method adopts a cash flows fulfillment approach and ensures that consistency in valuation of assets and liabilities will not create unintended and unrepresentative volatilities to an insurer’s earnings.

1 The Canadian Bankers Association (CBA) works on behalf of 51 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 260,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada’s economy. The Association also promotes financial literacy to help Canadians make informed financial decisions.
Investors pay a lot of attention to earnings as a proxy for understanding insurers’ cash flows. The proposed approach to use a discount rate for contract liabilities that is determined independently of the assets will not provide useful information to users, as insurers aim to match the expected future cash flows of the insurance contracts with the expected future cash flows of their portfolio of assets.

We also do not agree with the proposal to include only incremental acquisition costs in the determination of net fulfilment cash flows for insurance contracts, as this approach creates arbitrary distinctions between business models (e.g. broker-based versus internal sales) that are economically similar but under which costs are incurred in a different manner. Although incremental costs are mostly variable costs such as commissions paid to agents whereas fixed costs are those related to the underwriting of the policies, both are costs associated with the acquisition of the insurance contracts. In our view, these costs should have the same treatment and should be included in the initial measurement of contract cash flows. Furthermore, these costs should be identified at the portfolio level where they are being managed and monitored by insurers, not at the individual contract level.

As you will note from our letter to the IASB, we agreed with the IASB’s proposal that the measurement of contract liabilities include separate and distinct risk and residual margins, and rejected the approach favoured by the FASB that the measurement include a single composite margin. In our view, separate and distinct risk and residual margins produce information that is more useful to investors than does a single composite margin. In particular:

- We believe that separate and distinct margins provide for a more appropriate balance sheet presentation since at any given point in time the liability will be equal to the present value of expected cash flows plus a margin for risk as is appropriate at the time. We believe the composite margin provides an addition to the present value that is neither relevant nor market-consistent (because it is the unamortized balance of a relatively arbitrary measure).

- We believe that the composite margin approach masks the impact of changes in risk (both expected and unexpected) by “prescheduling” the amortization of the margin over the lifetime of the contract.

While we had our concerns over the separate and distinct risk and residual margins, these concerns were not at such a fundamental level as the concerns we hold in relation to the composite margin approach, and we would therefore prefer to see the FASB adopt the separate and distinct margins.

We are concerned with the proposed definition of insurance contracts which may include financial guarantee contracts, letters of credit and certain benefits provided to employees. Financial guarantee contracts and letters of credit should be accounted for as financial instruments by issuing banks as they are not assessed or managed using the same variables such as mortality rates that apply to insurance contracts. Benefits provided by an employer to its employees that otherwise meet the definition of an insurance contract, such as employer-provided health insurance, should be included in the accounting model for employee compensation and benefits as these arrangements are compensation provided to employees.

We support the FASB’s view that financial instruments with discretionary participation features should not be within the scope of insurance contracts. As indicated in our comments to the
IASB, we do not object to including such instruments in the scope of insurance contracts; however, we do not find the IASB’s rationale for inclusion, that these contracts share features with certain types of insurance contracts, to be convincing.

In regards to presentation and disclosure, our view is that the proposed presentation of the underwriting margin in the income statement as well as the release of either the composite margin as proposed by FASB, or the residual margin as proposed by the IASB, will present challenges to ordinary investors and will only be understood by sophisticated users of financial statements. We also expect significant implementation challenges due to pervasiveness of the proposed changes. To ensure that the model will produce information that is relevant to the decision making needs of users and is cost effective for preparers, we encourage the FASB to work with the IASB on field testing the proposals before finalizing the standard.

The DP makes specific reference to the IASB exposure draft on Insurance Contracts and the questions asked of respondents in both documents are similar. As a result, we have attached our letter to the IASB below to represent our comments on the DP. If you have any questions, we would be pleased to discuss them.

Sincerely,

[Signature]

Attachment: CBA Letter to IASB re Insurance Contracts
International Accounting Standards Board  
30 Cannon Street, 1st Floor  
London, EC4M 6XH  
United Kingdom

Dear Board Members:

Re: Exposure Draft – Insurance Contracts

The Canadian Bankers Association\(^1\) (CBA) would like to thank you for the opportunity to comment on the IASB Exposure Draft (ED) Insurance Contracts.

We appreciate that IASB and FASB are working together to develop a high-quality, compatible insurance accounting standard for insurance contracts and have undertaken this project as a joint project. The IASB’s coordination with FASB is of particular interest to Canadian financial institutions given our proximity to US financial markets. We strongly support the IASB in continuing to work with FASB to issue converged standards, and encourage the two boards to resolve any differences in their proposal for insurance contracts (as they finalize their views), in order to develop a single set of high quality global accounting standards.

