Institute
and Faculty
of Actuaries

Exposure Draft ED/2013/7: Insurance Contracts

International Accounting Standards Board

Consultative Document

25 October 2013

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Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
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25 October 2013

Dear Mr Hoogevorst

Exposure Draft ED/2013/7: Insurance Contracts

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to comment on the Exposure Draft ED/2013/7: Insurance Contracts (2013 ED). We recognise and welcome the objectives of the International Accounting Standards Board (IASB) in producing this 2013 ED and the desirability of developing a global standard in the accounting approach for insurance contracts.

As the chartered professional body for UK actuaries, with members working in the insurance industry in the UK and abroad, the adoption of any standard in this area will directly affect the day-to-day work of many of our members. As such, the IFoA is committed to working with the IASB to ensure the standard that emerges from this consultation period achieves the goal of providing a global standard that faithfully represents the economics of insurance contracts and, at the same time, is practical to implement.

We have worked closely with the International Actuarial Association (IAA) in the production of its response and request that the IASB also consider the IAA's response for wider technical discussions of some of the points identified within the 2013 ED. In this covering letter, we summarise a number of points raised in our response. Our comments regarding the application of the 2013 ED primarily consider the UK, although other jurisdictions may well be similarly affected, and we expand our thoughts under the questions posed in the 2013 ED.

Welcome developments of the 2013 ED

We welcome that in many areas there have been improvements in the 2013 ED compared with the 30 July 2010 Exposure Draft ED/2010/8 (2010 ED). In particular we support:

- The proposed Building Block Approach (BBA), using a combination of the present value of fulfilment cash flows, a risk adjustment and a contractual service margin (CSM) releasing the day one profit in line with the fulfilment of coverage and other services over the service lifetime of the contracts.
- The principle of unlocking of the CSM, enabling the measurement model to move closer to a measurement approach that defers the recognition of profit to when the associated cash flows are incurred and the contract obligations fulfilled. We raise a number of points regarding the detailed proposals in this area in our response to Question 1.
- The change from the 2010 ED that the Premium-Allocation Approach (PAA) is no longer mandatory for short duration contracts.
- The revised approach to transition to apply the standard retrospectively if practicable, and with simplifications if this is not the case. We provide further details in our response to Question 5.
- The inclusion of more expenses in the measurement of the present value of fulfilment cash flows as we believe these expenses are an integral part of the policyholder liability.

- That a “top-down” approach is now permitted to be used in setting the discount rate.
- The change in definition of the risk adjustment principle, the fact that the method used to measure the risk adjustment is no longer prescribed, and that restrictions around allowing for the diversification effect have been removed.

The remainder of our comments set out our views on how the proposed standard may be further improved.

Concerns regarding the mandatory nature of the OCI approach

We welcome the IASB’s proposal to include the use of other comprehensive income (OCI) in the 2013 ED in response to the expressions of concern regarding the volatility that would have arisen in the profit or loss (P&L) in many jurisdictions had the proposals in the 2010 ED been implemented. However, we disagree with the **mandatory** recognition in OCI of all changes in discount rates from the inception of an insurance contract. This will introduce a significant accounting mismatch in P&L for the many asset types held by insurers that are required to be classified as fair value through P&L in IFRS, which will arise even for insurers who on an economic basis match asset and liability cash flows. A primary principle of the insurance industry is that assets and liabilities are managed together. The 2013 ED proposals do not reflect this and will lead to material accounting mismatches. We set out alternative proposals in our response to Question 4.

Complexity of the mirroring proposals

While we understand the concepts that have led to the mirroring proposals in the 2013 ED, we recommend in our response to Question 2 that the proposal of mirroring is removed from the 2013 ED and instead the BBA is used for such contracts which require the entity to hold underlying items and specify a link to their return. This recommendation, fully detailed in our response to Question 2, has been driven by a number of factors:

- The mirroring proposals move away from the BBA.
- The mirroring proposals require separate measurement of different types of cash flows. We consider these proposals to be complex from an implementation perspective, inconsistent with how the participating contracts are designed and priced, and not reflective of the interactions that exist in practice between different types of cash flows.
- We believe the combination of the CSM, OCI and mirroring proposals lead to increased likelihood of accounting mismatches, overly complex calculations, and challenges for users to understand financial statements. We believe that this concern is mitigated, to a large extent, by removing the concept of mirroring.

