



Allianz Life Insurance Company  
PO Box 59060  
Minneapolis, MN 55459-0060

October 25, 2013

Technical Director  
File Reference No. 2013-290  
FASB  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

### **The FASB's Proposed Accounting Standards Update, *Insurance Contracts***

Dear Sir/Madam:

We appreciate the opportunity to respond to the Proposed Accounting Standards Update (Proposed ASU), *Insurance Contracts (Topic 834)*, issued by the Financial Accounting Standards Board (FASB).

We support the FASB's efforts to develop a high quality, comprehensive insurance accounting standard that provides relevant, reliable and decision-useful information to financial statement users.

Allianz Life Insurance Company of North America (Allianz Life®) is an insurance company licensed to sell annuity, group accident and health, and life insurance policies in the United States, Canada, and several U.S. territories. Allianz Life is a subsidiary of Allianz of America, Inc. (AZOA), a subsidiary of Allianz Europe B.V., a subsidiary of Allianz SE, a stock corporation in the form of a European Company (Societas Europaea). Allianz Life prepares financial statements in accordance with U.S. GAAP.

Overall, the Proposed ASU is an improvement compared to the FASB's Discussion Paper issued in 2010. In particular, we support the following changes:

- Introduction of other comprehensive income (OCI) for the recognition of short-term volatility due to changes in market interest rates on insurance contract liabilities and related investment assets;
- Recognition of the special nature and link between assets and liabilities for participating insurance contracts;
- Recognition of the importance of setting an appropriate discount rate, including the possibility to use a top-down method; and
- Retrospective transition guidance.



However, we have significant concerns regarding the proposed accounting for participating insurance contracts. In particular, we reject the bifurcation of cash flow approach and limited unlocking of the single margin, which is inconsistent with the current fulfilment value approach. Our views and recommended solution (the Alternative Approach) are consistent with views expressed by the global insurance industry (i.e., European Insurance CFO Forum and Hub Global Insurance Group) and presented below:

- The measurement of the insurance liabilities for participating insurance contracts should follow the general principles of the fulfilment cash flows model.
- All insurance liabilities would be measured at current fulfilment value on the face of the balance sheet without bifurcation of cash flows.
- The contractual service margin (CSM) should always reflect the unearned profit arising from the insurance contracts and be determined on a fully unlocked basis. For participating contracts, an intrinsic element of the unearned profit is the investment returns arising from the contract.
- Profit for all contracts would be recognized in accordance with fulfilment of the contract as services are provided, in accordance with general revenue recognition principles.
- These principles will apply uniformly. However, consistent with the differing types of products and the business model for asset and liability management, the practical application of the principles can be conducted under both a “Current Value through OCI” and a “Current Value through P&L” environment.

The Alternative Approach, which provides a robust solution for all types of participating insurance contracts globally, has the advantage of building on existing principles of the Proposed ASU, instead of defining an exception for insurance contracts with a link to underlying items. This results in more useful and understandable financial information, while enabling a significant reduction in complexity.

Furthermore, we strongly encourage the FASB to converge on key issues with the IASB. The Proposed ASU issued by the FASB and the Revised ED issued by the IASB differ in significant aspects. We believe that there are compelling reasons for the FASB and the IASB to develop converged standards on the accounting treatment of insurance contracts. First, convergence would benefit financial statement users that compare financial statements of insurance entities in different markets. Second, a multinational insurance entity may incur significant costs if required to implement and report under both IFRS and U.S. GAAP. Thus, convergence is critical for both users and preparers of financial statements.



Please refer below to our responses to select questions raised in the Proposed ASU. We appreciate the significant effort of the FASB to develop the Proposed ASU, which is another step on the path toward a high quality insurance accounting standard.

If you have questions or would like to discuss our comments in more detail, please contact us.

Sincerely,

A handwritten signature in black ink, appearing to read "Giulio Terzariol".

Giulio Terzariol  
Chief Financial Officer  
Allianz Life Insurance Company of North America

A handwritten signature in black ink, appearing to read "Kevin E. Walker".

Kevin E. Walker  
Chief Financial Officer  
Allianz of America, Inc.

A handwritten signature in black ink, appearing to read "Dieter Wemmer".

Dr. Dieter Wemmer  
Chief Financial Officer  
Allianz SE



## Detailed Responses to Select Questions:

### Question 2: Recognition

*Do you agree with the requirements included in this proposed Update for when noninsurance components of an insurance contract, including embedded derivatives, distinct investment components, and distinct performance obligations to provide goods or services, should be separately accounted for under other applicable Topics? If not, why?*

No. Allianz Life® does not support unbundling of asset management services or investment components. We believe that unbundling should be limited to components that are not closely related to the insurance contract (e.g., embedded derivatives) and distinct performance obligations to provide goods or services.

### Question 5: Measurement Approaches

*Do you agree that entities should apply different approaches to contracts with different characteristics, described as the building block approach and the premium allocation approach? If not, which model do you think should apply and do you think there should be any changes made to that model?*

Allianz Life supports having two measurement approaches included in an insurance accounting standard, the building block approach and a simplified approach. The building block approach is expected to apply to all of our life products, while the premium allocation approach is a more appropriate method for short duration products. However, as discussed below, we recommend certain changes to the building block approach detailed in the Proposed ASU.

### Question 6: Measurement Approaches

*Do you agree that entities should be required to apply the premium allocation approach if the coverage period of the insurance contract, considering the contract boundary guidance, is one year or less? If not, what would you recommend and why?*

No, Allianz Life does not agree that the premium allocation approach should be required if the coverage period is one year or less. We prefer the IASB's approach, since the premium allocation approach is a proxy for the building blocks approach. In addition, we encourage the FASB to work with the IASB to develop a converged premium allocation approach. Currently, there are a couple key differences between the premium allocation approach as proposed by the FASB and the simplified approach as proposed by the IASB. First, the FASB requires the premium allocation approach if certain conditions are met, whereas, the simplified approach proposed by the IASB is offered as an option. Second, the IASB allows the simplified approach only if it is a reasonable approximation of the building block approach, whereas, the Proposed ASU does not include this requirement.