Overall, we believe that several changes proposed in the ED do not provide users with more useful information to make economic decisions. We are particularly concerned with the proposed use of a discount rate for contract liabilities that is determined independently from the assets supporting the insurance contract. Delinking the liability-side from the asset-side ignores the correlation that is critical to an insurer’s pricing, product design and asset-liability matching activities, particularly in long term life products. The proposed methodology may result in an inaccurate reflection of the true economics of the insurance contract, as insurers aim to match the expected future cash flows of the insurance contracts with the expected future cash flows of their portfolio of assets, and as such, may not provide useful information to users.

Additionally, we are concerned with the proposed definitions of insurance contracts and incremental acquisition costs. Firstly, we do not believe that the definition of an insurance contract should include financial guarantee contracts and letters of credit. These contracts are commonly issued by financial institutions, and, unlike typical insurance contracts, they are not

\(^1\) The Canadian Bankers Association (CBA) works on behalf of 51 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 260,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada’s economy. The Association also promotes financial literacy to help Canadians make informed financial decisions.
assessed or managed using the same variables such as mortality rates that apply to insurance contracts. Accordingly, they should not be subject to the same reserving practices associated with typical insurance contracts, and should be accounted for as financial instruments by issuing banks. Secondly, we believe that incremental acquisition costs should include all direct and incremental costs related to insurance contracts, regardless of business model. All such costs should be accounted for consistently and included in initial measurement of insurance contracts to ensure comparability of financial information. Furthermore, these acquisition costs should be assessed at the contract portfolio level, where they are monitored and managed by insurers, not at the individual contract level, which may be impractical.

In regards to presentation and disclosure, we are concerned that the requirements proposed in the ED do not provide relevant information to users. Including only the underwriting margin and release of residual margin in income statements may only be understood by sophisticated users of financial statements. Ordinary investors may be challenged to understand the information in the absence of volume driven information on the insurers’ operations (e.g. premiums and claims) that are commonly used to assess the performance of insurers. Conversely, we are concerned that the additional disclosures proposed by the ED (e.g. confidence level ratios related to risk adjustments, changes in measurement due to changes in one or more inputs) may be dismissed as irrelevant by users. Disclosures are useful when they provide relevant information to users, but the relevance of information will be diminished if users are overwhelmed with a quantity of information that is not necessarily decision useful.

We also believe that the modified measurement approach for short duration contracts should be optional for the insurers. Under the proposed requirement, insurers with both long and short duration contracts would be required to use two separate methodologies or approaches to determine reserves for contracts, present contract information on financial statements and prepare notes disclosures. The costs to implement two approaches for insurance contracts will be significant to insurers, while the added value to users will be negligible.

Finally, we expect the implementation of the proposed model to present significant challenges to insurers. Significant system changes may be required to capture the granular data required to determine contract liabilities and for disclosures in the financial statements when compared with those being captured in existing systems. We feel that the time and resources required to implement the proposed changes outweigh the potential benefits to users in light of the concerns noted above.

Our comments to the specific questions of the ED are included in the Appendix. If you have any questions, we would be pleased to discuss them.

Sincerely,

[Signature]

Attachment
Appendix

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:
We do not agree that the proposed measurement model will produce relevant information for users to use to make economic decisions.

In our view, information that is of relevance to users should reflect the ability of an insurer to fulfill its obligations and the primary focus of such information is the earnings of the insurer and not a theoretical valuation framework that does not reflect the true economics of the insurance contracts. In proposing to apply an interest rate that is determined independently from the assets supporting the insurance contracts to discount the contract cash flows, the measurement model will introduce volatility to an insurer’s earnings that does not signal economically significant events or transactions (within the context of the insurer’s ability to fulfill its obligations). The Board should address why artificial volatilities would be considered relevant information for users in making economic decisions when it is not reflective of how the business is managed. While the proposal may have conceptual merits with respect to comparability, it fails to reflect the business model and the economics of the transactions, reducing the usefulness of information provided to users. Investment returns are generally taken into consideration by insurers in determining the policy premium, a significant component of the contract’s cash flows under the building blocks model. In ignoring the investment returns in determining the discount rate for the contracts, the insurers' obligations under the contracts will be overstated as the cash flows from assets supporting the contracts are being ignored. This discrepancy is even more pronounced for long duration life insurance contracts, which have a close relationship with the underlying investments in managing duration mismatch, than short duration contracts. Our concerns with the selection of discount rate are addressed further in Question 3. As an analogy, we point to the treatment of deposit liabilities which are held at amortized cost. This measurement approach implicitly includes expectations of investment returns on assets acquired to support the liabilities at that time, and seems to be inconsistent to the ED’s position that asset returns should not be recognized in measuring the liability.

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 fulfills 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 future cash outflows less future cash inflows as described in the fulfillment cash flow approach, because no other basis would as fully reflect the economics of the insurance contract and, therefore, the information provided by those other bases would be less relevant to users.