Inconsistencies in the circumstances in which the CSM is unlocked

While the 2013 ED defines the CSM as representing the unearned profit that the entity recognises as it provides services under the insurance contract, the CSM principle has not been fully developed for participating contracts. As drafted the 2013 ED imposes artificial constraints to exclude asset returns that are earned over the contract in line with the provision of services for these contracts. This creates inconsistent measurement of the CSM for participating contracts as compared to unit linked contracts where the CSM is recalibrated for the impact of changes in projected future fees arising from changes in asset values.

Appropriateness of the revised revenue presentation proposals

We support the revenue presentation approach described in the 2013 ED for short-term contracts eligible for the PAA as it is easier to implement; it approximates the BBA; and is akin to current practice for these contracts. For long-term contracts, we believe that the proposed approach leads to increased complexity and a disproportionate increase in associated work for preparers with uncertain benefit to users. In our response to Question 3 we set out our proposals for a mixed presentation model, with the revenue presentation approach used for PAA-eligible contracts and an approach similar to the 2010 ED summarised margin approach for longer-term business.

We trust that these comments will be useful to the IASB in further developing this standard. We reiterate the strong commitment of the IFoA to assist the IASB in this process and during the Post-Implementation Review period. If you have any further questions on the points raised in this response, please contact IFoA Policy Manager, Helena Dumycz, in the first instance (Helena.Dumycz@actuaries.org.uk; +44 (0) 20 7632 118).

Yours sincerely,

David Hare
President
Institute and Faculty of Actuaries

Q1. Adjusting the contractual service margin

We support the IASB's unlocking of the CSM, enabling the CSM to represent an ongoing measure of unearned profit in a portfolio of insurance contracts. This enables the P&L to faithfully capture the essence of profit being earned when expected cash flows are incurred and the contractual obligations fulfilled, thus enabling greater consistency with the balance sheet concept of the CSM at policy inception and the overall basis underpinning the 2013 ED measurement basis for insurance contracts.

In general, our response to this question revolves around expanding the role of the CSM, making it simpler to implement, and making it work more effectively.

1.1 Release of the CSM

We support the IASB's proposal to run off the CSM in line with the transfer of service.

1.2 Unit of account and accretion of interest

Paragraph 28 of the 2013 ED defines the unit for account for determining the CSM at inception to be at the level of a 'portfolio' of insurance contracts (as defined in Appendix A to the 2013 ED). The portfolio definition requires contracts that are 'priced similar to the risks taken on' to be grouped together which will result in a highly granular modelling of the CSM. The level of modelling would be more granular than that used by insurers to manage their business and would increase complexity due to resulting system requirements.

Following initial recognition of the CSM, there is no explicit unit of account in the 2013 ED for its subsequent amortisation. However, the requirement to accrete interest on the CSM using the discount rates at inception (paragraph 30(a)) will implicitly result in the requirement to model the CSM by individual cohort (i.e. by year of inception).

We believe that the proposed unit of account for the CSM is unnecessarily burdensome for preparers and is disproportionate for the uncertain level of enhanced clarity provided for users. We believe that a broader unit of account should be permitted and we offer our support in determining this.

We also refer to our response to Question 4 in section 4.2 where our alternative proposals include revisions to the accretion of interest and unlocking of the CSM.

1.3 Asymmetry around the order of events and resulting profit

Under the 2013 ED, negative changes in assumptions which more than extinguish the CSM brought forward and are subsequently followed by positive changes in assumptions for the same portfolio of insurance contracts would result in the reinstatement of the CSM albeit without recognising the prior loss through P&L. The newly established CSM is higher than the balance that would have been calculated if the sequence of assumption changes were reversed. We believe that this result is not a faithful representation of the insurance contracts' performance over the two periods.

We recommend that the IASB considers allowing previously recognised losses caused by the exhaustion of the CSM of a given portfolio to be reversed through the P&L before a new CSM for the same portfolio is re-established. This would avoid any asymmetric outcome from the sequencing of assumption changes.