### Question 7: Measurement Approaches

*Do you agree that entities should be required to apply the premium allocation approach if, at contract inception, it is unlikely that during the period before a claim is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract? If not, what do you recommend and why?*



As stated in our response to Question 6, we support a simplified approach but prefer the IASB's solution.

**Question 8: Portfolio**

*Do you agree with the definition of a portfolio of insurance contracts as included in this proposed Update? If not, what do you recommend and why?*

No. Allianz Life® supports the IASB's proposal which defines a portfolio as a group of insurance contracts that: 1) provide coverage for similar risks and that are priced similarly relative to the risk taken on, and 2) are managed together as a single pool.

Both proposals indicate the portfolio is the unit of account for recognition of incurred claims, margins, day one losses (the onerous contract test) and margin release. However, there are differences in the criteria used to define a portfolio that would likely result in contracts being grouped differently under the FASB's model than under the IASB's proposal. These differences would then lead to measurement differences that do not reflect the economics of the underlying contracts or the insurer's business model. For these reasons, we propose that the FASB modify its definition of portfolio by:

1. Deleting the criteria that contracts have similar duration and similar expected patterns of release from risk; and
2. Adding the criteria that the coverages or risks are "managed together as a single pool."

Rather than being required, it is suggested that the criteria to "have similar duration and similar expected patterns of release from risk" be offered only as additional consideration for how an entity might group portfolios. Using duration as a requirement may result in low levels of disaggregation for life products that are disparate from how life companies manage profitability. Policyholders in different age bands or those who select different features of the same product would be divided into separate portfolios when profitability on these products is managed as a single pool.

Adding the criteria "managed together as a single pool" will ensure entities do not disaggregate portfolios to a level that reduces the meaningfulness of the measured results. For example, a focus on pricing without consideration of how a company manages its business means the portfolios may not reflect the diversification strategies implicit in the business model of insurance. Diversification with respect to insurance obligations is typically achieved through writing a large portfolio of independent insurance contracts, across a number of different product lines, geographical areas or with varying risk characteristics (e.g. frequency/severity of claims). Accordingly, it may be appropriate and even necessary to group insurance contracts in a manner that allows that diversification to be reflected in the measurement result. Without the flexibility to group contracts according to how an entity manages its business, erroneous and misleading information may result from application of the measurement guidance in the Proposed ASU.

The law of large numbers indicates that the more voluminous the data is, the more reliable it is and the more weight can be given to it. Thus, the smaller the portfolio, the less reliable the data becomes. Further, the aggregated amount of risks within a product portfolio or at a company level may be smaller or less than the simple addition of the individual risks. If the entity cannot group contracts in a manner consistent with its business strategy, then the sum of the portfolios may not provide a meaningful result.



The Boards have indicated that they are substantially converged on the measurement of profit and that only the timing of profit recognition differs. However, we believe the FASB's portfolio definition, as currently expressed, is more prescriptive than the IASB's, and could lead to lower levels of disaggregation of portfolios than under the IASB model. This could lead to different amounts of profit/loss recognition. Without the modifications proposed above, the Proposed ASU may lead to:

- Greater disaggregation of insurance contracts than exists today due to singular focus on duration and pricing similarities;
- Diversity in practice due to differing judgment as to what "similarly" priced means, without the flexibility to group contracts according to how the product mix is managed;
- Added complexity and cost without a corresponding increase in value in terms of improved relevance and reliability of information presented; and
- Arbitrary grouping of contracts that is not meaningful for measurement and presentation purposes.

#### **Question 9: Contract Boundary**

*Do you agree with the requirements included in this proposed Update on contract boundary (that is, the requirements that establish how to identify the future cash flows that will arise as the insurer fulfills its obligations)? If not, what do you recommend and why?*

Allianz Life® prefers the contract boundary proposal in the IASB's Revised ED. We believe this is another key area that requires convergence. Specifically, a converged definition of the contract boundary would enhance comparability. Further, operational complexity could be reduced by technical clarification on boundary exceptions and detailed implementation guidance. The inclusion of examples from the life, non-life, and health sectors, using both the premium allocation approach and building block approach would support consistent application.

#### **Question 10: Fulfillment Cash Flows**

*Do you agree with the types of cash flows that would be included in the measurement of the fulfillment cash flows, including embedded options and guarantees, related to the insurance coverage under existing insurance contracts that are not separated and accounted for as embedded derivatives? If not, what cash flows do you think also should be included or excluded and why?*

No. Allianz Life supports the IASB approach to acquisition costs (see Question 28). However, Allianz Life supports the FASB approach for embedded options and guarantees, that are included as a regular part of the cash flows and not separated from the cash flow model.

The Proposed ASU includes asset management fees received for variable contracts with segregated accounts in the fulfillment cash flows. Allianz Life agrees with this approach. However, Allianz Life also believes that the implied fee on participating contracts without segregated accounts (e.g., universal life and fixed indexed annuities) should be included in the fulfillment cash flows.



**Question 14: Discount Rate and Discounting**

*Do you agree that the discount rates used by the entity for nonparticipating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?*

Yes. Allianz Life® supports a top-down approach, as described in ASC 834-10-55 Example 9, for all long-term liabilities.

**Question 15: Discount Rate and Discounting**

*For contracts measured using the premium allocation approach, do you agree that an entity should discount the liability for incurred claims? Do you agree that an entity should be allowed to elect not to discount portfolios when the incurred claims are expected to be paid within one year of the insured event? Why or why not? If not, what would you recommend and why?*

Allianz Life supports the FASB proposal of discounting the liability for incurred claims for contracts measured using the premium allocation approach. We also support the election not to discount portfolios when the insured claims are expected to be paid within one year of the insured event. This election is reasonable given the short-term nature of claim liability. Further, the election will reduce cost and operational complexity for the reporting entity.