(b) The Board should clarify whether the requirement to estimate the expected cash flows for all possible scenarios model is the same as the requirement to stochastically model cash flows.
We have interpreted the ED and the Basis for Conclusions as requiring insurers to identify scenarios and associated weights sufficient to determine the expected cash flows, that stochastic modeling would satisfy this requirement, but that stochastic modeling is not required to satisfy the ED. If our interpretation is correct, we believe the ED should clarify that it shall be left in the hands of management to apply a methodology that satisfies the requirement. If the Board intended a more demanding interpretation (i.e. stochastic modeling is required), then we believe the Board should limit itself to stating the principle and leaving the question of how to satisfy the principle to the insurers because the insurers are in the best position to assess future cash flows for the insurance contracts.

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

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

(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 with the concept that the discount rate should reflect the characteristics of the liability but disagree with the Board’s conclusions that this implies that the discount rate should not reflect the characteristics of the assets backing that liability.

- Insurance contract liabilities are financial obligations of the insurer. From a practical perspective, we observe that there is no deep and active market for insurance liabilities and that, therefore, no basis on which one can observe the appropriate discount rate for liabilities. In absence of an observable market for these obligations, deriving a discount rate for these liabilities will involve the use of judgment and assumptions where one must look to asset markets to infer the discount rate applicable to insurance contract liabilities. For example, the liquidity margin proposed in the ED will require insurers to look to the asset markets for information, and evidence on liquidity margins in those markets, and to make appropriate adjustments to the conclusions they draw from those markets to account for differences (if any) between asset and liability characteristics that should be reflected in the valuation. It seems unrealistic to pretend that this practical linkage can and will exist.

- In determining the appropriate pricing for an insurance product, the insurer takes into account the expected returns from invested assets that support the obligation under insurance contracts. On an ongoing basis, the goal is to ensure they have available funds to meet the claim and expense obligations under the contracts where insurers have developed asset-liability management models to monitor these cash flows. This is even more critical for life insurers whose business models are based on investing the cash flows from premiums to meet their contract obligations, especially for contracts of long duration. This link between assets and liabilities is reflected in the use of the Canadian Asset Liability Method (CALM) for life insurers in Canada which in essence, adopts a cash flows fulfillment approach. This approach also ensures consistency of the valuation of the assets and liabilities and will not create unintended and unrepresentative volatility to an insurer’s earnings as would be the case when the value of the liabilities is
determined independently from the value of the assets. We believe that CALM, or a similar approach, better reflects the way in which insurers manage their business portfolios and should be considered by the Board in developing an IFRS that appropriately reflects the business model of insurers. We believe the Board's position in relation to the measurement of deposit liabilities is an example of their willingness to adopt measurement methodologies that align with the business model, and are concerned with the departure from that practice in relation to the measurement of insurance liabilities. Alternatively, the Board could consider the use of the high quality corporate bond rate as the discount rate for insurance contract liabilities, consistent with the rate used for the post-employment obligation under IAS 19 Employee Benefits (IAS 19.78) which is also a long duration obligation.

- We believe that investors pay a lot of heed to earnings as a proxy for understanding cash flows and that the earnings volatility that will result from the balance sheet approach of the proposed model will obscure the economic significance of changes in the assets and liabilities and the actual risks of the business. Under the proposed model, asset and liability values will move differently as a result of (a) credit spreads in the assets that do not have a counterpart in the liability discount rate and (b) liquidity spreads in the assets that behave differently than the liquidity margin in the liability discount rate. Some of these differences, such as changes in expected asset default costs, are the result of events or transactions that have real economic significance that should be recognized in earnings. Others, such as changes in the spread for uncertainty around expected default costs, do not in our view represent an economic event that ought to be recognized in earnings unless and until it affects the ability of the insurer to fulfill its obligations (i.e. unless and until the uncertainty is crystallized into changes in expected default costs and/or actual defaults).

(b) While we agree with the concept of adjusting the discount rate for liquidity, there will be practical challenges in its application since there is no observable market for insurance contracts. Insurance contracts are not traded like securities and estimates of liquidity premiums will be highly subjective. Since the Board believes that it would not be appropriate to provide detailed guidance on how to estimate liquidity adjustments using a principle-based approach, this could potentially lead to inconsistency in application and lack of comparability between insurers, contrary to the Board's objective of developing this IFRS to promote comparability of information among entities. One need only observe the wide range of practice in MCEV (Market-Consistent Embedded Value) reporting to see the wide range of practice that is likely under this element of the proposed measurement model.