1.4 Risk adjustment

The risk adjustment may be viewed as unearned profit related to unexpired risk. Consequently, we propose that changes in estimates of the risk adjustment related to future coverage go through the CSM rather than going straight to P&L as currently proposed in the 2013 ED. We are aware of practical methods for preparers to achieve this outcome and the positive advantage that the additional disclosures will explain how the profit profile is impacted, addressing the concerns set out in BC37.

1.5 The CSM and UK-style with-profits business

In the light of the benefits the CSM offers to faithfully represent the performance of insurance contracts, it is unfortunate that the 2013 ED does not identify a way to use the unlocking of the CSM that is appropriate for UK-style with-profits business. We believe it should be possible to identify an approach such that value, and changes in value, attributable to the insurer can be earned in line with the transfer of services over the remaining term of policies for UK-style with-profits business. This is dealt with in our response to Question 2.

Q2. Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

While we understand the ideas that led to the 2013 ED mirroring proposals and concur that matching should lead to a consistent measurement of the liabilities with the related assets, in practice we would recommend that the concept of mirroring is removed from the 2013 ED and instead the BBA is used for such contracts. This recommendation has been driven by a number of factors, set out in this section and in section 6.1 of our response to Question 6.

2.1 Separation of cash flows

The 2013 ED requires that cash flows are separated between those varying directly with returns on underlying items, those varying indirectly and other fixed cash flows. There are differences in the discount rate and projected investment return assumptions for each type of cash flow. There are also differences in the presentation of changes in underlying assets, discount rates and non-financial assumptions (between CSM, P&L and OCI) for each type of cash flow. As a result, each type of cash flow is required to be assessed separately and so effectively the 2013 ED requires unbundling of the cash flows even for closely related items. Current actuarial models that are used for regulatory (including both Solvency I and Solvency II in Europe), financial and embedded value reporting use a combined projection of all cash flows within either a single deterministic scenario, or within each scenario of a stochastic model. To implement the 2013 ED proposals will require multiple calculations for each contract, a significant increase in the practical burden for preparers compared with current practice.

We consider the proposals are too complex from an implementation perspective, are not consistent with how participating contracts are priced, designed and managed (that is, the interdependence of cash flows, the pooling of risk and provision of service rather than separation of cash flows) and do not reflect the interactions that exist between directly varying, indirectly varying and fixed cash flows in the way portrayed by the 2013 ED. Furthermore, the level of guidance relating to the method of separation of the cash flows (paragraphs B83 to B87) is insufficient to provide a unique separation for the complex range of insurance contracts that exist globally. The subjectivity is likely to result in inconsistent application of the requirements.

The allocation of the impact of changes in the liability (excluding CSM) arising from changes in the underlying assets, asset volatilities, discount rates, non-financial assumptions etc. between P&L, OCI and CSM is determined by taking the difference between the multiple calculations described above. The order in which the analysis is undertaken will impact the size of each explanatory item. As a consequence, the order will impact performance reporting, i.e. both profit for the period and equity.

We propose that all cash flows of a contract where there is a link to the returns on underlying items are measured in a single calculation (or a single calculation per scenario where a stochastic model is used), consistent with the BBA used for contracts where there is no linkage to underlying assets. Furthermore, the projected investment return assumptions and discount rate should reflect the extent to which the cash flows reflect the returns on the underlying assets (as set out in paragraph 26 of the 2013 ED).

2.2 Treatment for UK-style with-profits products (participating contracts)

UK-style with-profits products can be found in many countries in Europe, North America, Africa, Asia and Oceania. These products are characterised by discretion being left to the insurer in determining the distribution of profits to policyholders and hence shareholders, with investment and other sources of surplus being key considerations. Often a significant deferral of these will exist to reward the long-term investment objectives that purchasers of these contracts have.

