October 24, 2013

International Accounting Standards Board (IASB)
30 Canon Street
London, EC4M 6XH
United Kingdom

Re: Comments on Insurance Contracts (Exposure Draft)

On behalf of the American Academy of Actuaries'[1] International Accounting Standards Task Force (IASTF), I offer the following comments on the IASB Insurance Contracts Exposure Draft (ED). Members of the IASTF are senior actuaries with extensive financial reporting experience with life, health, and general insurance companies.

We support the development of a new standard to provide better clarity and uniformity regarding the presentation of financial results and related risks in a way that provides more useful information. Actuaries are active in roles as preparers, auditors, and users of financial statements. Our comments represent the views of actuaries in all of these roles, and we hope these perspectives will help achieve the goals of the new standard.

We commend the IASB for its continued work on the insurance contract accounting model and for the responsiveness demonstrated by changes made after the first exposure draft in 2010. We hope that our comments on this draft also will be useful to the IASB.

We encourage the IASB to continue working with the FASB toward convergence on a worldwide accounting standard. Convergence is an important step in achieving uniformity in reporting for insurance contracts.

Our comments are organized into two main sections. The first includes summary responses to the seven questions in the exposure draft. The second section provides extended and detailed discussion, much like the "basis for conclusions" document that accompanies the exposure draft. Several of our summary responses in the first section refer to paragraphs in the detailed discussion for clarification.

We appreciate this opportunity to respond to your exposure draft on accounting for insurance contracts. If you have any questions, please contact Tina Getachew, Senior Policy Analyst, Risk Management and Financial Reporting Council, by phone (+1 202/223-8196) or email (getachew@actuary.org).

[1] The American Academy of Actuaries ("Academy") is a 17,500-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Sincerely,

Stephen J. Strommen FSA, CERA, MAAA
Chairperson, International Accounting Standards Task Force
Risk Management and Financial Reporting Council
American Academy of Actuaries

I. Summary responses to questions in the exposure draft

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?

Response: We agree that financial statements will provide relevant information if differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are reflected as an adjustment to the contractual service margin (CSM), subject to the condition that the CSM should not be negative.

In addition, changes in the risk adjustment related to future coverage and other future services should be recognized against the CSM. It is possible for actuaries to decompose changes in the risk adjustment between changes related to incurred claims, changes related to expiry of risk, and changes related to future coverage and other future services. Recognizing the changes in the risk adjustment for future coverage against the CSM is conceptually consistent with adjusting the CSM for changes in expected future cash flows so that the CSM would better represent the estimated unearned profit in a contract.

We also believe that the effect of changes in the credit quality of reinsurers should be recognized against the CSM. This change in credit quality does not, in most cases, have an immediate effect on the cedant, but rather on potential recoveries occurring in the future. Therefore, the change in credit quality of the reinsurer is a change in an estimate of events in the future. As such, it should be treated in a manner similar to other changes in assumptions.

The CSM should be reinstated if assumptions change for contracts that are onerous at inception or become onerous during the life of the contract and subsequently become profitable. Although BCA 143 implies that a CSM can be reinstated, the requirement to reinstate the CSM is not included clearly within the exposure draft. As a result, it is open to different interpretations. It would be useful to indicate in the standard whether losses recognized in profit or loss are reversed subsequently through profit or loss when a contract becomes profitable again or whether the subsequent favorable changes are all recognized as a CSM. We would suggest that

losses recognized in profit or loss on contracts that subsequently become profitable be reversed through profit or loss.

We also find that the guidance as to when to unlock the CSM is unclear. It can be interpreted that changes in future cash flows resulting from changes to current period experience (e.g., there are more policy terminations than expected) go through the CSM. Alternatively, it could be interpreted that changes in future cash flows due to credited rate changes in the current period can lead to changes in the amount of services provided in future periods that should go through the CSM. Another possible interpretation is that only changes resulting from changes to experience assumptions (e.g., mortality or surrender rates) go through the CSM. We suggest that the guidance in Paragraph B68 should be clarified to resolve this issue.

In addition, as discussed in our extended comments (EC50), the guidance should not double-count changes in projected cash flows in both other comprehensive income (OCI) and the unlocked CSM. Please refer to EC64 in which we recommend a standard approach that could be used to separate the effect of changes in estimates into those recognized in OCI and those used to adjust the service margin.

We support the amortization of the CSM in profit or loss over the coverage period in a systematic way that best reflects the provision of services under the contract. We are unclear, however, as to what "services" the CSM covers. For example, it is not clear whether investment management functions for non-participating contracts are to be included as part of the services. If not, it is unclear whether these functions would be considered services for a variable annuity. We suggest clarifying which services are intended to be recognized in the release of the CSM to assist preparers in determining the right release pattern.

While we support a principles-based standard, we are concerned that without further guidance there may be significant diversity in the patterns used to amortize the CSM, even for similar contracts. For some long-term insurance contracts the amortization of the CSM will be the primary determinant of profit recognition, so such diversity is a significant concern. For example, some people may say the transfer of service could be the net amount at risk under the contract that would result in an earlier recognition of profits. Viewing the service as a stand-ready obligation would result in a level pattern of profits; whereas, viewing the service as expected claims/benefits would result in profits being recognized later in the coverage period.

In the IASB's discussions on participating contracts, it concluded that the realization of investment gains or losses and the payment or declaration of policyholder dividends/bonuses are not reflective of the services transferred under a participating insurance contract. The standard should at least include this guidance in clarifying the services that are provided under such contracts if that is the IASB's intention.

Paragraph BCA 113 indicates that, in practice, entities will account for the CSM at a lower level of aggregation than the portfolio (e.g., by contracts that have similar inception dates, coverage periods, and service profiles). The standard should explicitly require that the CSM should be calculated for contracts within the portfolio by similar date of inception. This is necessary given

that interest accretes on the CSM using the locked-in rate from inception of the contract. So, the standard should be clear to avoid diversity in practice.

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 (i.e. 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?

Response: We agree with the special measurement exception for this particular kind of contract as proposed in the exposure draft. However, we question why this one type of contract was singled out for special treatment. As noted in our response to Question 4, contracts that involve a discretionary link to returns on underlying items (rather than a specified numerical link) also should be provided special treatment to recognize profit and loss interest expense on an

amortized cost basis. Our extended comments include a suggested methodology (see EC42 - EC45).

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?

Response: Except as provided below, we take no position on the proposed presentation of insurance contract revenue and expense. Useful information can be provided under any of the general approaches that have been discussed, including the due premium approach, the earned premium approach, and the summarized margin approach. The disclosed roll-forward of insurance liabilities provides information that can be used to reconcile all of the different approaches.

However, for proportional reinsurance contracts, we recommend two changes. First, ceding commissions should continue to be accounted for gross of ceded premiums or claims. This treatment allows for ceding and assuming companies to have much more similar financial reporting results and more comparable key metrics (e.g., revenue, loss ratio, expense ratio, combined ratio). Second, we disagree that fixed reinsurance ceding commissions should be offset against reinsurance premiums and that experience-rated ceding commissions should be combined with reinsurance claim reimbursements. These recommendations address concerns we have identified that reduce the usability of the information provided.