(c) We are of the view that the proposed discount rate will misrepresent the economic substance of insurance contracts, particularly long-duration insurance contracts. Long-duration contracts can and do produce very significant, long-duration liabilities and insurers invest the policy funds in corresponding long-duration assets. The earnings volatility that is likely to emerge will be significant due to "mismatches" between the assets and the liabilities (e.g. movement of credit spreads in the assets that are not mirrored in the liabilities, asset and liability liquidity margins that don't move in sync). While some of the resulting volatility does, in our view, reasonably reflect the economic impacts on the business (e.g. a change in expected asset default costs is a real cost that ought to be recognized) other elements, such as changes in the margin for uncertainty surrounding asset default costs, do not. In a long-term business such as insurance where "buy and hold" is the favoured operating model, transitory changes in uncertainty around asset risks does not affect the ability of the insurer to fulfill its obligations unless and until the uncertainty is crystallized into fact, and should not be recognized as a gain or loss until that time.
We believe that there are a number of possible alternatives that would produce more appropriate results. Our preferred approach is the use of a reference portfolio (which may or may not be the actual assets backing the liabilities) and an analytical approach that demonstrates that the insurer's obligations can be fulfilled by that reference portfolio (making appropriate provision for the default costs anticipated in relation to the assets). Such an approach would be a variation of the Canadian Asset Liability Method, although important changes might be required (e.g., elimination of the provision for interest rate risk). The Board's deliberation around "own credit risk" offers another potential approach, in combination with other changes, although we are concerned about the implications of the approach and believe that the approach does not fully address our concerns.

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

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

**Comments:**

We support the IASB's proposal to use a risk adjustment and a residual margin as they serve different purposes which cannot be effectively achieved with a single composite margin. In our view, the risk adjustment is a dynamic amount that reflects an appropriate provision for risk at any given point in time. This amount by definition cannot be structured and amortized in an arbitrary way as it is contemplated in the single composite margin. The two fundamentally different objectives demand distinct approaches. In comparison, we see the composite margin as creating a relatively scripted emergence of profit which does not necessarily reflect the economics of the insurance contracts.

**Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)**

(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment 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 agree in principle but have a significant issue with the practicality of its application. We believe that the Board has a practical problem in defining something in relation to a market that does not exist. We also believe that the risk adjustment should not depict the maximum amount the insurer would rationally pay to be relieved of risk. This definition brings questions of individual circumstances, risk appetites and perceptions of risk into question and effectively allows insurers to determine (rationally) the level of risk adjustment that they would prefer to carry. This seems tantamount to not defining the risk adjustment at all. We believe that there are two alternatives to this definition – (1) define acceptable ranges for the
risk adjustment (or the factors used in deriving the risk adjustment) and require insurers to justify their choice within that range or (2) tie the definition of the risk adjustment to observable markets by requiring the risk adjustment be consistent with the “price” of risk in those markets. While the latter approach clearly bears some technical challenges related to inferring appropriate risk adjustments for liabilities from observable market information, we believe that this approach is more sound (conceptually) than the first alternative which involves departing from the stated principle and specifying (somewhat) arbitrary bounds for practice.

(b) We do not agree with limiting the techniques for estimating risk adjustments to three choices and the Board should not specifically identify the acceptable techniques/approaches in the IFRS as doing so will have the following consequences:

- Estimation techniques evolve and improve over time. It will be administratively burdensome for the Board to update the standard whenever there is a change to the technique. If the standard is not updated on time, insurers will not be permitted to use the improved technique to estimate the contract liabilities. This will not provide relevant financial data for the users as the information will not properly reflect the obligations of the insurers.

- Specifying the techniques in the standard is a prescriptive approach, contrary to the Board’s principle-based approach for accounting standards. The Board should articulate the criteria that would need to be met by the technique chosen by the insurer. This principle-based approach would allow the use of new or improved techniques that are indetified in the future, providing flexibility to the standard while maintaining its quality.

(c) We agree with the principle that disclosure of information that helps the user understand and compare the relative magnitudes of risk adjustment is useful, but are concerned that the ED’s focus on the confidence level to the exclusion of other approaches will limit and, possibly, mislead users. The confidence level is not a good fit for all products and is discouraged for skewed distributions (extreme losses in tail). For the same reason that the confidence level may not be a good fit and insurers may choose another method in order to determine an appropriate risk adjustment, it may prove difficult or impossible to translate the results of another risk adjustment methodology into a confidence level. We believe it would be more appropriate to articulate a requirement that insurers provide information to help users understand the relative magnitude of the risk adjustment and not specifically require insurers to translate into a confidence level.

(d) We agree that the risk adjustment should be measured at a portfolio level of aggregation to achieve a result that is statistically meaningful. Risk adjustments will likely differ between different types of contracts and lines of business. Insurers measure and manage risk on a portfolio basis and a different basis for determining the risk adjustment would not be consistent with the insurance business model. An appropriate risk adjustment measurement needs to reflect the characteristics of the portfolio groupings, and balance the credibility of the underlying data and the portfolio mix differentials.

(e) As indicated in our response to (b), we do not believe the Board should specifically identify the acceptable techniques/approaches in the standard.
Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

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

(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 agree that the insurer should not recognize any gain at initial recognition of an insurance contract. This approach takes into account costs related to a wide spectrum of supporting activities that will be incurred by the insurer subsequent to issuance of the insurance contract and better reflects the economics of the contract. Conceptually, a gain should be recognized only as the contract is performed and not when a contract is initiated.