**Question 16: Discount Rate and Discounting**

*Do you agree that an entity should segregate the effects of underwriting performance from the effects of changes in the discount rates (which would reverse over time) by recognizing changes in the present value of the fulfillment cash flows due to changes in the discount rates in other comprehensive income? If not, do you think that the effect of changes in the discount rates should be presented in net income? Please explain your reasoning.*

Allianz Life supports the introduction of an OCI model in the Proposed ASU and the related Fair Value through OCI (FVOCI) category in the Proposed ASU, *Financial Instruments*. However, the use of OCI must not be mandatory.

Under the OCI model, insurers are able to report a balance sheet measured at current value while preserving a decision-useful income statement that reflects the long term nature of the insurer's business. This model provides more relevant information to users of our financial statements, avoiding the issue of short-term market movements that do not impact the policyholder or shareholder distorting the insurer's earnings.

From a technical perspective, the OCI component represents a "bridging item." It contains the effect from applying two different discount rates for the balance sheet and statement of operations – a current discount rate for the balance sheet and a cost-based discount rate for the statement of operations.

*However, OCI must not be mandatory as some products are backed by assets that are not eligible for the FVOCI category under the Proposed ASU on Financial Instruments or managed on a full fair value basis.*

As mentioned above, we strongly support the use of OCI for insurance contracts. However, we are very concerned that for some contracts, the mandatory application of the OCI solution would not provide meaningful information to users.



Insurance liabilities and the related assets should be measured and presented in a consistent way, reflecting their interaction. Despite the introduction of a FVOCI category for simple debt instruments in the proposed ASU on Financial Instruments, measurement at FVOCI is not applicable for all asset categories. Thus, we are very concerned that the mandatory application of the OCI approach would create an accounting mismatch if a large share of the assets backing an insurance liability are not eligible for measurement at FVOCI.

In addition, some contracts, such as unit-linked or variable annuity contracts, are based on a fair value through profit or loss business model. For these contracts, using a FVOCI measurement basis in the statement of financial position would not provide relevant information to users of financial statements.

As a result, we strongly believe that the standard should contain an option to present effects from changes in discount rate directly in profit or loss.

*We support the use of an unlocked or updated discount rate for the determination of interest expense in profit or loss.*

We agree that the discount rate for determination of interest expense in profit or loss under the OCI model should be the discount rate determined at inception of the contract, as stated in paragraph ASC 834-10-55-118, Example 11, of the Proposed ASU. This discount rate should be unlocked when changes in underlying items change the expected future cash flows of the liability, which is slightly different from paragraph ASC 834-10-35-25 of the Proposed ASU. The Proposed ASU recommends that an entity shall adjust the interest accretion rates upon any change in expectations of the crediting rates on the affected policies that will affect the measurement of the insurance contract liability. To the extent that the expected liability cash flows for participating contracts also change, e.g. when there is a change in the reinvestment assumptions, the update of the discount rate should reflect such changes as well, consistent with ASC 834-10-35-25, which would apply equally to policies where crediting rates have changed through a discretionary feature or a contractually-linked feature.

*We strongly support the creation of the FVOCI category for assets under the Proposed ASU, Financial Instruments.*

In addition, we strongly support the reintroduction of FVOCI for simple debt instruments in the Proposed ASU on Financial Instruments, as we see OCI as a vital element to adequately reflect the performance of certain insurance products with the implementation of a current fulfillment model for insurance contracts.

*The OCI Model is fully consistent with the industry's Alternative Approach.*

The Alternative Approach described in our response to question 35 is fully consistent with the OCI model introduced in the Proposed ASU. It is also consistent with the FVOCI concept introduced in the Proposed ASU on Financial Instruments that would apply for a large part of the assets held by an insurance company.

The Alternative Approach implicitly distinguishes between the asset-liability-matched and unmatched part of the contract. For the matched part (the duration where fixed interest rate debt instruments provide cash inflows which match expected cash outflows), changes in discount rate do not change the expected cash inflows and outflows under the contract. Due to discounting, however, an interest rate change impacts the current value of the insurance liability. This effect reflects short-term movements that reverse automatically over the life of the





contract. Insurers would use OCI to report these changes in the insurance liability arising from changes in the current discount rate in the period in which the duration of the insurance liabilities and related assets are matched. For the unmatched part, the insurer is exposed to reinvestment risk. A change in discount rate changes the expected investment returns and the expected crediting rate, and thus changes the expected cash inflows and outflows under the contract. These changes relate to future asset management services and affect the unearned future profit from the contract. The CSM would thus be unlocked for changes in reinvestment assumptions relating to the unmatched part, consistent with its definition as unearned future profit from the contract.

OCI would be the difference between:

- The carrying amount of the liability measured using the current rate; and
- The carrying amount of the liability measured using the discount rate for determination of interest expense in profit or loss.

As a change in discount rate equally affects both the discount rate to determine the interest expense in profit or loss (via current reinvestment assumptions) and the current rate, there would be no OCI effect from the unmatched part.

The proposed Alternative Approach supports a clear and economically based separation between CSM and OCI:

- The CSM reflects consistently the unearned profit of the shareholders arising from the insurance contract at inception and is fully unlocked in all subsequent periods over the life of the contract.
- The purpose of OCI is to capture the short-term market movements in assets and liabilities that do not impact the policyholder or shareholder during the period in which assets and liabilities are matched.

Allianz Life® recommends that the fair value option for insurance contract liabilities currently allowed under ASC 825-10-25-7, *Financial Instruments*, be retained. Separating or identifying embedded derivatives is generally impracticable with complex products that blend aspects of fixed and variable annuities and where the insurance company may be unable to reliably identify whether the fixed account or the variable account is the host contract. Allowing the fair value option also may decrease accounting volatility in situations where the changes in the fair value of derivatives purchased for a product would match the changes in the fair value of the insurance contract. In these situations reporting fair value of the entire contract through profit or loss, following the fair value guidance in ASC 820, *Fair Value Measurement*, would most faithfully represent the financial position and performance of the entity on an economic basis.