- We understand that ceding commissions are to be netted against ceded premiums for ceding companies. Since the exposure draft does not address assuming company accounting for ceding commissions, we would expect assuming companies to continue accounting for ceding commissions in a manner that is gross of assumed premiums. As such, the different treatment of ceding commissions would result in a different presentation model for ceded reinsurance contracts than for direct and assumed contracts. Given that industry practice (including insurers and investors) is to evaluate gross and net information in comparisons between insurers and for the industry aggregate, this proposal would reduce the usefulness and transparency of the financial statements. Further, the gross and net results of insurers with different mixes of direct/assumed versus ceded would no longer be comparable, even though they are comparable under current accounting rules.

- As noted above, the proposal would impair the ability to produce industry totals. When the accounting rules are the same for the direct, ceded, and assumed contracts (as is the case throughout much of the world for property/casualty contracts), the results of all the insurers in the industry can be aggregated to produce a view of the entire industry. This industry total can be compared to individual insurers and to various segments in the

industry, resulting in useful information and evaluations regarding individual insurers and industry segments. Under the exposure draft, industry totals would no longer be produced, as the sum of direct premiums ceded would no longer match the sum of direct premiums assumed.

- The current net premium metric is a commonly used and effective measure of both earned revenue and exposure to risk. By doing away with "net premium" and by netting commissions against reinsurance premium (so that only net-of-commission ceded numbers are available), the exposure draft eliminates the net premium as a measure of exposure to risk. The elimination of a separate ceded commission expense eliminates the relative comparability of risk exposure due to the impact on expected loss ratios.

As an alternative, we recommend that assumed and ceded premiums under proportional reinsurance contracts be stated gross of ceding commissions. An additional entry in the income statement would then include ceding commissions. This would allow for net premiums to be a consistent measure of both net revenue and exposure to risk and for direct and assuming companies writing the same risk to have comparable loss ratios.

We also are concerned with the requirement to remove “investment components” that are “highly interrelated” from insurance contract revenue and expense. Whether the cost of removing the investment components is greater than the benefit achieved should be investigated further (i.e., through field testing) before a final decision is made. We note there is significant ambiguity and confusion in the exposure draft’s current guidance in this area. For example, it only mentions repayable amounts rather than repayable or additional amounts as occurs in retrospectively rated insurance policies. This also should be investigated further before the finalization of any guidance.

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?

Response: We agree that the use of OCI, as described by the IASB and FASB, could provide relevant information that faithfully represents the entity's performance in many situations for contracts accounted for under the building block approach (BBA). However, in certain cases under the BBA model, and in most cases under the premium allocation approach (PAA), OCI should not be used in such a manner because it does not provide relevant information. Therefore, we recommend that the use of OCI not be required.

In situations in which the expense and complexity are justified, the fundamental operations of insurance should be captured in net income, with other changes captured in OCI. To accomplish this, modifications to the boards' approach to determining the amount of OCI are necessary in order to provide relevant and representationally faithful information or are desirable from an operational perspective. The most critical proposed modifications are that:

1. The only bifurcation of cash flows within an insurance contract should be between
    a. cash flows that are contractually linked to the underlying items, which should qualify for mirroring; and
    b. all other cash flows, which should use the BBA.
2. The discount rate used for net income for discretionary participating contracts, and for non-mirrored cash flows within other par contracts, should be updated in a manner that does not generate an immediate P&L impact when credited rates change.

In addition:

1. Changes to interest sensitive cash flows, such as lapse rates, should be reflected in OCI.
2. Use of a single locked-in interest accretion rate for P&L for non-participating contracts should be permitted, rather than mandating a locked-in yield curve.
3. To the extent that risks within a portfolio of insurance contracts are hedged, there should not be OCI or CSM unlocking to the extent of the hedged risk.

The modifications that we recommend are explained in our extended comments. Please refer to EC13 – EC51.

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?

Response: We agree that the proposed approach to transition balances comparability with verifiability. Comparability is achieved by applying the new standard retrospectively rather than requiring a standardized transition formula that might not be appropriate for all entities. We understand that verifiability will be affected by the need to make many estimates when applying

the new standard retrospectively. However, those estimates will in most cases be made by actuaries who are subject to appropriate standards.

However, those estimates will in most cases be made by actuaries, and the professional standards under which actuaries practice make us comfortable that good faith estimates will lead to comparable and reliable results.

There will be certain reinsurance agreements in which the data necessary under the exposure draft's requirements to retrospectively apply the new standard is not available. An example is a situation in which many years ago a business was ceded on a 100 percent coinsurance basis to a reinsurer that also took over the administration of the business. When such agreements are struck in the future, the parties will be able to require the administrator to be able to provide the information required to complete the ceding company's financial statements. For agreements that were struck prior to the effective date of the exposure draft, the data needed may not have been retained since there was no requirement for this data. There is a precedent for this type of issue in FASB's FIN 46R in which there was a practical expedient that allowed carry-over of pre-transition accounting for situations in which data was not obtainable.

We suggest that field testing is important to ensure an effective transition. The exposure draft represents a substantial change from existing accounting practice and will create the need for many new calculations. Field testing is needed to uncover potentially unforeseen situations that may need to be addressed.

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.

Response: For contracts under the BBA, we expect that the transparency and comparability between financial statements of different entities that issue insurance contracts will be enhanced.

However, this may not be the case for many contracts that fall mainly under the PAA. Including discounting and risk adjustments for such contracts in a financial reporting model is reasonable in theory. At the same time, the current accounting model followed in most jurisdictions that has

undiscounted amounts is simple, well understood, more easily audited than the proposed model, and has generally proven to be effective. As such, we have concerns that inclusion of discounting and risk adjustments could negatively affect transparency and comparability of results for such contracts.

Please also see our comments in EC57 – EC62.

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?

Response: The clarity of drafting could be improved in several areas to better reflect the decisions made by the IASB. Our extended comments outline several specific issues for which the standard is not clear. In each case, we propose new wording that would clarify the exposure standard.

We also urge the IASB to create a working group to oversee implementation of the standard. The working group could consist of preparers, audit firms, users, and actuaries. The group could review questions from preparers and auditors that emerge during implementation and propose responses for the IASB to consider. The working group could be temporary, lasting only until the effective date of the standard, and could supplement the work of the IFRS Interpretations Committee. Due to the highly technical nature of this standard, there is a strong need for experienced individuals to review and recommend resolution of such issues. This would greatly enhance the ability of the IASB to resolve issues in a timely fashion.

Please see extended comments in EC63 – EC71.

II. **Extended comments**

Extended comments regarding discount rate

EC1 We are comfortable with the discussion of discount rates in the exposure draft. However, some of the statements in the implementation guidance are unclear and some are conflicting. We also wish to state the way we interpret the standard as it applies in certain situations.

EC2 Some of the guidance regarding discount rates seems unclear as to whether it applies to all insurance contracts or only those with cash flows that do not depend on underlying items (e.g., invested assets). For example, Paragraph B70(a)(i) states that in applying the top-down method, market risk premiums should be excluded from the discount rate. This seems appropriate for contracts with cash flows that do not depend on underlying invested assets. However, contracts that participate in returns on underlying assets acquire characteristics of those assets, including some of the related risk. As such, the

discount rate for such contracts should include that part of the market risk premium that is a characteristic of the contract due to its participation in asset returns.

