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

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Chris Barnard  
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17 August 2013

- File Reference No. 2013-290  
- Insurance Contracts (Topic 834)

Dear Sir.

Thank you for giving us the opportunity to comment on your Proposed Accounting Standards Update: Insurance Contracts (Topic 834). I will make some general comments now. For the record, I also enclose the comment letter that I submitted to the IASB on their Exposure Draft ED/2013/7 Insurance Contracts. This supports the much of the IASB’s approach, and is relevant, given your joint deliberations with the IASB on this topic.

**Risk adjustment and contractual service margin vs single margin**

I would recommend that the FASB should also adopt the risk adjustment and contractual service margin approach proposed by the IASB. This better reflects the economics and business of insurers, which is selling and managing risk, and it is consistent with the pricing of insurance contracts. It is also consistent - in principle - with market pricing of tradeable instruments. I believe that this approach better depicts the financial and risk drivers under insurance contracts, and will provide more meaningful information to users of financial statements.

**Remeasurement of margin**

I would further recommend that the margin is unlocked and remeasured at each reporting date to reflect changes in cash flows or risk that relate to future coverage periods. This would then represent a current value, which is consistent with its measurement at initial recognition.
Please note that the comments expressed herein are solely my personal views

It would also be more market consistent, which is surely more appropriate than traditional deferral-and-matching techniques.

Yours faithfully

C.R.B.

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

APPENDIX

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Chris Barnard  
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16 August 2013

- Your Ref: Comment letter on Exposure Draft ED/2013/7
- Insurance Contracts

Dear Sir,

Thank you for giving us the opportunity to comment on your exposure draft ED/2013/7 Insurance Contracts. These new proposals build and expand on your 2010 Exposure Draft on Insurance Contracts. They maintain the main measurement model based on fulfilment cash flows together with a simplified premium-allocation approach for certain short-duration contracts. However, in response to the feedback received on the 2010 ED the new proposals introduce some significant changes, including:

- the contractual service margin would be unlocked and adjusted for changes in the estimate of the present value of future cash flows that relate to future coverage and other services;
- an entity should apply a specified measurement and presentation exception, or mirroring approach, when a contract requires the entity to hold underlying items and specifies a link to returns on those underlying items;
- an entity should present revenue and expenses in profit or loss for all insurance contracts;
- the effects of changes in the discount rate would be presented in other comprehensive income (OCI);
- the new standard would be applied retrospectively if practicable and with a modified retrospective approach otherwise; and
- increased volumes of disclosure.

I must say that I appreciate the efforts that you have made to improve the 2010 ED, and believe that these proposals represent a step in the right direction, particularly considering your proposed amendments to IFRS 9 Financial Instruments. However, I am not convinced
that the new proposals would better allow users of financial statements (users) to measure the performance of an entity during the reporting period compared to the 2010 ED proposals together with my proposed amendments and recommendations. In particular, I am not convinced with the proposed measurement and presentation exception for contracts that require the entity to hold underlying items and specify a link to the returns on those underlying items. This is not consistent with the fulfilment cash flow model, introduces complexity and will reduce the understandability of insurance contract accounting. Furthermore I do not support the proposal that changes in the discount rate should be presented in OCI as this would not be consistent with the rest of the accounting model, and would even introduce accounting mismatches for some insurance contracts. However, I welcome the proposals on unlocking the contractual service margin, and some of the new proposals concerning the risk adjustment, which I will discuss further below.

Unbundling

I welcome the proposals on separating components from insurance contracts. These are clearer compared with the 2010 ED proposals. I still argue that policyholder behaviour would be expected to be different in a contract consisting of a bundle of components, compared to the individual components if unbundled. Furthermore, it does not make sense to unbundle components where the insurer has priced the contract as a whole, or manages the contract as a whole, i.e. as consisting of a bundle of components. I would therefore support that components are not unbundled where the insurer prices or manages the contract as a whole.