#### **Question 17: Discount Rate and Discounting**

*Because the proposed guidance includes the approach under which changes in the insurance liability arising from changes in the discount rates should be recorded in other comprehensive income, do you think that a test should be required to trigger recognition in net income of some or all of the amounts in accumulated other comprehensive income (that is, a loss recognition test based on asset-liability mismatches)? Why or why not?*

No. In a current fulfillment value model, there is no need for a loss recognition test. The fully unlocked CSM absorbs unfavorable changes in cash flows and when it is depleted, all charges flow directly to profit or loss.



**Question 21: Margin for Contracts Measured Using the Building Blocks Approach**

*Do you agree that an insurer should not recognize a gain at initial recognition of an insurance contract (such a gain would arise when the expected present value of the cash outflows is less than the expected present value of the cash inflows) but, rather, should defer that amount as profit to be recognized in the future? Why or why not?*

Yes, however, Allianz Life® supports the IASB's proposal whereby the CSM is considered unearned profit at inception, fully unlocked in all subsequent reporting periods, and recognized over the coverage period in a systematic way that best reflects the remaining transfer of services that are provided under the contract. Allianz Life believes that this is a key area that requires convergence by the Boards.

The proposed ASU requires that entities recognize the single margin as an insurance entity is released from exposure to risk as evidenced by a reduction in the variability of cash flows in a portfolio of insurance contracts [ASC 834-10-35-19]. This approach will load profits on spread products with guarantees towards the end of the contract term, as they have variability based both on timing and severity. Conversely, the IASB's Revised ED, requires entities to release the CSM in a systematic way that best reflects the remaining transfer of services that are provided under the contract, and does not prescribe a specific pattern of release. We believe that a meaningful pattern for the allocation of the margin considers the provision of services as satisfied over the life of the contract. Additionally, we believe that the systematic release reflecting the transfer of services provided under the contract is more aligned with the Revenue Recognition proposal than release from variability in the cash flows.

**Question 22: Margin for Contracts Measured Using the Building Blocks Approach**

*Do you support using a one-margin approach, as is included in this proposed guidance, or an explicit risk adjustment and a contractual service margin (as the IASB proposes)? Please explain the reason(s) for your view.*

We believe that the IASB's inclusion of a separate risk adjustment as well as a CSM is a more transparent solution than a single margin. The risk adjustment represents the compensation required by the insurance entity for bearing uncertainty about the timing and amount of cash flows and includes factors that reflect the entity's diversification across portfolios. The risk adjustment would be remeasured each reporting period. The techniques used to measure the risk adjustment would not be restricted to diversification at the portfolio level, as it would overprice the risk. So the risk adjustment would be measured with a technique and level appropriate to the contracts and entity issuing them. In our view, the separate recognition of the risk adjustment will enhance transparency and support comparability.

**Question 23: Margin for Contracts Measured Using the Building Blocks Approach**

*If you support a risk adjustment and a contractual service margin, do you agree with the IASB's approach to adjust the contractual service margin for changes in estimates of cash flows? Why or why not? Do you agree with the IASB's approach to not specify acceptable approaches to determine the risk adjustment? Why or why not?*

Yes, we agree with the IASB that changes in estimated future cash flows should be included in the CSM. However, Allianz Life® supports a fully unlocked CSM that includes gains/losses on underlying items, reinvestment risk, changes in the time value of options & guarantees, and changes in risk adjustment related to future services. A fully unlocked CSM would provide external users of financial statements with decision-useful information consistent of a current fulfillment value insurance liability on the balance sheet and profit recognition in the profit



or loss according to the services provided under the contract. In addition, preparers may not need to use non-GAAP performance reporting measures, such as embedded value, any longer. This approach is a logical extension of the “no gain at inception” concept.

Additionally, consistent with the IASB approach, the CSM should be recognized over the coverage period in a systematic way that best reflects the remaining transfer of services that are provided under the contract. The FASB recognition model based on release from risk would significantly strain new business for long-term insurance contracts and is inconsistent with the actual earnings pattern on spread products, such as universal life and annuities.

Allianz Life believes all measurement components should be considered in the subsequent measurement of the CSM, i.e., measurement with completely updated assumptions.

*The CSM should be unlocked for gains/losses on underlying items and reinvestment risk for participating contracts.*

The IASB’s Revised ED excludes income from investments related to insurance contract liabilities from the fulfillment cash flows and instead the investment income is recorded and classified in accordance with other accounting literature. Allianz Life proposes that the CSM be fully unlocked. Therefore, gains/losses on underlying items and reinvestment risk should be adjusted through the CSM. Otherwise, net income will be extremely volatile and not reflect the economic performance of the period. This is caused by asset performance and reinvestment risk being reported through profit or loss as incurred. Therefore, we strongly believe gains/losses on underlying items and changes in reinvestment assumptions should be included in the CSM.

*The CSM should be unlocked for changes in the time value of options and guarantees.*

Changes in the time value of options and guarantees represent cash flow changes which are included in the current fulfillment value of the insurance contract. We agree that options and guarantees cannot be separately valued independent of the other components of the insurance contract. The FASB proposes that changes in discount rates be reflected in OCI for all fulfillment cash flows. We agree with the FASB’s conclusion in paragraph BC193 of the Proposed ASU, which states “The Board determined that these options and guarantees should be considered in the expected present value of the cash flows. Although some embedded options or guarantees have no ‘intrinsic value’ because they are currently ‘out of the money’, there is a time value because they could be ‘in the money’ at some point during the life of the contract. Because the expected present value approach considers all possible outcomes, it incorporates both the intrinsic value and time value of embedded options and guarantees. The Board decided that this more faithfully represents the economic substance of these guarantees and options.” However, we propose that the CSM be unlocked for these changes in expected cash flows, with the difference between expected and actual cash flows from current and prior periods reflected in net income.