EC3 Paragraph B75 specifically addresses a situation in which insurance contract cash flows depend on underlying assets. It suggests that in some cases a replicating portfolio technique might be used. This may be appropriate only in cases in which "mirroring" is used (Paragraph 33), in which case the actual portfolio is used and no replicating portfolio need be constructed. In all other cases, the second approach in Paragraph B75 should be used. That is, the discount rate should be "adjusted for any asymmetry between the entity and the policyholders in the sharing of the risks arising from those assets."

EC4 Paragraph B79 states "The estimates of future cash flows and the discount rates that are disclosed to comply with paragraphs 73–85 shall not include any implicit adjustments for risk." This seems to conflict with Paragraph B75 in the case of contracts with cash flows that depend on underlying assets, as discussed above.

EC5 Since liquidity is one of the considerations in determining the discount rate, and liquidity involves uncertainty in the timing of cash flows, the discount rate should reflect uncertainty in the timing of cash flows (but not uncertainty in the amount of cash flows). We agree with the last sentence in Paragraph B72, which states that "applying paragraph B70(a) may result in different yield curves in practice, even in the same currency." Our understanding is that uncertainty regarding the timing of cash flows can be reflected in the discount rate and that the risk margin should provide for uncertainty regarding the amount of cash flows, but not necessarily their timing.

EC6 Paragraph 26(a) specifies that the discount rate for cash flows that depend on underlying items should reflect the extent of that dependence. The discount rate for such cash flows is thus different from the discount rate for cash flows that do not depend on underlying items. We agree with these descriptions of the discount rate and with the complexity in reporting that arises when cash flows under a single contract must be split in order to apply those two different discount rates. We also agree with the statement in BC58 that "Any separation of cash flows is, to some extent, arbitrary." That statement appears in the midst of discussion that mandates a specific method for separating cash flows for an example contract. We are concerned that guidance specific to that example could be generalized improperly to other contracts. In particular, some of the most common kinds of life insurance contracts issued in the U.S. could incorrectly be viewed as having some cash flows that depend on underlying items and some that do not. All cash flows under these contracts, which include some universal life contracts and some contracts issued by mutual companies, depend on underlying items. We interpret the exposure draft to impose no requirement to split the cash flows under such contracts into asset-dependent and non-dependent parts because all cash flows are asset-dependent.

EC7 It seems that the exposure draft anticipates using a full yield curve rather than a single discount rate in most situations. However, in some situations in which contract cash flows depend on returns on underlying assets, application of Paragraph 26(a) requires the use of a single discount rate to reflect that dependence. If the total return on the

underlying assets is shared equally with all insurance contracts regardless of the timing of the contract cash flows, use of a single discount rate based on the total return on the underlying assets (and developed using the top-down approach) should be used instead of a full yield curve. In that situation, one of the characteristics of the liability is the participation in the total return on the underlying assets regardless of the timing of cash flows, similar to the way returns on a mutual fund are shared equally by shareholders in the fund regardless of when those shares are withdrawn or sold. This situation occurs with many universal life insurance contracts and with many participating life insurance contracts issued by mutual companies. We agree with the discussion in BCA80 which concludes: "As a result, the discount rate for the liability would in part respond to changes in credit spreads and the effects of the mismatches might be reduced." The idea that the discount rate for the liability can respond to changes in credit spreads is vitally important in the valuation of long-term contracts under this exposure draft, especially those with cash flows that do not depend on underlying items. One example of such a contract is an annuity that provides fixed monthly payments for the remainder of the contract owner's lifetime.

EC8 The discount rate for such contracts can be determined using a "top-down" approach. This approach sets the discount rate equal to expected returns on assets of comparable duration, with adjustment for risks inherent in the assets that are not inherent in the liability such as expected and unexpected losses. Therefore, the "top-down" approach requires one to subtract credit spreads from the return on assets in order to get the discount rate for liabilities. We wish to clarify that the credit spreads to be subtracted can reflect a stable, long-term estimate of market credit spreads over the future rather than the currently observed market credit spreads. That is needed so that "the effects of mismatches might be reduced" as observed in paragraph BCA80.

EC9 If the credit spreads subtracted in the "top-down" method are not stable long-term estimates, the result is to introduce widely fluctuating valuations of unknown future losses into the measurement of net worth on the balance sheet. These fluctuations flow into net worth because they are to be included in the measurement of assets but not the measurement of liabilities. Fluctuations in credit spreads are reflected in the market valuation of assets but would be removed from the discount rate for liabilities.

EC10 It is well known that market credit spreads are both larger and much more volatile than actual credit losses. The effect of market volatility in such spreads should not flow immediately to net worth. The effect of such volatility is to bring in fluctuations in net worth that are known to be both larger and more volatile than actual credit losses.

EC11 Net worth reported based on fluctuating valuations of future credit losses is not useful information. If, instead, the credit spreads deducted from the discount rate for liabilities are stable long-term estimates, then the discount rate for both assets and liabilities will move in parallel and the volatility in net worth due to changing valuation of unknown future losses will be significantly reduced, as was observed at the end of BCA80. The resulting information will be more useful to users of financial reports.

EC12 In addition, we note that BCA81 states that "if there are no observable inputs for determining the discount rate, the entity should use an estimate that is consistent with the IASB's guidance on fair value measurement, in particular fair value measurements categorized within Level 3 of the fair value hierarchy" We agree with the comment in BCA81 that "because forecasts of unobservable inputs tend to put more weight on long term estimates than on short-term fluctuations, this counteracts concerns that current-period fluctuations in discount rates exaggerate the volatility of very long-dated liabilities." However, this does not address situations in which there are observable inputs at the long end of the yield curve but that data is based on markets that are not as deep or liquid as the shorter end of the yield curve. For such inputs, the guidance should permit an estimate consistent with level 3 fair value estimates. Such estimates would likely put some weight on the observable inputs but also would incorporate long-term estimates to some degree. This would mitigate the effect of short-term fluctuations in less reliable points of the yield curve, which can have substantial impacts to the insurance contract liability.

Extended comments regarding interest expense and related OCI

The measurement of interest expense for profit and loss is a complex issue. Our comments begin with a statement of our understanding of the IASB and FASB approaches to interest expense in profit and loss.

IASB approach:

EC13 As we understand the IASB approach, any cash flows that are contractually directly linked to returns on underlying items that are contractually required to be held would be subject to a valuation approach sometimes referred to as "mirroring," in which the liability matches the asset valuation, including the use of OCI. Any other cash flows in such contracts would be bifurcated into two components:

a. Fixed cash flows, for which the discount rates for net income purposes are locked in at inception, and
b. Other cash flows, for which no OCI would be recorded.

EC14 As we understand Paragraphs 33 and 34, contracts that would qualify for mirroring include European 90-10 contracts, variable and unit linked contracts, and participating whole life contracts within closed blocks. Typical participating life contracts within mutual insurance companies in the U.S. would not meet the criteria for mirroring because the mutual insurance company expects to retain an amount of capital in all future periods. We understand the term "direct" to include the interest credits on par whole life contracts, even though there may be some interest spread taken, by analogy to the use of term "direct" in Paragraph 60(h).