The impact of changes in underlying assets on the shareholders' share of future profits on existing contracts and (depending on the interpretation of the 2013 ED in this regard – see section 6.3) the shareholders' share of the undistributed surplus (commonly known as the "estate") will be taken directly to P&L under the proposals in the 2013 ED. This does not reflect that the key obligation insurers have from issuing these contracts is to manage the returns of underlying items such that they would be able to provide smooth pay outs to policyholders thereby resulting in a similar smoothing of pay outs to shareholders from the same underlying items. This is the obligation that insurers issuing participating contracts have assumed and that the 2013 ED recognises in paragraph B66(k). The services provided by these contracts are asset management, the provision of protection benefits, administration, guarantees and participation in the returns of underlying items. Under the 2013 ED, profits or losses will not be recognised in line with the provision of these services.

Furthermore, it appears that with-profits contracts would exhibit a more volatile accounting profit profile than an equivalent unit linked contract as the impact of changes in underlying assets on future asset management charges in unit linked contracts is taken to the CSM (presuming this is the intention of paragraphs B68(d)/(e) and 66b). This does not reflect in a consistent manner the similar service transfer pattern of these two products.

We believe that it is possible to address this inconsistency by the use of a "floating" CSM. The contractual service margin should be recalibrated for changes in estimates of future cash flows resulting from changes in the value of underlying items, with the CSM released in line with the pattern of the transfer of services for these products. The floating CSM would be restricted to be non-negative, similar to the CSM for other product types, with unfavourable experience being recorded as losses for the year. We therefore recommend that the IASB reconsiders its previous rejection of a floating CSM solution.

Q3. Presentation of insurance contract revenue and expenses

The performance presentation approach described in the 2013 ED is a reasonable approach to presentation for short term insurance contracts.

However, we do not consider that the proposed performance presentation approach is a reasonable approach for many long term insurance contracts. In particular, we do not agree with the disaggregation of inter-dependent investment cash flows from the overall measurement of insurance contracts, as required in paragraph 58 for the measurement of revenue and incurred claims. Separating inter-dependent cash flows may reduce the reliability because it increases the variability of the calculation of revenue and incurred claims. We propose that paragraph 58 is deleted; however, we have also considered alternative solutions below, which, if used, would remove the need for paragraph 58.

For long term contracts, we believe that the proposed approach leads to increased complexity and much more work for preparers, with questionable value to users. This increased complexity arises in relation to the need to unbundle investment components (explained in the paragraph above), the unlocking of the CSM (see response to Question 1) and the separation of the unwind in the original discount rates and the variation in current discount rates (see response to Question 4).

Further, we do not consider that the proposed presentation basis will necessarily provide more transparent or useful information for users than is currently available in the public domain. Currently, many insurers use a "sources of cash flow" approach based on items such as premiums, claims, expenses and change in reserves, which provides useful information for management and investors. Alternatively, the "sources of surplus" approach advocated by the 2010 ED and the similar embedded value analysis of movement provide useful information for value-based management. It is questionable what the resulting presentation proposed in the 2013 ED will represent in relation to long term contracts and how useful it will therefore be to users and preparers. Consequently, we do not believe that there will be meaningful cross-sector comparability.

For long term contracts we consider that the summarised margin approach described in the 2010 ED, or more generally an analysis of sources of surplus approach, is more appropriate for showing the underlying performance of long term business measured using the BBA. This method is more likely to be used to make business decisions. Such a method also addresses the IASB concerns regarding savings-related premium being treated as revenue.

We understand that the IASB seeks for insurance contracts to be presented in the comprehensive income statement using similar principles to those applying to other similar contracts. The challenge faced is that insurance contracts encompass a diverse spectrum of contract designs. At one extreme, insurance contracts are similar to financial instruments, whilst other types of insurance contracts are much more like service contracts.

We believe that it will not be possible to find a single performance reporting basis that will appropriately present the performance of the wide diversity of insurance contracts in a manner consistent with other similar contracts, which also show a diverse range. Our recommended solution is therefore that there should be two performance reporting bases for insurance contracts.