*The CSM should be unlocked for changes in risk adjustment related to future services.*

The Revised ED from the IASB requires that the CSM is not adjusted for changes in the risk adjustment, which instead are recorded directly in the statement of operations. To be consistent with the concept of unlocking of the CSM for changes in cash flows relating to future coverage and future services, we also believe that the CSM should be unlocked for changes in the risk adjustment that relate to changes in risk for future periods. This is also required to ensure a consistent determination of the CSM at initial recognition and subsequent measurement dates. We



believe that the distinction between changes of the risk adjustment which relate to past and those which relate to future coverage and services is operationally feasible.

#### *Accretion of interest / Discount Rate*

The Revised ED requires that interest be accreted on the CSM using, in all cases, a locked-in discount rate. We disagree with this guidance. We believe that accretion of interest on the CSM should be based on the discount rate that is used to determine interest expense in profit or loss for the other components of the insurance liability. The use of such a discount rate, which would be unlocked for participating contracts, would allow the CSM to reflect present value of future profit expectations. In summary, the determination of the time value of money should be performed on a consistent basis for all components of the insurance liability including the CSM.

#### *Risk Adjustment*

We agree with the IASB's approach to not specify acceptable approaches to determine the risk adjustment. Numerous methods could be used, depending on the regulatory environment, product mix, and diversification of the insurance contracts held by a reporting entity. In general, if a standard specifies various methods, even if other methods may be acceptable or more relevant, the specified methods become the only available methods.

#### **Question 24: Margin for Contracts Measured Using the Building Blocks Approach**

*Do you agree that a loss at initial recognition of a portfolio of insurance contracts should be recognized immediately in net income (such a loss would arise when the expected present value of the cash outflows exceeds the expected present value of cash inflows)? Why or why not?*

Yes, Allianz Life® agrees with this proposal as the methodology is consistent with current loss recognition guidance for onerous contracts. However, we believe that the definition of a portfolio, which is used to measure onerous contracts, should be revised to allow entities to group contracts in a manner that reflects their business mix and diversification strategies. See response to Question 8.

#### **Question 25: Margin for Contracts Measured Using the Building Blocks Approach**

*Do you agree with the proposed method(s) of recognizing the margin (that is, as the entity is released from risk under the insurance contracts as evidenced by a reduction in the variability of cash outflows)? If not, what do you suggest and why?*

No, Allianz Life® supports the IASB proposal that the CSM should be recognized over the coverage period as services are provided under the contract and that the separate risk adjustment should be measured over the coverage and settlement periods.

Example 16 suggests that the way to recognize release from risk under an insurance contract is by using a change in standard deviation of the cash flows for the insurance contract. On long-term insurance contracts, such as annuities, it may take many years before the standard deviation of cash flows changes significantly. This implies that the margin on such contracts would be recognized towards the end of the contract life, while services are usually provided throughout the contract life. The CSM for annuities includes margin attributable to spread (the



difference between interest earned on assets and interest paid to policyholders), asset management services, fees charged for the provision of guarantees or riders, and the cost of providing all of these services and benefits. Since only a portion of the CSM relates to risks, using the change in risk to determine how to recognize that margin over time does not appropriately represent the earnings process on annuities.

**Question 26: Margin for Contracts Measured Using the Building Blocks Approach**

*Do you agree that interest should be accreted on the margin and therefore affect insurance contract revenue? If not, why?*

Yes, Allianz Life agrees that interest should be accreted on the margin; however, we believe it should be accreted using the discount rate that is used to determine interest expense in profit or loss.

**Question 27: Margin for Contracts Measured Using the Building Blocks Approach**

*Do you agree that if the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance contracts will exceed expected cash inflows, an entity should recognize the remaining margin immediately in net income? Why or why not?*

The term “expected cash outflows” is not defined in the Glossary. We assume this means the combination of both actual inflows and outflows and expected cash inflows and outflows. If this assessment does not include previous cash inflows, nearly all single premium products (such as annuities), would recognize the remaining margin immediately in net income after receiving the single premium, which is illogical. This term should be defined within the guidance or perhaps a different term should be used, such as “actual and expected cash inflows and outflows” which would be more clear.

**Question 28: Margin for Contracts Measured Using the Building Blocks Approach**

*Do you agree that the direct acquisition costs presented with the margin should include only the costs directly related to the entity's selling efforts that result in obtaining the contracts in the portfolio and that all other acquisition costs should be recognized as expenses when incurred? If not, what do you recommend and why?*

Allianz Life® supports the IASB definition of acquisition costs which is those costs directly attributable to acquiring the portfolio of insurance contracts. Including the portion that the FASB refers to as “successful efforts” results in very little difference in financial reporting (less than 10% difference in reported acquisition costs), but requires significantly more cost and effort to apply. Additionally, Allianz Life supports convergence on which costs should be included in acquisition costs to reduce the costs in applying the standard. Finally, Allianz Life does not support the FASB model that results in effectively maintaining a deferred acquisition cost asset and reporting it in significant detail, combined with the margin. Instead, we prefer the IASB approach whereby the acquisition costs are included in the fulfillment cash flows and recognized as part of a net margin. This approach is more consistent with other treatment of transaction costs.

**Question 35: Participating Contracts**

*Do you agree that participation features that are contractually dependent on the performance of other assets or liabilities of the insurer or the performance of the entity itself should be measured on the same basis used to*



*measure the underlying items and changes in the measurement should be presented in the same statements (that is, net income or other comprehensive income)? Do you agree that this approach should be limited to only participating features for which the amount of the performance of the underlying items passed through to policyholders is contractually determined and not extended to participating features that allow an entity discretion about the amount of the performance of the underlying item to pass through to the policyholders? If not, what do you recommend and why?*

The mirroring approach in the Proposed ASU can only be applied if the contract requires the entity to hold the underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items. This is a very narrow, legalistic definition that excludes certain contracts for which the entity is not required to hold the underlying items but are otherwise in substance economically the same. For instance, there are many contracts for which the cash flows are dependent on asset returns. For some of these contracts, there is a contractual link. Other contracts do not have such a contractual link; and not all of these contracts require the entity to hold the underlying items. While the legal aspects of the contract may differ, the economic substance of sharing returns with the policyholder is the same. Thus, we oppose the scope that is proposed by the FASB for participating contracts, which will lead to different accounting for similar insurance contracts.