(b) We agree that the residual margin should not be less than zero at initial recognition. While recognizing a gain at issue does not seem appropriate given that contract performance has not begun, recognizing a loss at issue appropriately recognizes the economics of the contract – the insurer has entered into a contract in which the costs outweigh the anticipated revenue (having made provision for risk) and in doing so has incurred an immediate cost to the organization which ought to be recognized at that time.

(c) We agree that an insurer should estimate the margin at the portfolio level because insurers manage their business on a portfolio basis and the measurement of losses on some contracts and gains (that are eliminated with a residual margin) on other contracts would not provide relevant information because analysis and understanding would be distracted by attempts to understand why individual contracts were or were not profitable. We believe that the definition of ‘portfolio’ is ambiguous and the Board should provide more clarity on how to identify a portfolio. In our view, the portfolio should include contracts that have a similar risk profile. In addition to similar date of inception and similar coverage period, other factors that are used by insurers in determining the pricing of the insurance contracts, such as geographic location, nature of coverage and profile of the insured items, should also be considered in the aggregation process.

(d) We generally agree with the proposed methods of releasing the residual margin as we believe that recognition of the excess profits (any day 1 accounting gain at the inception of the contract) that are deferred by the residual margin is most appropriately spread over the period in which service is provided to the policyholder (i.e. the coverage period). However,
we note that the Board has declined to provide for periodic readjustment of the residual margin, other than for variations in survivorship from that expected at issue, and suggest that the Board may want to revisit this question. In particular, we are concerned that failure to re-measure the residual margin may present arbitrage opportunities or the ability to carry a residual margin on or after the date at which an insurer has materially increased either the expected present value of future cash flows and/or the risk adjustment due to a deterioration in experience or risk since inception of the contract. In the latter case, it seems to us to continue to defer “excess profits” after the point in time in which an insurer concludes that those “excess profits” no longer exist.

(e) We do not support the use of a composite margin as the risk adjustment and residual margin serve different purposes.

(f) We agree that interest should be accrued on the residual margin as the basic model recognizes the time value of money. Amortizing the residual margin in a pattern that does not reflect the time value seems to introduce an inconsistency both with respect to the balance of the measurement model and the investment activity in which the insurer will engage. In the latter case, insurers will typically earn investment income on assets held in relation to the residual margin and the failure to recognize the time value of money in the amortization of the residual margin will result in the reporting of excess investment margins.

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)
(a) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

Comments:
(a) We do not agree with the approach articulated in the ED. Limiting costs recognized in the initial measurement to those that are incremental to the insurance contract creates arbitrary distinctions between business models (e.g. broker-based vs. internal sales) that are economically similar but under which costs are incurred in a different way.

Our view is to include direct and incremental costs in the insurance contracts. The Board has indicated in BC 140 that incremental costs can be clearly identified as relating specifically to the contract. While this is an appropriate observation for variable costs such as commissions paid to agents or brokers on policies issued, the same cannot be applied to other fixed costs related to the underwriting of the policies. In our view, both types of costs should have the same treatment. Depending on the business model used by the insurers, the proposal would result in very different financial results for insurers who use a commission-based sales force versus a salaried-based sales force to sell the policies. The undue focus on costs that are incremental to the insurance contract creates a measurement model that fails to recognize that insurers sell portfolios of new policies and that costs that are not incremental to an individual insurance contract are incremental at the portfolio level. Effectively, the model proposed in the ED is based on the presumption that costs are either fixed or variable (and the basis for that determination is the insurance contract) which flies in the face of the economic reality that many costs, direct costs in particular, are variable at least to some degree. Characterizing non-incremental costs at the contract level as being fixed will result in a model that does not appropriately reflect the economics of the insurance business and reduces the relevance of the information provided by the model. In our view, all direct and incremental costs related to issuance of contracts should be included in the initial measurement of contract cash flows to ensure comparability of information across entities.
We also believe that identification of costs should be performed at the portfolio level where they are being managed and monitored by insurers, and not at the individual contract level. In our view, the ED has proposed a portfolio basis for measuring and valuing insurance contracts (consistent with the approach for determining risk adjustments and maintenance expenses), which we support, and the use of a different basis (the contract basis) to determine acquisition costs to be recognized in the initial measurement creates inconsistencies in the measurement model that will reduce the usefulness and relevance of the information produced under the model.

Further, identification of costs on a contract by contract basis will require detailed expense tracking systems to properly identify these expenses, and certain of these costs may not be easily discernible, as is the case when the insurance agents are paid on a combination of fixed salaries and commissions. While commissions paid on contracts issued can be identified by the insurers, identifying the portion of fixed salaries related to these contracts will be impracticable. To comply with the requirement, insurers will likely make subjective estimates for the cost per contract, resulting in information that may not be useful to users.

**Question 8 – Premium allocation approach**

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

(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) The Board should permit, but not require, a modified measurement approach for the pre-claim liabilities of some short-duration contracts. Requiring a modified approach would create a significant burden for entities, such as life insurers, whose contracts are primarily of long duration. Such entities already have infrastructure in place to account for long and short-duration contracts; thus, mandating a modified measurement approach will require these entities to modify/create new measurement systems for a comparatively insignificant number of short-duration contracts.