In order to apply two measurement approaches we need to have a criteria to determine which presentation basis should apply. The following two options seem appropriate as potential solutions:

a) The choice of basis depends on the eligibility to use the PAA (regardless of whether the PAA is actually used or not) and this basis is already written into the standard. Contracts that are not eligible to use the PAA would use the Summarised Margin presentation. This would result in most non-life and group life contracts being reported under the Revenue presentation and most individual life contracts being reported under the Summarised Margin approach; or

b) The Summarised Margin approach is used for insurance contracts where the policyholders reasonably expect that at some time interval(s) over the coverage period or at maturity they will receive minimum benefits equal to premiums paid less incidental expenses from the contract. The Revenue presentation approach in the 2013 ED should then apply to all contracts where the policyholders do not anticipate any significant return from the insurance contracts unless an insured loss event occurs. We have developed this proposal further and would be happy to discuss this with you.

We recognise that this may make it difficult to make a direct comparison between contracts presented under each approach. Comparing life and general insurance contracts will always be difficult due to the fundamental differences in the nature of the contracts and their cash flows. Therefore, having a different presentation basis for each is not the only barrier to comparability and may in fact assist users in understanding the differences in the drivers of performance.

Q4. Interest expense in profit or loss

4.1 Mandatory recognition in OCI

We welcome the IASB's proposal to include the use of OCI in the 2013 ED in response to the many expressions of concern about the volatility that would have arisen in many jurisdictions had the proposals in the 2010 ED been implemented. However, we disagree with the mandatory recognition in OCI of all changes in discount rates from the inception of an insurance contract as we believe it will still result in volatility due to the different treatment of assets and liabilities. Mandatory recognition in OCI fails to reflect a primary principle of the insurance industry that assets and liabilities are managed together. This is both the business model and is applied for risk management purposes.

Currently IAS 39 and the impending IFRS 9 standard will only permit an OCI approach ("Fair Value through OCI" – FVOCI) to the presentation of changes in certain debt instruments while equities, derivatives, investment property etc. and other debt instruments (commonly held by the insurers to minimise potential mismatch of future cash flows) are required to be assessed at Fair Value through Profit or Loss (FVPL). Consequently an insurer, who on an economic basis matches asset and liability cash flows, is exposed to a significant and unjustified accounting mismatch in the income statement (where some of the assets are FVPL) if it were forced to use OCI for liabilities.

This approach neither provides relevant information nor faithfully represents an entity's financial performance. A common example of a product significantly impacted by the proposals would be a non-participating annuity in payment – an important pension product in many markets. The regular payments to the policyholder are closely matched on an economic basis through a combination of debt instruments, derivatives and other asset classes with similar characteristics. Many of these assets types will always be classified as FVPL in IAS 39 / IFRS 9, thereby causing the accounting mismatch.

We also have reservations more generally on the use of the OCI from a practicable and complexity perspective due to the requirement for multiple actuarial valuations and because, where assets and liabilities are economically matched, an accounting mismatch may arise due to the different timing of recycling gains and losses from OCI to P&L.

4.2 Alternatives to mandatory recognition in OCI

The overall principle should be consistency in the measurement and presentation of assets and liabilities to avoid accounting mismatches in the income statement where economically no such mismatches exist. In view of this principle and the current status of IFRS 9 developments, we briefly set out below two alternatives to mandatory OCI, each of which we believe is preferable to the 2013 ED proposal.

We would not propose to mandate recognition in P&L of all changes in the discount rate, as suggested in the 2010 ED. We acknowledge that this approach is not a global accounting solution, given the prevalence of the amortised cost and FVOCI assets in some territories and the IFRS 9 developments.

Alternative 1 – Optional recognition in P&L or OCI
In alternative 1, there is an option, restricted at outset for each portfolio of contracts (as defined in the 2013 ED), to either:

a) Present all changes in the liability resulting from changes in the discount rate in P&L. As a consequence, the CSM would both accrete interest and be unlocked for amounts determined at the current discount rate (rather than the rate at inception); or

b) Present all changes in the liability resulting from changes in the discount rate in OCI. As a consequence, the CSM would both accrete interest and be unlocked for amounts determined at the locked-in discount rate at inception.

The approach in a) would eliminate the accounting mismatch where the backing assets are FVPL. As it is an option, if the backing assets are FVOCI or amortised cost then the approach in b), to take discount rate changes to OCI, can be applied. Where the backing assets are partially FVOCI/amortised cost and FVPL, then adopting the IFRS 9 fair value option to move all assets to FVPL would eliminate accounting mismatches when applied together with the P&L option a) on the liabilities. The current transition measures in the 2013 ED would permit the IFRS 9 fair value option on first time adoption of the resulting Insurance Contracts Standard.