Risk adjustment

I strongly support the proposal that the risk adjustment should measure the compensation that an entity would require to make the entity indifferent between fulfilling an insurance liability with a range of possible outcomes and fulfilling an insurance liability that will generate fixed cash flows with the same expected present value. This is principles based and is the correct economic view of the risk inherent in the business. I also agree with paragraph B81 that you should not prescribe techniques to determine the risk adjustment; the 2010 ED proposals limited the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques, and this was one of the more arbitrary proposals in the 2010 ED.

Another improvement is your revised proposal on the aggregation level for measuring the risk adjustment. Paragraphs B37(b) and B77(a) now propose that the risk adjustment should reflect the degree of diversification benefit that the entity considers when determining the compensation for risk, rather than requiring the portfolio level of aggregation. This will allow

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1 See ED/2010/8 Insurance Contracts, IASB, July 2010; my comment letters CL6 and CL6A are available at:
entities to more faithfully represent their business and risk management practices and actual pricing bases in the measurement of the risk adjustment. There is evidence that insurers allow for diversification across portfolios and lines of business when pricing their contracts, and such insurers should reflect this when measuring the risk adjustment.

**Differences between the IASB and the FASB**

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

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2 See Diversification Benefits of the Variable Annuities and Equity-Indexed Annuities Mixture, Guanghua Cao, 2006; Natural hedging of life and annuity mortality risks, Cox and Lin, 2005.
Answers to specific questions raised by the IASB

Question 1—Adjusting the contractual service margin

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

(a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

(b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

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

I agree that an entity should unlock and remeasure the contractual service margin at each reporting date to reflect differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services; this is consistent with its determination at initial recognition and is also more consistent with the IASB’s revenue recognition proposals. This unlocking was one of my main recommendations on the 2010 ED proposals; that the contractual service margin should represent as closely as possible the expected present value of future profitability for insurance contracts at each reporting date, as this would provide more meaningful information to users. It would also mitigate counterintuitive results that would result from not unlocking the contractual service margin; for example, an adverse change in the measurement of the fulfilment cash flows, leads to an immediate loss being reported in profit or loss, whilst a profit will continue to be recognised from the release of the associated contractual service margin.3

Although I support the proposals to unlock the contractual service margin, I do not agree with paragraph BC32(e) that "the effect of changes...in the risk adjustment do not affect the amount of unearned profit because those changes unwind over time"; this is just a statement. I would propose that an entity should also unlock and remeasure the contractual service margin at each reporting date to reflect changes in risk that relate to future coverage periods. This would increase internal consistency and would provide relevant information that more faithfully represents the current value of insurance contracts in line with economic reality, and in line with how we price insurance contracts. The insurance industry is steering the business more on risk-adjusted profitability than just profitability, and proposing to unlock the contractual service margin in line with the risk adjustment would align insurance contract accounting with this business steering.

I agree that the contractual service margin should not be less than zero, so that a loss on insurance contracts would be recognised immediately in profit or loss. This is entirely appropriate and consistent with basic accounting principles.

3 See also paragraph BC31.
Please note that the comments expressed herein are solely my personal views.

I agree with paragraph 32 that the contractual service margin should be released systematically over the coverage period to reflect the remaining transfer of services under the contract. This is similar to the Margin on Services (MoS) approach adopted for life insurance company reporting in Australia.

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

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

(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?

(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfilment cash flows as follows:

(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

(ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and

(iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

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

I appreciate the effort that the IASB has made to come up with this elegant approach for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items. However, this approach effectively leads to three different accounting models for insurance contracts: the fulfilment cash flow model; the simplified premium-allocation approach for certain short-duration contracts; and this measurement and presentation exception, or mirroring approach, when a contract requires the entity to hold

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A modern (for its time) approach, MoS is designed to release the profits earned on a life insurance policy over the term of the policy as the services under the policy are provided (and the income received). Profit carriers facilitate this release and include, for example, claims for protection business, bonus rates for participating business and fund management costs for unit-linked business.
underlying items and specifies a link to returns on those underlying items. I would ask why we need a special “mirroring” approach for linked contracts, such as participating contracts? Participating benefits are integral to the rationale (and sale) of many insurance contracts, and their generation, management and distribution are constrained by custom and practice, including policyholders’ reasonable expectations, regulatory, legal and constructive obligations. The proposed mirroring approach requires an entity to split these cash flows into those that vary directly with returns on underlying items and those that do not, and it is not clear how this should be done, particularly for participating businesses containing buffers, terminal bonuses, offsetting items, cross-subsidies between contracts and generations, and fund-based management of a wide variety of different contract types. It is also not clear that this mirroring approach will lead to profit emergence in line with economic reality as anticipated in the pricing of such contracts. Finally, the requirement to recognise cash flows that vary indirectly with underlying items in profit or loss means that changes in the time value of options and guarantees would increase volatility in profit or loss, although this may not be a bad thing (see my comments and answers to question 6).