Instead, there should be no exception for the measurement of participating contracts and the FASB should define how to apply the general principles of the Proposed ASU to contracts with a link to underlying items.

*Bifurcation of cash flows is overly complex and flawed.*

We agree with the FASB conclusion in paragraph BC91, that "Separating a single contract into components when the cash flows attributable to the components are intertwined could result in complex accounting." The Proposed ASU would still require entities to decompose the cash flows arising from insurance contracts between those that are expected to vary with returns on underlying items and those that are not and to apply different principles or sometimes different discount rates to those cash flows. Some parts of the insurance liability would be measured under the general measurement requirements, and those cash flows might still have different discount rates applied to them, and another part would be measured on a basis which is driven by the basis on which the underlying items are measured. This would result in an insurance liability that does not represent a reliable estimate of the ultimate probability-weighted expected cash flows and mixes measurement bases for one liability, which would result in a meaningless presentation in the balance sheet.

We believe that for all types of contracts, including contracts with cash flows that are dependent on the returns of underlying items, the present value of the fulfillment cash flows would more faithfully represent the entity's contractual rights and obligations, and convey more useful information about the amounts, timing and uncertainty of the cash flows generated by those rights and obligations.

In addition, bifurcation of cash flows adds significant complexity to the measurement of the insurance contract liability. It is artificial and arbitrary and for many insurance contracts and not practical for the following reasons:

- In some cases policyholder participation is not based on investment income but on the entire earnings of the entity or the net result of a portfolio of assets and liabilities; and
- In many jurisdictions, bonuses are declared to individual policyholders each year and are guaranteed after the declaration. Increases in guarantee either from profit allocation but also from additional premium



payments force a new decomposition of the cash flows during subsequent measurement from those backing the variable part to those backing the fixed part. This not only introduces high operational complexity, but also has an impact on earnings since the cash flows are measured using different measurement bases.

*We recommend the global insurance industry's Alternative Approach to accounting for participating insurance contracts.*

- (1) The approach proposed in the Proposed ASU for participating contracts (bifurcation of cash flows and limited unlocking of CSM) is seen by many constituents as the key concern. The global insurance industry has developed an Alternative Approach which can be summarized as follows:
  - No exception for the measurement of participating contracts. Instead define how to apply the general principles of the Proposed ASU to contracts with a link to underlying items;
  - All insurance liabilities would be measured at current fulfilment value on the face of the balance sheet without bifurcation of cash flows;
  - The CSM should reflect the unearned profit arising from the insurance contracts and be determined on a fully unlocked basis;
  - Profit would be recognized in accordance with the fulfilment of the contract as services are provided, in accordance with general revenue recognition principles;
  - OCI solution within the proposed ASU is needed, but OCI must not be mandatory.
  
- (2) Key advantages of the Alternative Approach:
  - Builds on existing principles instead of defining an exception for contracts with a link to underlying items;
  - Fully current measurement for all insurance contracts and all components of the liability including updated CSM for better comparability;
  - Full transparency of potential impact of changes in reinvestment assumptions in CSM;
  - Statement of operations reflects long-term nature of business: distinguish between earned returns for services provided (net income) and changes in the expected future profits (CSM);
  - Fully unlocked measurement enables simple and high quality retrospective application; and
  - No bifurcation of cash flows and use of a single discount rate for the whole contract in line with current actuarial practice.

Below is our description of key aspects of the Alternative Approach, that is further described in an appendix to the European Insurance CFO Forum comment letter to the IASB:

### *Scope*

Economically similar contracts are measured in a consistent way under the Alternative Approach, including all contractual and discretionary expected future cash flows. Contrary to the FASB proposal in paragraphs ASU 834-10-30-8 and 9 in the proposed ASU, the Alternative Approach would not establish an exception for the measurement of participating contracts but proposes a current fulfilment value measurement for all insurance contracts in accordance with the general building blocks approach as defined in the Proposed ASU. Participating insurance contracts or contracts with discretionary participation features would include all those policies whose policyholders have a right to receive, as a supplement to guaranteed benefits, additional benefits. Examples of these contracts include European 90/10 participating contracts, universal life type contracts, and equity indexed annuity contracts.



### *Current fulfilment value measurement basis*

Under the Alternative Approach, all insurance liabilities should be measured at current fulfilment value on the face of the balance sheet to ensure a consistent measurement basis. There is no bifurcation or separation of asset dependent and non-asset dependent cash flows within a contract.

For participating contracts whose cash flows significantly depend on asset returns, asset management services are an explicit service under the insurance contract. The expected cash inflows and outflows under these contracts depend on the investment returns from the underlying items. Thus, for participating contracts all cash flows from returns on underlying items relate to services provided under the contract. They are cash flows from the contract and need to be considered for initial and subsequent measurement of the fulfilment cash flows and the CSM. Accordingly, all cash flows arising from contractual or discretionary participation features should be reflected in the fulfilment cash flows. Entities should consider all expected cash flows including (i) expected cash flows from existing assets, which would be reflected in the expected cash flows of the insurance liability, and (ii) expected cash flows from future reinvestments, which would be considered in the measurement of the liability using current market rates.

An insurance contract is a bundle of rights and obligations that should be accounted for together (after separating investment components, embedded derivatives and performance obligations in accordance with paragraphs ASC 834-10-25-2 through 834-10-25-10 of the proposed ASU).