EC15 For contracts with cash flows that are expected to vary directly with returns on underlying items, but for which either the link is not contractual or the underlying items are not contractually required to be held, we understand that the cash flows would again be bifurcated into two components:

a. Fixed cash flows, for which the discount rates for net income purposes are locked in at inception; and
b. Other cash flows, for which no OCI would be recorded, except under unusual circumstances.[2]

EC16 As we understand Paragraph 60(h), contracts that would use this treatment include non-variable universal life contracts, fixed deferred annuity contracts, and participating whole life contracts issued by stock companies and not held within a closed block. We understand the use of the term "direct" to include the interest credits on such contracts; otherwise, it is unclear which features would be included within the scope of this paragraph.

EC17 We further understand that the universal life, deferred annuity and whole life contracts typically sold in the U.S. would not require splitting cash flows, since all cash flows, including death benefits, require the contract to remain in force. This depends to some extent on credited rates. We are concerned that without clarification, the language in the exposure draft could be read to require cash flow splitting. As such, our comment letter addresses that possibility.

EC18 For contracts with cash flows that do not depend on returns on underlying items, the discount rates for net income purposes are locked in at inception.

FASB approach:

EC19 Our understanding of the FASB approach is that contracts qualifying for the mirroring approach are the same as for the IASB. However, for cash flows that qualify for mirroring, there might be an adjustment to the liability to reflect any difference between the U.S. GAAP accounting basis of the underlying items and the basis on which the returns on the underlying items impact liability cash flows. For cash flows within such contracts that do not qualify for mirroring, there would be no bifurcation of cash flows. Rather, the discount rate used for net income purposes (the interest accretion rate) would be updated to reflect the impact of any change in credited rates on the projected future cash flows.

EC20 For contracts that do not qualify for mirroring but for which credited rates may change, the interest accretion rate would be adjusted as per the non-mirrored cash flows within a contract that qualifies for mirroring. For contracts with cash flows that do not vary with interest rates, the interest accretion rates would be locked in at inception.

Need for OCI for certain contracts:

EC21 Before getting to specific issues, we agree that OCI is necessary for certain contracts to provide relevant, representationally faithful information. Given that the IASB and FASB positions are to use current discount rates for insurance liabilities measured under the BBA, OCI is necessary to avoid obscuring the impact to net income of underwriting

[2] Our understanding is that OCI would be recorded on this component only if projected credited rates remain unchanged from the prior reporting period at all future durations. In that case, the discount rates used for net income purposes in the prior reporting period would continue to be used in the current period.

results with significant changes to the liability from changes in discount rates. Given the long duration of many insurance liabilities, and the near impossibility of perfectly matching the asset and liability cash flows in many cases, the use of current discount rates can cause large fluctuations in comprehensive income that often would be several times greater than the impact of underwriting results. This is particularly the case to the extent that changes in discount rates reverse over time. Even if asset and liability cash flows are matched, the fact that the IASB position is that the liability discount rate should not be equal to the yield on the assets backing the liability means that when interest rates change, the impact to asset and liability values will be different, creating volatility.[3] It is thus important for many contracts to separate the impact of changes in discount rate and show the change in OCI, similar to the use of OCI for many financial instruments.

EC22 OCI is particularly important for many insurance contracts given decisions within the financial instruments project to use amortized cost and fair value with certain changes in fair value presented in OCI as the classification for many financial instruments other than insurance contracts. For insurance contracts to show net income consistently with that of other financial instruments that are not held for trading, it is necessary for OCI to be used so that net income is consistently shown on an amortized cost basis.

Key concerns—Mandatory OCI:

EC23 One key concern we have with both the IASB and FASB approaches is the requirement to use OCI for all insurance contracts. Although there are many contracts for which OCI can provide reliable, representationally faithful information, there are at least two circumstances in which it may not do so. Thus, there needs to be an ability to exclude OCI under these circumstances.

EC24 For unpaid claim estimates related to contracts under the PAA, the current rate and not the discount rate at inception should be used for discounting and interest accretion. This still would allow for separation of underwriting and investment performance, provide information in a manner that is more consistent with the business model of contracts under the PAA, and would be far simpler from an implementation and disclosure perspective.

EC25 Insurance contracts eligible for the PAA are principally property/casualty contracts with a business model that is not an interest rate spread model. Rather, its business model is principally a claims management model. Claim settlement decisions do not depend on what interest rate was in effect at the time the contract that generated the claim was issued. While investment income is considered in the performance evaluation of property/casualty insurance companies and its claims function, the model is not an interest spread model due to the relative unpredictability of the amount needed for and

[3] For example, assume that both assets and liabilities have cash flows of Currency Units (CU) 10 per year for 20 years. Assume the asset yield is 6 percent and that the liability discount rate is determined to be 5.6 percent, producing an asset value of CU 114.7 and a liability value of CU 118.5. Because Macaulay duration is a function of both the cash flows and the discount rate, the assets would have a Macaulay duration of 8.605 years and the liabilities would have a Macaulay duration of 8.723 years, a more than 0.1 year mismatch. If interest rates declined by 1 percent, affecting assets and liabilities equally, the asset value would increase by CU 9.9 while the liability value would increase by CU 10.4, creating a mismatch in income despite the perfectly matched cash flows.

timing of claims. A typical approach taken to operate a property/casualty company is to manage the difference in durations between estimated claims payout and invested assets in the aggregate, while maintaining current liquidity to cover large settlements, catastrophic events and similar sources of volatility.

EC26 Further, this issue is more pronounced for those property/casualty insurance and reinsurance contracts that have claim emergence and settlement periods spanning many years, such as observed in workers compensation, excess liability, directors and officers, and casualty excess-of-loss reinsurance. For many larger insurance and reinsurance companies, a large portion of their unpaid claim liabilities arise from these contracts. Claims for these contracts tend to emerge very differently from that expected at contract issuance. There are often cases of initial claim recognition and changes in unpaid claim estimates being many years, even decades, after the original contract was issued. For example, most liabilities for asbestos related claims were only recognized and established decades after contract issuance. In these cases, discounting using the yield curves that existed at the issuance of the contract produces both irrelevant and useless information. In fact, discounting current changes in estimates using interest rates that existed in a different yield curve era has the potential to produce misleading income statement information.

EC27 Finally, using current rates is far simpler than having to track separate calculations, maintain differences through OCI and then work to explain such differences to users of the financial statements, particularly when such differences are most likely due to mechanical changes and not due to the economics of the business model.

EC28 For example, if there are two spinal cord cases outstanding, one with a locked in discount rate of 8 percent and another with a locked in discount rate of 4percent, and the allocation of the expected claims shifts between the two contracts, without impacting the overall expected claim costs or the timing of expected claims, net income will be affected because the different claims are being discounted at different rates for net income purposes. But since the economics of the situation are unaffected by a re-allocation of claim costs among different contracts, such net income effects are inconsistent with the business model.

EC29 Another situation in which OCI may not provide reliable, representationally faithful information is if the liability (or a portion) does not qualify for mirroring and the assets backing the liability (or relevant portion) are required to be held at fair value with all changes in fair value recorded in net income. If a significant portion of the assets backing the liability are required to be held at fair value through profit and loss, but the liability is required to use OCI, then OCI may create an accounting mismatch. For example, an insurer may actively trade its investment portfolio, making it ineligible for amortized cost treatment. Alternately, the investment strategy may involve extensive use of hedging instruments that are held at fair value through net income. This can be addressed by providing an option to exclude OCI on a contract if doing so would mitigate an accounting mismatch, similar to fair value option criteria being proposed in the financial instruments project.