(b) We agree with the concept of the proposal but have concerns with the definition for short-duration contracts. As defined, the criteria of ‘approximately 1 year or less’ might mean that two contracts with different coverage periods (i.e. one for exactly one year coverage and the other for slightly greater than one year) will be subject to two different measurement models simply due to the difference in coverage period, while economically they could generate the same business return to the insurer. Most property & casualty insurers offer coverage periods of one year, two years or even three years for home, automobile and surety contracts, and life insurers generally offer coverage in excess of one year for disability insurance. All of these contracts are relatively ‘short-term’ in nature and behave substantially the same as those of slightly less duration. To avoid the artificial one year cut-off criterion for the modified approach while providing relief to contracts that are substantially of short-duration, the Board could require entities to apply the basic building block approach to all contracts, and permit the use of the modified measurement approach when this approach would not result in material measurement differences.

In addition to the artificial one year cut-off, we also questioned the practicality of applying the modified measurement approach. As proposed, an insurer is required to perform the onerous contract test by using the present value of the fulfillment cash flows to assess if the modified approach can be applied (see paragraphs 60 and BC 148(c)). Since insurers still
have to apply the basic approach to the contracts at inception and are required to update the measurement at the end of each reporting period, we do not believe this approach will provide material relief to insurers. Further to our suggestion in the preceding paragraph, the application of a materiality criteria in relation to the use of the modified approach would eliminate the need to apply the onerous contract test as well as provide a more flexible criteria for determining its application. We ask the Board to reconsider the requirements for the modified approach as the benefit is expected to be minimal to insurers.

Question 9 – Contract boundary principle
Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

Comments:
We agree with the contract boundary principle but disagree with the recognition principle which requires an entity to recognize the liability when the contract is signed. Recognition when the insurer is legally bound is not a practical criterion as insurers frequently do not know whether they are legally bound until the beginning of the coverage period (e.g. P&C renewals). Furthermore, it is our view conceptually that an entity should be required to recognize the liability only at the commencement of the coverage period as that is the date when the entity is legally exposed to the contract obligation.

Question 10 – Participating features
(a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?
(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) We agree conceptually that insurance contracts with participating benefits should include those features in their measurement bases as the proposed valuation will produce a more appropriate reflection of the economics of these contracts.

(b) We have no objection to including financial instruments with discretionary participation features within the scope of the IFRS on insurance contracts. However, we do not find the rationale that these contracts share features with certain types of insurance contracts to be overwhelmingly compelling and are concerned that there may be unintended consequences of taking this approach (e.g. non-insurance financial institutions that issue such contracts may not be paying close attention to the IFRS 4 discussion and may fail to raise important considerations relating to the inclusion). Unintended consequences might be avoided if these contracts were included under the financial instruments standard with references to the IFRS 4 valuation methodology where appropriate.
(c) We agree with the definition, however, the Board should clarify if other participating features typically offered in insurance contracts, such as experience rate refunds or commission adjustments based on claims experience of the contracts, are also scoped in under this definition.

(d) We agree with the modification made to the measurement proposal for discretionary participation contracts as the insurer’s obligation ceases when the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature in that contract. We also support recognition of the residual margin based on the passage of time or the fair value of assets under management due to the lack of significant insurance risk transfer.

**Question 11 – Definition and scope**

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

(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 IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

**Comments:**

(a) Overall, we agree with the definition of an insurance contract proposed in the ED as the concepts relating to insurance risk are generally consistent with the definition in current IFRS 4. The proposal also requires a further test to be performed taking into account the time value of money (see Appendix B, B25 and B 26, and Basis for Conclusion BC 191). This test requires that for transfer of insurance risk, the present value of net cash outflows must exceed the present value of premiums. While this test may result in fewer contracts that qualify as insurance contracts, we believe this concept is acceptable and appropriate.

(b) We agree with the scope exclusions on paragraph 4, subject to our comments on financial guarantee contracts below.

(c) We agree with the Board’s view as discussed in BC 193 to BC 195 that a financial guarantee contract transfers credit risk as it requires the issuer to make specific payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment as required by the terms of a contract when due. While such contracts are similar to credit insurance contracts issued by insurance entities, we question the appropriateness of including such contracts issued by banks under the scope of IFRS on insurance contracts for the following reasons:

- Banks follow the guidance under IAS 39 *Financial Instruments: Recognition and Measurement* to record financial guarantee contracts and record them at fair value when issued. This measurement basis provides a best estimate of the underlying exposure of such contracts. We ask the Board to clarify how measurement of such contracts using the building blocks approach will be superior to the fair value model.