I would much rather recommend that the IASB should introduce the 2010 ED proposal that the measurement of insurance contracts should include participating benefits on an expected present value basis. In fact I would propose the fulfilment cash flow model for all insurance contracts, without exceptions, as this would increase internal consistency, improve comparability within insurance businesses, and reduce complexity.

Finally, concerning participating contracts, paragraph BCA62 states that: “if the contract provides policyholders with the right to participate in the whole of any surplus of the issuing entity, there would be no equity remaining and no profit reported in any accounting period”. I would ask the IASB to clarify this. In particular, does “policyholders” refer to both current and future, or potential future, policyholders?

**Question 3—Presentation of insurance contract revenue and expenses**

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

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

I am in two minds here. I appreciate that the IASB is now proposing a presentation of gross performance, as this is widely used in the insurance industry. I also appreciate that the proposals are consistent with the principles in the 2011 Exposure Draft Revenue from Contracts with Customers, and will therefore increase comparability with other entities. However, stakeholders have stated that they value a presentation of gross performance based on gross written premium (GWP), and we should recognise this.⁵ Therefore, as a compromise, I support that entities should report measures of gross performance like GWP in the notes to the financial statements.

⁵ I also agree with paragraph BC115 that forcing comparability between entities in different industries, when stakeholders do not value that comparability, is rather inefficient.
Regarding presentation and disclosure, analysts, investors and other stakeholders are very interested in the free cash flow position of insurers, and the amount of cash generated by writing insurance business. This has become much more important since the financial crisis. I would recommend some more thought on how this be communicated through presentation and disclosure. An example would be to disclose the expected distributable profits by calendar year, or even the expected cash flows by calendar year, split by broad line of business, and broad type e.g. premiums, claims, administration and maintenance expenses, acquisition expenses etc. I would recommend that this information should be disclosed separately for in-force and new business, as this will provide more meaningful information to users.

**Question 4—Interest expense in profit or loss**

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

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between:

(i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and

(ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

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

I support the IASB’s proposed intent here; to separate the underwriting performance in profit or loss from market-related volatility on interest rates. The proposals are elegant and workable. However, I am not convinced, on principle, that arbitrarily segregating part of an entity’s performance into OCI is a good idea, and these proposals would not be consistent with the rest of the accounting model. Furthermore, the proposals would lead to accounting mismatches for some contracts.

I would propose, in line with the 2010 ED proposals that changes in insurance contract liabilities should be recognised on profit or loss. I would also propose that entities should segregate the discount rate components of the changes in insurance liabilities within profit or loss, if this would provide more meaningful information to users. This would increase internal consistency and permit entities to provide information that faithfully represents their businesses.

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6 See also my comments and answers to question 6: this market-related volatility exists, and is actually the major part of performance for most insurers.
Question 5—Effective date and transition

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

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

Yes, I agree that the proposed approach to transition appropriately balances comparability with verifiability. The proposed transition requirements are a vast improvement compared with the 2010 ED proposals, as pre- and post-transition contracts will be treated more consistently. I also support the proposed modified retrospective approach as this provides a reasonable, and practicable, simplified method of estimating the contractual service margin on transition.

However, I would strongly recommend that the IASB should align the effective date of IFRS 9 with the effective date of the proposed insurance contracts standard. This would be helpful and would allow entities to manage the transitions simultaneously to minimise business disruption and operational complexity. I would also recommend that early adoption should be permitted, as this will only lead to faster accounting improvements and understandability compared with current requirements under IFRS 4.