Key concerns—Theoretical concerns regarding bifurcation of cash flows:

EC30 Under the IASB approach to OCI for contracts with returns that depend on underlying items, there is interpretation risk that the cash flows would be bifurcated. While it may make sense to treat any cash flows that qualify for mirroring separately, further bifurcation not only adds complexity but also creates accounting mismatches and misleading results. The cash flows under contracts that do not qualify for mirroring should not be bifurcated. Rather, a single, appropriate discount rate should be applied to all cash flows that do not qualify for mirroring for purposes of determining net income.

EC31 Although the wording is different for cash flows that do not qualify for mirroring within contracts for which some contracts qualify for mirroring (Paragraph 66), and for cash flows within contracts that do not qualify for mirroring (Paragraph 60), the result would be similar. The exposure draft says that there would be some fixed cash flows that would be valued at a discount rate (or curve) locked in at inception for net income purposes, and some "interest sensitive" cash flows for which current discount rates are used for net income purposes.[4] This approach is problematic in at least two ways:

a. Separating interest sensitive cash flows from fixed cash flows within a single contract, and
b. Revising the discount rate used for interest sensitive cash flows to current rates

EC32 Per Paragraph BC121 of the IASB Basis for Conclusions, the approach of updating the discount rate for interest sensitive cash flows is similar to the approach used for determining the amortized cost of a floating rate financial asset in Paragraph AG7 of IAS 39. However, when valuing a floating rate financial asset under Paragraph AG7 of IAS 39, the same updated effective yield applies to all cash flows within the financial asset, not just the interest sensitive cash flows. For example, in a 10-year indexed bond, with interest rates indexed to one-year U.S. Treasury yields, the interest payments vary depending on the index, but the principal payments are unaffected by such movements of the index. The amortized cost of the bond, however, is determined by applying the same discount rate to both the fixed principal cash flows and the interest sensitive interest cash flows. Doing otherwise would not produce a correct or meaningful amortized cost value. The combined impact of the lower (higher) cash interest payments would not be fully offset by the lower (higher) discount rate applied to those payments, since the difference would be offset by the lower (higher) discount rate applied to the principal repayments. As such, there would be a bias toward a lower present value (and gain on a liability) when interest rates decrease and a higher present value (and loss on a liability) when interest rates increase, regardless of the economics of the contract. Similarly, applying different discount rates for net income purposes to the fixed and interest sensitive cash flows within an insurance contract will produce results that are not meaningful.

[4] As noted above, we acknowledge that there may be some circumstances under which there could be some OCI for the interest sensitive cash flows within non-mirrored contracts, but we expect those circumstances to be rare. We also realize that we may be misinterpreting the word "direct" within Paragraph 60(h), and we assume that is not IASB's intention that discount rates be updated for UL and participating whole life interest credits. However, this would create an accounting mismatch in that the cash flows would change due to interest rates but the discount rate would remain constant. That would be similar to valuing an index bond at a locked in rate, which would be inconsistent with IAS 39 Paragraph AG7, and we assume that is not the IASB's intention for such insurance contracts.

Key concerns—Elimination of OCI for liability cash flows that depend on underlying items:

EC33 The other issue with the IASB's proposed OCI approach is that the discount rate applied to the interest sensitive cash flows for net income purposes appears to adjust all the way to current market yields.[5] By resetting the net income discount rate to current market rates, the discount rate used for net income is equal to the balance sheet discount rate, and there is no OCI. Paragraph AG7 of IAS 39 notes that when floating rate financial instrument is recognized initially at an amount equal to the principal payable at maturity "re-estimating the future interest payments normally has no significant effect on the carrying amount" of the financial instrument. We agree that this is an appropriate objective for the net income valuation of an insurance contract. But this is not achieved by adjusting the discount rate used for net income purposes to current market rates. Even with floating rate financial instruments, the change in discount rate per paragraph AG7 of IAS 39 is not necessarily equal to the change in the credited rate, especially if there is a discount or premium from inception of the instrument or if the re-valuation is performed on other than an interest rate reset date. And it is more so the case with insurance contracts, because credited rates on insurance contracts do not necessarily change by the full extent of the change in current period market interest rates. Typically, the credited rate is changes based on the change in yield based on the amortized cost of the assets backing the liabilities. Changing the discount rate by the full amount of the change in market rates when the credited rate changes less than that will create mismatches with amortized cost assets, and create mismatches within net income.

EC34 In contrast, the FASB approach to applying OCI for such contracts recognizes this issue. Per Paragraph BC149, the IASB did not consider this approach because it would recognize some changes in cash flow estimates in OCI. However, the FASB approach does not recognize changes in cash flows in OCI, rather it adjusts the discount rate in a manner consistent with the method used to value floating rate financial instruments at amortized cost. The impact of this discount rate would unwind naturally over time, as per the objective of OCI. Paragraph BC149 also notes a concern about interest expense being recognized in a different manner after the first period in which the interest accretion rate is adjusted from the manner that interest expense is recognized in prior periods. However, an approach similar to the current FASB approach to adjust the discount rate can be appropriate. Since projected credited rates change virtually every reporting period, we would expect that for most contracts the interest accretion rate would adjust in every reporting period, so that there would rarely be any opportunity for an inconsistency with an approach applied prior to the interest accretion rate adjusting. Nonetheless see the section below (*Future impact of FASB approach*) describing an adjustment to the current FASB proposal that we believe is necessary to fully reflect the characteristics of the liability.

EC35 We also are concerned about the IASB position on reporting changes in the value of options and guarantees in net income, rather than OCI. This is inconsistent with the reporting of similar features within financial instruments. For example, an interest rate floor within a floating rate financial instrument would not preclude reporting that

[5] We acknowledge that the IASB exposure draft does not explicitly say to what extent the discount rate is adjusted for such cash flows, but our interpretation is that it adjusts based on Paragraph 25.

instrument at amortized cost, with changes in value of the floor excluding from net income. It is unclear why a similar interest rate floor should not be reported in net income just because it is included within an insurance contract. Indeed, within an insurance contract the change in value of the floor would be shown in OCI. But, for a non-insurance financial instrument, the change would be excluded from total comprehensive income altogether. Of course, if the option or guarantee meets the definition of an embedded derivative that is not clearly and closely related to the host it would be bifurcated and reported in net income whether the financial liability was an insurance contract or not.[6] But if the IASB believes that certain other features need to be reported at current value through net income, criteria should be developed based on principles that would be applicable to all financial instruments. And, even if the IASB decides to report the change in value of options and guarantees through net income, the impact of floating rate cash flows on insurance contracts that are not part of the option or guarantee should not be excluded from OCI.

EC36 Further, even if it is appropriate for certain options to be excluded from OCI, the exclusion of "guarantees" from OCI are potentially a concern, since the very nature of insurance is to provide guarantees. For example, the death benefit in a term insurance contract is a "guarantee." As such, if certain options and certain guarantees are to be excluded from OCI, a precise definition of what is to be excluded is needed.