- Implicit in the building block approach is the identification of a risk adjustment and a residual margin. The primary risk for a financial guarantee contract is credit risk and is reflected in the pricing of the contracts by the banks, similar to the adjustment made to interest rates in granting loans to customers of different credit ratings. However, neither IAS 39 nor IFRS 9 currently requires specific adjustment of credit risk and residual risk for loans, even though banks are exposed to the credit risk of the borrowers and adjust
the loan pricing to generate profits. The Board should explain this inconsistency in applying different models to products with similar risk exposures.

- If banks were to apply this ED to their financial guarantee contracts, they would be required to present these contracts using the underwriting margin approach, which differs significantly from the presentation used for other products provided by banks. We do not believe this will improve financial reporting for banks as it will increase the complexity of financial statements, rendering the information more difficult to comprehend by analysts and investors.

In view of these concerns, we believe that financial guarantees issued by the banks, most notably Letters of Credit and Credit Default Swaps, should comply with the accounting guidance for financial instruments and should not be included in the scope of the insurance contracts standard. Contracts that contain insurance risk should comply with the accounting guidance for insurance contracts. For example, a creditor life insurance policy designed to pay off a borrower's outstanding debt if that borrower dies should be in the scope of this ED,

**Question 12 – Unbundling**
Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

**Comments:**
We believe the proposal impacts policies with investment features such as Universal Life contracts but is a matter of form over substance as we believe entities will continue to value the contracts such as Universal Life contracts in their totality and only separate out the Universal Life fund balances for disclosure. We believe it will be more appropriate not to unbundle the components of an insurance contract when they are closely related to the insurance host. The information derived from this unbundling exercise will not provide additional value to users of the financial statements. Therefore, unbundling for Universal Life contracts should not be permitted.

**Question 13 – Presentation**
(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?
(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

**Comments:**
(a) We do not believe the summarized margin presentation will be useful to users of financial statements. The proposed presentation would be a fundamental change to current reporting practice and would potentially result in a loss of essential information for users. Further, consolidation will be a significant problem for consolidating insurance subsidiaries with non-insurance affiliates, given the lack of volume related statements of the insurance entities (proposed by ED). We recommend using a written premium approach that recognizes premiums received as revenue at the same time the corresponding increase in liability is presented as an expense.

(b) We agree that all income and expenses should be recognized in profit or loss. In our view, the relevance and clarity of the information presented to users of financial statements will diminish if not all income and expenses arising from insurance contracts are presented in profit or loss.
Question 14 – Disclosures
(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) We agree with the proposed disclosure principle that an insurer should explain the amounts recognized in the financial statements relating to insurance contracts and the nature and risks arising from those contracts. The information provided should help users understand the amount, timing and uncertainty of future cash flows arising from insurance contracts.

(b) We are concerned with the quantity of information required for disclosures. Prior to finalization of the standard, we ask the Board to validate each of the proposed disclosures to ensure that they in fact provide added value without burdening users with excessive amount of data. The proposed disclosures are complex and the Board should provide examples to illustrate the extent of details that entities are expected to provide. We would recommend the standard provide the objective and overall principle of insurance contract disclosures with expectations and examples, and entities should assess their own business operations in order to determine how best to comply with the disclosure requirements to fulfill the stated principles. Paragraph 93 also requires disclosure of risk, other than insurance risk, arising from insurance contracts. The Board should clarify what are the other risks that would be included in paragraph 93, as credit risk, liquidity risk and market risk are addressed in paragraphs 94, 95 and 96 respectively.

(c) We do not believe that disclosing the net exchange differences arising on foreign currency amounts, as required by paragraph 87(h), is useful to users. It is also not clear whether this foreign currency amount relates to contracts that are still outstanding at reporting date, or should also include contracts that have matured/expired/terminated during the reporting period. To comply with this requirement, insurers will have to ensure their systems are capable of capturing foreign currency translation impact related to insurance contracts, potentially requiring changes to systems to generate data that may not be of importance to users in their decision making process. If the objective of this disclosure is to highlight the foreign currency exposure on insurance contracts, the Board could require insurers to disclose contract liabilities by source currencies.

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

Comments:
We agree with the proposal to require single line presentation of assets, liabilities, income and expenses for unit-linked contracts rather than co-mingling them with other assets, liabilities, income and expenses. The proposed treatment presents unit-linked contracts not containing guaranteed elements as a single line item rather than co-mingling them with other assets and liabilities of the entity. This is consistent with the Board’s approach to unbundling and separately presenting assets and liabilities in which investment risk is borne by the policyholder rather than the entity. However, the Board should clarify if the proposal only applies to those
contracts that are issued by segregated funds or separate accounts, and whether the unbundling requirement discussed in paragraphs 8 to 12 will apply to unit-linked contracts.