### *Discount rate*

The discount rate for adjusting the estimates of future cash flows for the time value of money should reflect the dependence of the liability cash flows on the return of underlying assets. It should be determined:

- a. for the portion of the contract's duration that is matched with the assets' duration, based on the yield of the assets that back the insurance contract; and
- b. for the portion of the contract's duration that is not matched with the assets' duration, based on the expected reinvestment yield based on current market-consistent rates and the existing or projected asset allocation.

This discount rate is in line with ASC 834-10-35-7 of the proposed ASU. This requires, however, that the term "underlying items" is applied in a broad sense and that reference can be made to the actual portfolio of assets when there is no asset-liability mismatch, and to expected reinvestment rates when there is such mismatch.

### *Risk adjustment*

The determination of the risk adjustment for participating contracts does not differ from the determined risk adjustment for contracts without a participation feature. The general requirements of the IASB approach would apply.





### *Contractual Service Margin (CSM)*

Under the Alternative Approach, the CSM reflects consistently the unearned profit of the shareholders arising from the insurance contract at inception and in all subsequent periods over the life of the contract. Determination of the CSM is consistent with the measurement of the other building blocks and aligned with the principles of the revenue recognition project. This requires that all assumptions underlying its calculation are updated.

### *Unlocking of the CSM*

For participating contracts, asset management activities, including crediting asset returns to the policyholder, are explicit services under the insurance contract. The difference between the expected investment returns and the amount credited to the policyholder is (part of) the compensation in exchange for the asset management services provided by the insurer. Thus, changes in the expected investment returns and changes in the expected crediting rate affect the unearned future profit from the contract. The CSM should be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services. This would mean that:

1. For asset management fees, the CSM would be unlocked only for changes in the estimates of future fees; and
2. For changes in asset returns including reinvestment assumptions, the CSM would be unlocked for changes in the expected amount retained by the insurer (e.g., as a result of a change in the proportions of asset returns shared between the policyholders and the insurer).

Changes in reinvestment assumptions are thus not “hidden” but are fully transparent in the current insurance liability and unlocked CSM. However, net income is not distorted by effects from changes in expected future profits.

Therefore, the CSM represents the unearned profit from the entire contract, at inception and is fully unlocked afterwards. If the contract becomes onerous, the CSM disappears and all changes go directly through profit or loss.

As explained in our response to question 23, treatment of risk adjustment should be consistent with other fulfillment cash flows (i.e., the contractual service margin should be adjusted for changes in the risk adjustment related to future coverage or other future services).

### *Accretion of interest*

A fully unlocked measurement would imply accretion of interest on the CSM based the discount rate that is used to determine interest expense in profit or loss for the other components of the insurance liability. The use of such an unlocked discount rate would allow the CSM to reflect future gross profit expectations, considering assumptions for reinvestment rates.



**Question 40: Presentation**

*Do you agree with the presentation requirement included in this proposed Update? If not, what would you recommend and why?*

No. We are not convinced that the FASB's presentation proposal meets the objective to provide relevant and reliable information that faithfully represents the entity's financial performance. We believe the FASB should reconsider the summarized margin approach.

The FASB's proposal to present 'earned premium' (i.e., change in single margin +/- expected claims) as insurance revenue for long duration contracts measured using the building blocks model does not provide relevant information that faithfully represents the entity's financial performance.

Furthermore, we are concerned about the proposal to exclude receipts and payments of investment components from premiums, claims and benefits presented in profit or loss, which is of questionable value and adds unnecessary complexity for both preparers and users.

Thus, we do not support the FASB's proposal regarding presentation of revenue and expenses in the statement of operations.

We believe that the Board should reconsider the summarized margin approach that was originally proposed in the Discussion Paper. The summarized margin approach enables a more flexible approach for all insurance products. While no top line revenue is presented on the face of the statement of operations, revenue information can be provided using the appropriate industry definition via the segment disclosures.

We do not believe that earned premium as defined in the Proposed ASU provides relevant information. In particular, earned premium is derived artificially from the changes in the building blocks. Thus, it is not capable of making a difference in investor decisions – it provides no additional information of predictive or confirmatory value that could otherwise be obtained from the summarized margin. Thus, it is not useful.

Also, we do not believe that earned premium provides a faithful representation of the revenue that is earned and, therefore, is not reliable. In particular, the earned premium is not complete, i.e. is not linked to the customer consideration that is paid to the entity. The customer consideration is a significant fact that is absent from the earned premium approach. Furthermore, the information provided needs to be accepted and used by analysts and investors to justify the costs to produce it. During discussions with top analysts for Allianz SE about the IASB presentation model, which is similar to the FASB presentation model in the Proposed ASU, Allianz SE heard significant concerns regarding the presentation proposal for long duration contracts measured using the building blocks approach. We would also point out that insurance revenue for a conglomerate insurance company is not a useful piece of information. Profitability varies significantly depending on the insurance product. Therefore, there is no "one-size-fits-all solution".

Based on these points, we conclude that the earned premium approach does not provide useful financial information.



*The presentation proposal increases complexity for preparers and users.*

The presentation proposal does not provide a revenue number that is intuitive. Instead, users must consider the various components of the revenue number to understand the drivers (i.e., change in contractual service margin, change in risk adjustment, and change in expected claims).

Furthermore, the Proposed ASU proposes that premiums, claims and benefits presented in the statement of operations should exclude receipts and payments of investment components, where investment components are defined as the amount that the insurer is obligated to pay to policyholders or to their beneficiaries regardless of whether an insured event occurs. (Note: This is different from current practice, which defines the deposit element as premium received.) The purpose of this guidance is to separate the deposit element of the insurance contract. However, we have the following concerns:

- This adjustment to reported revenue, claims and benefits further complicates the statement of operations presentation for the users.
- Separation of the investment component for presentation is not aligned with unbundling guidance, which requires separation of investment components that are 'distinct'. This results in the exclusion of revenue and expenses for presentation but not in measurement. We do not see an argument which justifies this inconsistent treatment.
- The investment component is not linked to the actual customer consideration that is received.