EC37 Although we think the FASB approach, adjusted as described below, is one appropriate method, other approaches to adjusting the discount rate for net income purposes also may be appropriate. We encourage IASB and FASB to agree on a single approach that will produce an "amortized cost" for insurance liabilities that is consistent with the approach to calculating amortized cost for financial assets.

Key concerns—Practical concerns about bifurcating cash flows:

EC38 In addition to theoretical concerns about bifurcating cash flows, we have a number of serious practical concerns. For example, when splitting interest sensitive cash flows from fixed cash flows within a universal life contract that does not qualify for mirroring, it is unclear how premiums should be treated. It is not clear whether premiums are fixed, because the premium amounts themselves do not have an interest component or they are interest sensitive, since the interest rate environment can cause policyholders to decide to pay more or less premium. It also may be possible to conclude that premiums should be allocated pro-rata based on the allocation between fixed and interest sensitive cash outflows. The allocation of premium to two buckets can have significant impacts on the net income presentation. Also, it may be possible to interpret the cash flows that would be paid up to a minimum interest guarantee be considered "fixed" while the cash flows over the guarantee would be considered "asset dependent," even if they are components of the same benefit (e.g., a death surrender benefit paid in a given period).

[6] An exception might be an embedded derivative that itself qualifies as an insurance contract. But a solution to that may be to require such insurance derivatives to be reported at current fulfillment value without OCI, but limit the OCI exclusion to such insurance derivatives.

EC39 Similarly, is the classification of fixed versus interest sensitive cash flows locked in at inception, or can the classification of particular cash flows shift over time? For example, a universal life contract may have a secondary guarantee on the death benefit that gets triggered when certain conditions are met. At inception, all the death benefits may be interest sensitive because until the conditions are met the contract could lapse due to the account balance running out, eliminating the death benefit. But after the conditions are met, those death benefits may not depend on interest rates. It is not clear whether the classification would change at the point the secondary guarantee conditions are met. This would be particularly problematic to implement if it were necessary to change classification of contracts during a projection, and likely produce results that are difficult to understand.

EC40 Although we agree with treating cash flows that are contractually linked to underlying assets using the "mirroring" approach, effectively bifurcating those cash flows from those using the building blocks, we have concerns about the approach suggested in the IASB exposure draft for doing that. In particular, the approach provided for splitting cash flows in a 90-10 contract do not seem applicable to other types of contracts that qualify for mirroring, such as variable annuities, since for these contracts the amount that qualifies for mirroring is not a fixed percentage of the underlying assets. Further, variable annuities can have general account funds, which vary directly with the underlying assets but there is no contractual link. Applying mirroring to such funds creates disparate accounting between such funds within variable annuities and similar funds within contracts with similar features that are within contracts that do not qualify for mirroring.

EC41 Therefore, although mirroring is appropriate, it should only be applied to the cash flows that are contractually linked to a fixed percentage (possibly 100 percent) of the underlying assets. All other cash flows in the contract, including interest credits and asset management expenses charges that might be described as "directly linked" to the underlying assets should be valued using the building blocks. Those cash flows should be eligible for OCI, similar to the cash flows non-mirrored universal life-type and participating contracts, using a technique that updates the discount rate used for net income purposes applied to all such cash flows based on the change in credited rates on the liability, or a similar approach.

Key concerns—Future impact of FASB approach:

EC42 Although the FASB approach for adjusting the interest accretion rate for changes in credited rates avoids net income impacts from current period changes in interest rates, there is an impact to the pattern of net income in the future. That is because often the interest rate projected to be credited to the insurance contract will change over time in the direction of the difference between the current credited rate and current market interest rates. Under the FASB approach, often when interest rates decline, the adjusted interest accretion rate will be lower than the projected credited rates in the near term but higher than the projected credited rates further in the future, and vice versa. This in turn can cause a pattern in which expected net income in the near term increases (decreases) and expected net income further in future decreases (increases) when interest rates decline (rise). Such impacts are not consistent with the economics of the contract.

EC43 This situation can be avoided by adjusting the approach such that the interest accretion rates are calculated to be consistent with the pattern of projected future credited rates. Instead of calculating a single effective yield, a constant spread (which could be positive or negative) would be calculated off of the path of projected credited rates, such that the value of the liability used for net income purposes after the change in both credited rates and interest accretion rates equaled the value of that liability before the changes in rates.[7]

EC44 This would accurately reflect the economics of the contract, in that the path of projected credited rates is a characteristic of the liability. Although this approach is slightly different than the calculation typically used for amortized cost bonds, it is different in a way that is consistent with the difference in the economics of the two types of contracts. Bonds generally have a single expected credited rate at any time – even indexed bonds would not generally project changes in future credited rates resulting from changes in the index as of any given valuation date. But nature of many universal life-type and participating insurance contracts is to have credited rates that are expected to change over time, even if the interest rate environment remains constant. This is a result of the fact that the credited rate typically moves only part of the way towards current market rates. And such projected credited rates are necessarily the rates used to project the future cash flows within the BBA. Thus, it is consistent with the characteristics of such liabilities to reflect the expected future changes in credited rates when determining the interest accretion rates.

EC45 There are some valid alternatives to such an approach, such as using a constant spread off the projected asset book yields. We understand that the IASB and FASB are concerned about using asset book yields as a basis for discounting these insurance liabilities, since they are concerned that the book yields do not necessarily reflect the characteristics of the liabilities. However, for insurance contracts for which the credited rates are based on underlying assets, even if there is not a contractual link, we believe that the asset book yields are relevant to the characteristics of the liability. But if the IASB and FASB disagree, an interest accretion rate based on projected credited rates as described above would be appropriate.

Other concerns—Interest sensitive cash flows:

EC46 Under the IASB and FASB approaches to OCI, the impact changes in interest sensitive cash flows, such as interest sensitive lapses, would be reported in net income or as an adjustment to the contractual service margin rather than in OCI. Many actuarial models incorporate a formula to automatically adjust such interest sensitive cash flows for the current interest environment. It could be operationally challenging to exclude the impacts to these formulas from the change in interest rates from the valuation. Thus it may be preferable to permit changes in interest sensitive cash flows to be reported in OCI, consistent with the change in discount rates.

[7] It may be possible to interpret the existing wording of the exposure draft to permit a path of interest accretion rates based on the path of expected future credited rates. However, even if this is the case, it would be helpful to clarify that point in order to make it more explicit and avoid confusion.

EC47 Please refer to EC64 in which we recommend a standard approach that can be used to separate the effect of changes in estimates into the part to be recognized in OCI and the part to be used to adjust the service margin.

Other concerns—Different mirroring approaches:

EC48 Although the IASB and FASB have proposed similar approaches for contracts that qualify for mirroring to the extent that the cash flows within those contracts qualify for mirroring, there are differences between their positions. In particular, they differ with respect to treatment of non-mirrored cash flows that vary directly with the underlying item, and whether an adjustment is needed to the mirrored liability value if the liability cash flows are based on a different accounting basis from the underlying items' accounting basis. On the former issue, as discussed above, it is unclear how the IASB treatment could apply to cash flows that vary directly but are not a fixed percentage of the underlying item. On the latter issue, both positions could be appropriate, and we would encourage the IASB and FASB to agree on unified position.