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

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

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

(a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and

(b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

The proposed requirements will lead to an improvement in consistency, comparability and transparency compared with current requirements under IFRS 4. They will also lead to greater complexity and a step change in reporting and presentation requirements that will demand significant communication with, and education of, entities’ stakeholders. There will be an increase in financial statement volatility due to the current fulfilment value approach that will be more pronounced for entities writing longer-term insurance business, and business with long-term options and guarantees, particularly those businesses that are not well matched. For example, compare three entities: entity A writes 20-year guaranteed business, but is limited to investing in suitable liquid assets of up to 5 years duration;
entity B writes 20-year guaranteed business and is able to invest in suitable liquid assets of up to 20 years duration; and entity C writes 20-year guaranteed business with the right to reset the guarantee each 5 years, and is limited to investing in suitable liquid assets of up to 5 years duration. Entity A is far more exposed to investment uncertainty and the inability to match guarantees, and it would be a very fair reflection of the associated business risks if entity A's financial statements reflected this. Therefore increased financial statement volatility is not necessarily a bad thing, as well-matched business will yield less volatility compared with unmatched businesses, but we have to bear this in mind going forward. Some would argue that an insurer should take on risk – that is its raison d'être. I agree with this. However, the financial statements should faithfully represent the business and its risks. I am not totally convinced that the proposed requirements achieve this, as their associated complexity provides for structuring economically similar contracts in different ways to obtain different accounting results.

The costs of complying with the proposed requirements will certainly be higher compared with the 2010 ED proposals together with my proposed amendments and recommendations. The proposals will be costly to implement; most entities will have to make major data, tracking and systems changes, and will be required to model a greater range of business and economic scenarios to satisfy the reporting requirements.

Concerning the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis, I would say that this depends on the individual entity. Many entities are already reporting embedded value type information, and many European insurers (including their worldwide subsidiaries), are preparing for full SII implementation. These entities, and their stakeholders, will find the transition easier compared with other entities that would have to apply present value and complicated probability weighted techniques to cash flows for the first time.

Question 7—Clarity of drafting

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

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

The proposals are drafted clearly; however, I would suggest some amendments and clarifications, for completeness, as follows:

- the wording of question 1 in the Exposure Draft (Do you agree that financial statements would provide relevant information that faithfully represents the entity’s financial position and performance if differences between the current and previous estimates of the present value of future cash flows if) should be amended for clarity;
- the scope requirements in paragraph 4 concerning reinsurance contracts held and investment contracts with discretionary participation features are redundant given the overarching scope requirements in paragraph 3;
- paragraph 82 requires disclosure of the interest on insurance contracts “in a way that highlights the relationship between the interest on the insurance contracts and the
investment return on the related assets that an entity holds". However you argue in paragraphs BC147(b) and BC159(c) that it is not appropriate to identify which of the entity’s assets are held to back insurance liabilities, as this is subjective, arbitrary and difficult. Given your arguments I would recommend that you should clarify what you mean by “insurance contracts and … the related assets that an entity holds”.

- Paragraph B61 states that an entity “shall not take into account future events, such as a change in legislation” that would change obligations under the existing insurance contract; however, this is not consistent with paragraphs 46-47 of IAS 12 Income Taxes, which state that tax items shall be measured “based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period” (see also paragraph 48 of IAS 12). For completeness I would recommend that you amend paragraph B61 to be consistent with IAS 12 here.

- Paragraph B66(k) referring to cash flows within the boundary of an insurance contract includes payments made to future policyholders on existing contracts. I would ask for clarification of which future policyholders you mean here; are these known future policyholders, expected future policyholders or potential future policyholders?

Summary of my main recommendations to the board:7

- Require unlocking the contractual service margin to reflect changes in the risk adjustment that relate to future coverage periods
- Introduce the fulfilment cash flow model for all insurance contracts
- Require disclosure of expected cash flows by calendar year
- Require entities to segregate the discount rate components of the changes in insurance liabilities within profit or loss
- Align the effective date of IFRS 9 with the effective date of the proposed insurance contracts standard
- Do not unbundle where the insurer prices or manages contracts as a whole

Yours faithfully

C.R. Barnard

Chris Barnard

7 Should be read in conjunction with my comment letters on the 2010 ED proposals.