**Question 16 -- Reinsurance**

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

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

**Comments:**

(a) Conceptually, we agree that the proposed expected loss model to recognize the risk of default of the reinsurer is a sound approach as it recognizes the uncertainty of credit risk associated with the future expected reinsurance cash flows related to the reinsurance asset, unlike the incurred loss model which recognizes credit losses only when they have been incurred. The expected loss model is also consistent with the use of present value of expected cash flows under the fulfillment cash flows approach, and allows for timely recognition of change in counterparty credit risk and reflects expected credit losses over the term of the reinsurance assets. However, the Board should also consider the comments received on its impairment project under IFRS 9: Financial Instrument Phase II -- Amortized cost and impairment of financial assets and deliberations of issues on the expected loss model prior to finalizing the decision for reinsurance assets.

(b) We agree with the proposed principle underlying the measurement of reinsurance ceded contracts both at initial recognition and at subsequent measurement periods. In our view, the proposal that an entity is allowed to recognize gains at contract issuance due to reinsurance ceded is appropriate as the direct insurer has transferred the risk to a reinsurer. However, we disagree with the proposal to treat ceding commission paid to the cedant as a reduction in premium ceded to the reinsurer. In our view, such netting will result in loss of useful information with no added value to presentation of the financial statements.

**Question 17 -- Transition and effective date**

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

(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) While we agree that the proposed transition requirements will avoid the practical difficulties of determining residual margins that should be established at the inception of the contracts, we do not support them as this measurement approach at transition is inconsistent with the treatment of new contracts post-IFRS. In our view, this approach will distort the profitability of the insurers in future periods for existing in-force contracts, with greater impact on contracts that are of long-duration. This will impact the determination of earnings per share which is widely used by analysts to measure the performance of insurers. While we agree with the Board that retrospective determination of the residual margin would some times be impracticable (refer to paragraph BC 248), we believe a proxy residual margin could still be reasonably determined. Therefore, we recommend that the Board allow entities to
determine residual margins as the difference between pre- and post- IFRS liabilities upon transition as discussed in BC 249 to allow for some continuity.

(b) We disagree with the FASB approach whereby risk adjustment is not re-measured over future periods as this could lead to entities recording a reserve balance that is either inadequate or excessive.

(c) We believe it is critical to align the effective date of insurance contracts with that of IFRS 9 Financial Instruments as financial instruments play a major role in asset-liability management of insurers and are significant elements in their operations. Aligning the effective date for the two standards will avoid any unintended consequences that may result in reporting insurers’ financial position under IFRS 9 but not the insurance standard, and will also minimize the implementation burden for entities.

(d) We estimate the minimum time required to implement the proposed requirements for insurance contracts to be approximately 24 months for detail analysis of the new IFRS, implementation of changes or updates to systems, and 12 months for testing of their readiness. We do not expect that entities will be ready by January 1, 2013, the effective date for IFRS 9 as currently stated. Therefore, the Board should prescribe an effective date that is later than IFRS 9 and consider the time expected to implement the revised IFRS for insurance contracts.

Question 18 – Other comments
Do you have any other comments on the proposals in the exposure draft?

Comments:
While we appreciate the Board’s effort to develop a uniform accounting standard for insurers, the Board should address why it believes a uniform standard should be applied to different types of insurance contracts. The nature of life and health (L&H) insurance business is very different from those of property and casualty (P&C) business, and within L&H and P&C businesses themselves, there are various forms of policies. Claims reserves for L&H and P&C contracts are determined by actuaries who are knowledgeable of the insurers’ business model and features of the insurance contracts, and apply the appropriate actuarial approach to determine the liabilities for the contracts. Therefore, the use of uniform accounting guidance for all insurance contracts is questionable as it may not take into consideration the uniqueness of different types of insurance contracts. We believe the Board should address the differences between L&H and P&C policies, as well as the differences between direct insurance and reinsurance, in developing the accounting model for insurance contracts. In addition, we also request that the Board address the following issues in finalizing the IFRS:

• Provide more explicit guidance on whether options and guarantees that are commonly offered in North American Universal Life contracts, variable annuities, and segregated fund contracts would require a bifurcation valuation approach.

• Provide additional guidance and examples on how to apply the proposed model to various types of reinsurance contracts, since they are more complex than direct insurance contracts.

Lastly, we ask the Board to resolve any differences with the FASB prior to finalization of the standard, as it will be critical to have a common global accounting model for insurance contracts that can be applied by all entities to ensure comparability of information.
**Question 19 – Benefits and costs**

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

**Comments:**

As indicated in our comments above, we are concerned with the proposed use of the discount rate and the relevance of financial information generated by the model, as it no longer considers the merits of the asset-liability matching model widely used by insurers to manage and forecast their cash flows and commonly referred to in the pricing of their insurance contracts. We are also of the view that the proposed presentation which focuses on the risk adjustment and residual margin will not enable users to properly assess the performance of an insurer, as information on premiums that will enable users to assess the underwriting volume of the insurer will no longer be presented in the statement of income. To implement the proposed model, entities will need to invest a significant amount of time and economic resources to invest in training and systems upgrades, as the changes are materially different from the current model. In view of our reservations on the usefulness and relevance of the financial data generated by the proposed model, we are of the view that the substantive costs to implement the proposal will outweigh the benefits.