Other concerns—Discounting using yield curve:

EC49 Our understanding is that the discount rate used for net income purposes would generally be a full yield curve of rates rather than a single effective yield. It is unclear why this is necessary, since it is more complex than the single effective yield that is used for valuing the amortized cost of financial instruments. Using a full yield curve also can create a situation in which OCI is generated, even though the market yield curve has not changed, as a result of cash flows within a contract rolling through the locked in curve. While using a full yield curve may be appropriate in some circumstances, it should not be required in circumstances in which it would require more cost or effort than the benefit of the information. This often would be the case for contracts that use the PAA.

Other concerns—Interaction with adjusted contractual service margin:

EC50 We are concerned that the adjustment of the contractual service margin for changes in estimates of cash flows that are expected to vary directly with returns on underlying items and relate to future insurance services per Paragraph B68(e) may double count offsets that are already taken into account in OCI. The IASB should apply approaches to OCI and to adjusting the contractual service margin that will ensure there is no effect on net income resulting from changes in credited rates caused by changes in interest rates, while avoiding double counting any such impacts in the contractual service margin.

Hedged risks:

EC51 Similar to, but somewhat distinct from, our concern about mandatory OCI is the impact of OCI (and floating contractual service margin) when risks within an insurance contract are hedged using derivatives but OCI is otherwise appropriate for that contract. Since the unit of account is a portfolio, and a portfolio often remains open for some time after inception, and hedging often can only be effective at a portfolio level, IFRS 9 makes it difficult to achieve hedge accounting for hedged risks within a portfolio of insurance contracts. This could be addressed within the insurance contracts standard by allowing a version of hedge accounting for insurance contracts. If a hedged risk would qualify for hedge accounting under IFRS 9, other than for issues related to being part of a portfolio,

then that risk could qualify for a version of hedge accounting within the insurance standard. Subject to similar documentation requirements as for hedge accounting under IFRS 9, the cash flows related to the hedged risk within an insurance contract would not apply OCI and would not be subject to unlocking the contractual service margin. This would be similar to the treatment of hedged risks within financial instruments at fair value through net income.

Disclosure of confidence interval for risk adjustment:

EC52 We do not agree that disclosure of the equivalent confidence interval for the entire entity's insurance business should be required, for the following reasons:

a. Restricting the confidence level to the insurance elements of an insurance contract may provide misleading adequacy information about the entity's ability to satisfy its obligations with respect to the entire insurance contracts;
b. Use of the confidence interval method has inherent problems in providing useful information in many cases, especially those for which significant asymmetric risks exist. This method may be the least used approach to the determination of risks;
c. Aggregation of confidence intervals across product lines may be highly subjective; and
d. It may require entities to perform the equivalent of two valuations—one using the selected risk adjustment method(s) and the confidence interval method, possibly solving by trial-and-error the equivalent confidence over all portfolios.

EC53 While understand the underlying reason of the IASB in proposing this requirement, disclosure of the relationship between the risk adjustment and the overall liability by business segment should inform the user of the relative degree of adjustment for risk for the entity.

Other disclosures

EC54 No useful information is provided by the requirement to report portfolios in asset or liability position separately. It is normal for portfolios to be in an asset or liability position at different times over their lifetime. We note that presenting portfolios in an asset position separate from those in a liability position is cumbersome, particularly for entities with a large number of subsidiaries, systems, and portfolios. We suggest the requirement be eliminated.

EC55 Paragraph 93 (c) requires disclosure of a maturity analysis of net cash flows. For most insurance contracts that would be accounted for under the BBA, we do not believe that this is useful information, for several reasons:

a. The results could be misleading for very long-term contracts. It could appear that there is an asset/liability mismatch when participation mechanisms largely mitigate the mismatch.
b. Most insurance contracts do not have fixed maturities, so the timing is uncertain and tabular presentation could make the timing appear certain.

c. Since not all cash flows (e.g., overhead, general marketing, taxes) are included, this disclosure would have little use.

EC56 For these reasons, the maturity analysis of net cash flows should not be required for contracts accounted for under the BBA.

Likely effects of the new standard

EC57 We support the adoption of the BBA for measurement of all long-term insurance contracts. Elimination of the multiplicity of measurement models used in the past will improve consistency and make financial statements easier to understand.

EC58 For short-duration contracts that generally fall under the PAA mode, we understand that the proposal directs preparers to discount the liability for unpaid claim estimates since the time value of money is viewed as a basic tenet of finance. We agree with this basic tenet. We also understand the IASB proposals recognize another basic tenet of finance, that the value of certain cash flows is not the same as the value of uncertain cash flows without some reflection of risk and uncertainty.

EC59 There are alternatives that could can be used to reflect risk and uncertainty:

a. Through an explicit risk adjustment, either as an increase to the unpaid claim estimates, such as proposed by the IASB, or as an adjustment to the yield curve that is used to present value the liabilities; or

b. Through an implicit margin, such as the current accounting model under U.S. GAAP for short-duration contracts, where the amount of discount is offset implicitly by an adjustment for uncertainty by not discounting or restricting the extent of the discounting.

EC60 There are advantages and disadvantages to the above approaches:

a. Explicit risk adjustments can be tailored to better reflect the amount of uncertainty in the unpaid claim estimates. On the other hand, explicit risk adjustments likely would not be consistent among preparers, and such amounts cannot be back-tested. That is, it is not possible to know if a risk adjustment is a reasonably appropriate amount, whether it is too much, or whether it is not enough.

b. Implicit margins which, in substance, are consistent with today's U.S. GAAP accounting model for short-duration contracts, are not tailored to the degree of uncertainty. However, the current accounting model is simple, well understood, and more easily audited than the proposed model. It also generally has proven to be effective.

EC61 While approaches that reflect uncertainty have limitations, they are preferable to not recognizing uncertainty.

EC62 We also considered the value of using explicit margins to reflect risk and uncertainty, in which such amounts are set at contract inception and decreased as the company is released from risk. In our view, this approach would be unlikely to produce decision useful information for users. While such explicit margins may produce more consistency among preparers, they are not reactive to the degree of uncertainty of the estimates and can cause many practical difficulties for more erratic and/or longer-tail liabilities.

Clarity of drafting

The following is a list of issues on which the exposure draft is not clear. For each issue we first explain what is not clear and then suggest language to clarify any uncertainty.

EC63 **Issue:** For contracts with cash flows that depend on underlying items, the interest accretion rate used for interest expense is to be reset whenever changes in interest rates are expected to change the projected cash flows.

What is unclear? It is not clear what the basis of the re-set rate should be. One interpretation is that the new rate would be based on current market conditions and, thereby, would be the same as the discount rate used for balance sheet valuation. However, that interpretation would not support the concept that interest expense be measured on an amortized cost basis. For many contracts with cash flows that depend on underlying invested assets, the projected cash flows are expected to change whenever interest rates change, which occurs every reporting period to some degree. If the interest accretion rate is always reset to a current market rate, then interest expense constantly changes in a manner that is inconsistent with interest accretion on an amortized cost basis.