Determining the amount that the insurer is obligated to pay to policyholders or to their beneficiaries regardless of whether an insured event occurs adds additional complexity in transition and ongoing reporting. Since existing systems are not able to provide this information, system changes will also be required, and we do not believe that the benefits of this information exceed the costs of producing it.

Thus, we do not support the proposal and ask the Board to reconsider the summarized margin approach that was originally contained in the Discussion Paper.

#### **Question 41: Disclosure**

*Do you agree with the disclosure requirements included in this proposed Update? If not, which disclosure requirement(s) would you change and why? Are there any additional disclosures that would provide decision-useful information and should not be required? If so, which ones and why?*

No. We do not agree with the disclosure requirements included in the Proposed ASU. While the information to make the disclosures would be available from either the measurement calculations or the presentation calculations, the overabundance of disclosures will diminish their benefit to the user.

Users of financial statements need disclosures that allow them to: 1) Assess the prospects for future net cash inflows of the entity and 2) Make decisions about providing resources to the entity.

In paragraphs 834-10-50-5 through 50-7, the FASB proposes that entities present reconciliations, or rollforwards, of opening and closing balances. The complexity of the six separate rollforwards prevent a user from clearly understanding new contracts issued, cash flows, the effect of changes in assumptions, or derecognition of contracts.



**Question 42: Effective Date and Transition**

*The Board will establish the effective date of the requirements when it issues the final amendments. However, the Board is interested in determining the key drivers affecting the timing of implementation. What are those key drivers? How do those drivers affect the time it will take to implement this proposed guidance?*

Allianz Life® expects it will take at least three years to implement the new insurance contract accounting standards. Key drivers include:

- Differences between the FASB and IASB models. If they are very different (as they are now), then the US subsidiaries of foreign based insurers may be required to develop and implement both models. This is much more costly and complex than implementing one model.
- Complexity of the new model.
- Detail required for retrospective application if hindsight is to be applied (as opposed to using actual cash flow information and ignoring the effects of changes in discount rates).
- Volume of new information to be measured and acquired.

**Question 44: Effective Date and Transition**

*Do you agree that the practical expedients relating to transition included in this proposed guidance are sufficient for retrospective application (that is, are the transition provisions in this proposed guidance operable)? If not, what would you recommend and why?*

No. Allianz Life supports the decision to require retrospective application of the new standard, which is key to enable a comparable and decision-useful reporting of the performance of insurers. The effective date of the new standard for insurance contracts must be aligned with the first application of the Proposed ASU on Financial Instruments.

Use of the fully unlocked CSM at transition significantly simplifies retrospective application. Combining actual past cash flows with future cash flows and a current discount rate would achieve the balance of the first period presented without having to remeasure each prior period in a 30 year contract. The FASB should consider adding the IASB transition approach for contracts with insufficient information for a full retrospective application as an option as well.

*Effective date of the proposed ASU on Financial Instruments and the Proposed ASU for Insurance Contracts need to be aligned for insurers.*

We strongly believe that insurers should not be required to adopt the proposed ASU on Financial Instruments before the effective date of the Proposed ASU for Insurance Contracts. Insurers would have to implement two significant accounting changes in short succession, which would be operationally burdensome and distort the informative value of insurers' financial statements for users over several periods. Effective dates of these two Proposed ASUs should be aligned so that for entities conducting insurance business the mandatory application of both standards coincides.



Should application dates of the two Proposed ASUs differ, it is requested that the Proposed ASU for Insurance Contracts provide a fully unconstrained re-designation option for all financial instruments at the date of first application of the new ASU for Insurance Contracts.

*The CSM should be determined on a fully unlocked basis*

That said, we have identified significant problems with transitioning based on the current measurement guidance for participating insurance contracts. The measurement approach introduced in the Proposed ASU causes significant operational complexity for retrospective application. Since the CSM is not fully unlocked and thus cannot be measured independently of prior period data, the remaining margin at the date of the earliest period presented needs to be determined by estimating the required building blocks and changes for the period between initial recognition of the respective portfolio of insurance contracts and the beginning of the earliest period presented.

This complexity could be significantly reduced / avoided if the measurement concept for the CSM is changed to a fully unlocked margin. A fully unlocked CSM would eliminate the need to recalculate prior period building blocks and options/guarantee values upon transition to the new standard.

*Fair Value Option*

The Proposed ASU eliminates the fair value option for insurance contracts currently in ASU 825-10. If use of the fair value option is not retained, the Proposed ASU needs to address transition for contracts where the fair value option has been elected. The fair value option is an irrevocable election, so entities are generally not prepared to change the accounting on these contracts. The transition guidance should address this situation.

#### **Question 47: Costs and Complexities**

*Describe the nature of the incremental costs of adopting the guidance in this proposed Update, distinguishing between one-time costs and ongoing costs. Explain which aspects of the guidance in this proposed Update are driving those costs and include ideas to make the proposal more cost effective.*

Allianz Life® is concerned about the cost to implement a new insurance accounting standard both one-time and ongoing. Many costs relate to requiring additional information and new modeling for very old, small lines of business or run-off business that is fully reinsured, where no cash flow modeling is currently performed. Another factor that will no doubt influence implementation costs will be the availability of resources, e.g., actuaries, accountants, and IT professionals. As companies compete for those resources, the effect will be to drive up the total cost. It is difficult to estimate whether those costs are incremental or opportunity costs. Whether the costs are incremental or not, the result is the same, i.e., significant cost to implement the new standards.

Ongoing costs are difficult to estimate at this point in time. Most assuredly, there will be ongoing costs consisting of increased professional staff and audit fees. The degree of complexity of the standard will not only drive the costs, added complexity could have the effect of making it more difficult for users to understand the financial statements potentially leading to an increase in the cost of capital.



Implementation costs will be less burdensome if the FASB and IASB resolve their differences especially with regard to measurement and presentation. Every effort should be made to minimize complexity and significantly reduce or eliminate differences with the IASB proposed standard. Since there are no free resources, the cost will ultimately be reflected in the price of insurance products.