Suggested language: We suggest that the interest accretion rate section should be modified so that changes in the interest accretion rate are based on changes in the interest rate expected to be actually credited to the insurance contracts. The following language could be used in implementation guidance:

> The interest accretion rates generally should change in parallel with changes in interest crediting rates. Therefore the interest accretion rate should be equal to the expected crediting rates plus a level spread. On initial recognition of a contract, the level spread should be determined so that no OCI is created. When changes in interest rates lead to a change in expected cash flows, the interest accretion rates should be reset in a manner that recognizes any changes in the estimated interest crediting rates on a level-spread basis over the remaining life of the contracts.

EC64 **Issue:** It is not clear how the effect of changes in estimates are to be divided between those due to interest rate changes (which are reflected in OCI) and those related to future coverage and other future services (which are to adjust the service margin).

What is unclear? The cash flows under an insurance contract are often inter-related. For example, an increase in interest crediting can lead to an increase in expected future claim

payments due to automatic increases in the sum insured under the contract. Is the increase in future claim payments that arise due to an increase in interest rates to be reflected in OCI or in the service margin? What if expectations regarding the rate of future claims change at the same time?

Suggested drafting: When there are several changes in expectations at the same time, we suggest that a standard actuarial technique be used to separate the total effect into parts. The changes in expectations should be introduced one at a time, sequentially. The change in liability value due to each change in expectations can then easily be determined. However, the amount of change in liability due to each kind of change in expectations, as determined under this approach, will depend on the order in which the changes are introduced.

Whenever the changes in expectations include a change in interest rates, the change in interest rates could be the first change introduced in the sequence. The liability value reflecting changes only to interest rates will differ from the liability value before any change, and that difference should be used to adjust OCI. Normally, remaining changes in expectations are related to future coverage and other future services. The liability value reflecting all changes will differ from the liability value reflecting only the interest rate changes, and that difference can be used to adjust the service margin.

In the example discussed above in which an increase in expected future interest crediting leads to an increase in future claim payments, this procedure would reflect that increase in claim payments due to increased interest crediting rates in the measurement of OCI, not the margin. If at the same time expected rates of claim changed, then the additional effect on expected claim payments due to the change in claim rates would be quantified and used to adjust the margin.

Implementation guidance such as the following would help clarify this procedure:

> When changes in expectations lead to a change in the value of the liability, the effect of those changes must be divided between those that affect OCI (due to changes in interest rates) and those that affect the service margin (due to changes in cash flows that relate to future coverage and other services). In order to divide the total effect of changes in expectations, the change in liability due to the change in interest rates should be measured first and used in determining OCI. The remainder of the change in liability, due to changes in expectations, should be used to adjust the service margin.

Guidance such as this is needed to clarify that the effects of multiple changes in expectations should not be somehow double-counted.

EC65 **Issue:** Paragraphs 78(a) and 78(b) of the IASB exposure draft refer to amounts with respect to “insurance contracts issued.”

What is unclear? It is not clear whether "insurance contracts issued" refers to contracts issued in just the current reporting period or whether it includes contracts issued in previous reporting periods and still in force at the beginning of the current reporting period. If the latter is intended, we recommend clarifying the language as follows below.

Suggested drafting: Implementation guidance should clarify that the term "insurance contracts issued" is not limited to contracts issued in the current reporting period.

EC66 **Issue:** In Paragraph 82 of the IASB exposure draft, it states: "An entity shall disclose 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 the entity holds."

What is unclear? The phrase "interest on insurance contracts" could refer to either the interest accreted to the accounting liability or the interest credited to the contract owner under terms of the contract. If the intent is to refer to the interest accreted to the accounting liability, we would suggest clarifying the language as indicated below.

Suggested drafting: The phrase "interest on insurance contracts" could be changed to "interest accreted to the liability for insurance contracts."

EC67 **Issue:** There is frequent reference to sections of the exposure draft by paragraph. In many cases, this should be replaced by a description of what is being referenced with paragraph numbers in parentheses.

What is unclear? It's difficult to tell what the exception is without having to reread the referenced section.

Suggested drafting: For instance, references such as "Unless paragraph 35-40 apply" in Paragraph 29 should be replaced with words like "unless a contract uses the PAA (see paragraph 35-40)." This will simplify the intent and make understanding easier. There are many instances of this type of language that should be fixed.

EC68 **Issue:** There are a number of places in the exposure draft, Basis for Conclusions, and illustrative examples, in which the term "best reflects" or similar use of the word "best" appears.

What is unclear? It is difficult in practice to demonstrate that an estimate or method is the "best" that is available. This can cause some issues in determining the extent of effort required. Preparers should not be held to a standard that is expressed in terms of "best," unless there is some known practical limit to the application of the word. Auditors, likewise, will have difficulty reviewing the preparer's processes to ascertain if the estimates and assumptions are the best reflection of the circumstances, either in the view of the preparer or in the view of the users of the financial statements.

Suggested drafting: The IASB should replace "best reflects" (Paragraphs 32, 47(c), B89(a), B90(d), B91, IE16, IE17, IE Example 8) or "best represents" (Paragraph 92) with wording such as "faithfully represents." There are other uses of the term "best" in the documents that suggest "to the best extent possible" (BC147, D5) or other phrases including "best" with similar meaning (B48, BC102, BC144, BCA195).

EC70 Issue: Paragraph B68c is hard to understand.

What is unclear? There are three sentences in B68c. The second sentence is self-contradictory and the third sentence is circular. Here is the current drafting:

> B68(c) the contractual service margin is not adjusted for a delay or acceleration of repayments of investment components if the change in timing did not affect the cash flows relating to future services. For example, if an entity estimates that there will be a lower repayment in one period because of a corresponding higher repayment in a future period, the change in timing does not affect the cash flows relating to future periods. The contractual service margin is adjusted only for any net effect on the contractual service margin of the delay or acceleration.

Suggested drafting: We suggest the following replacement:

> B68(c) the contractual service margin is not adjusted for a delay or acceleration of repayments of investment components if the change in timing did not affect the cash flows relating to future services. For example, if an entity estimates that there will be a lower repayment in one period because of a corresponding higher repayment in a later period, the change in timing may affect the cash flows relating to future services. The contractual service margin is adjusted only for any net effect on the cash flows related to future services of the delay or acceleration.

EC71 Issue: Paragraphs B40 and B41 contain certain language concerning the unbiased probability-weighted expected value (statistical mean). Deleting certain language would avoid misinterpretations that may be unintended**.**

What is unclear? It should be unnecessary in certain cases to explicitly identify specific scenarios, a range of scenarios, explicit unbiased probability estimates of each scenario, or a probability distribution that represents the probabilities of various outcomes. For many types of insurance there is considerable actuarial literature that will be used to estimate the mean, such as the actuarial central estimate, without the need to develop explicit scenarios or probabilities, although in all such cases the range of possible outcomes is considered. The measurement objective is clearly stated in terms of the expected value being an unbiased estimate, representing a probability-weighted average, and should provide sufficient guidance for preparers, actuaries and auditors.

Suggested drafting: The IASB should delete the language concerning the need for explicit scenarios to estimate the mean. We recommend including language such as:

> For example, if an entity determines that the statistical mean can be estimated in a way that is consistent with the objective of appropriately considering the full range of possible outcomes and the associated unbiased probabilities, it is

acceptable to estimate the statistical mean without explicit scenarios and explicit probabilities.