Alternative 2 – Aligning recognition to the business model

In alternative 2, the presentation of changes in the discount rate is determined according to the business model of the insurer. The concept of the business model in the resulting Insurance Contracts Standard would be aligned to the proposed IFRS 9 requirements, so as to achieve consistency in measurement and presentation of assets and liabilities. For example, the default approach for each portfolio could be to take all changes in discount rate to P&L unless the business model requirements result in amortised cost or FVOCI assessment of the assets where an OCI presentation would be permitted. The approach to the accretion of interest on the CSM would also be aligned as in alternative 1.

4.3 Cash flows that vary indirectly with returns on underlying item where paragraph 66 ("mirroring") does not apply

Under the 2013 ED, there are cash flows that vary indirectly with returns on underlying items where paragraph 66 does not apply. For these cash flows, it is not clear why the effect of interest rate changes on financial options & guarantees are presented in OCI for these contracts yet would go through P&L if the contracts were in the scope of paragraph 66 of the 2013 ED. We believe that there should be a consistent approach to the measurement and presentation of financial options and guarantees across the resulting Insurance Contracts Standard.

We believe that many index-linked contracts would fall outside the scope of paragraph 66. For these contracts, it is appropriate to assess changes in cash flows and discount rates for the purposes of unlocking the CSM and presentation in OCI to be changes in "real" (inflation adjusted) and not "nominal" amounts. We recommend that if cash flows and discounting use real returns then changes in interest rates and cash flows should be assessed on a real rather than nominal basis. The interaction between paragraphs 26 (real versus nominal discount rates) and paragraph 60(h) requires further clarification to achieve this consistency. We set out an example in section 6.1 of the potential unintended consequences if further clarification is not made available.

Q5. Effective date and transition

We strongly support the revised approach to transition to apply the standard retrospectively if practical, and with simplifications if not practical. We do have some concerns regarding some of the simplifications proposed by the 2013 ED which are addressed by the response from the IAA. Whilst we would prefer such changes to the draft we would be willing to accept no changes provided preparers and auditors were able to agree practical approaches going forwards.

We welcome the IASB suggestion within the 2013 ED that there will be approximately three years from the date of the final standard to implementation. Whilst three years is probably a reasonable period for larger preparers, a longer period may well be needed for small and medium sized companies and companies in less developed markets. Therefore, we would recommend that "approximately" becomes "at least three full years".

Q6. The likely effects of a Standard for insurance contracts

6.1 Interaction between CSM unlocking, OCI and mirroring

Our primary concern regarding Question 6 relates to the interaction of the CSM, OCI and mirroring proposals. While each proposal in isolation has some merit (notwithstanding the points that we raise above under Questions 1, 2 and 4 respectively), we believe the combination of proposals leads to:

a) An increased risk of introducing accounting mismatches on either the balance sheet or the income statement; and
b) An increase in the level of complexity in the calculations and in the difficulty of explaining the results.

This arises as the liabilities are decomposed into components where each component is measured and presented differently and full alignment with the IFRS 9 measurement and presentation of assets does not exist.

For example:

Example 1: Index linked annuities in payment
Consider a portfolio of index linked annuities in payment that are perfectly cash flow matched by a portfolio of index linked government bonds and assume that future inflation and nominal yields increase by the same amount, so real yields and the value of the bonds are unchanged. Whether you consider this change in a nominal or real context will impact the accounting result. However, the 2013 ED does not provide clarity on the approach to adopt. Paragraph 26 of the 2013 ED only refers to consistency between cash flows and discount rate.

In practice there is no economic impact from the change as the liabilities are economically matched. However, in the context of the accounting basis proposed, the position could be as follows:

- There is an increase in the claims outflow, increasing the base liability and consequently reducing the CSM on the balance sheet. To the extent the CSM does not become negative then there is no impact to the overall liability or P&L; and
- There is also an increase in the current discount rate used for the balance sheet, reducing the liability and increasing shareholder equity through OCI with no P&L impact; and
- In the income statement, the locked in interest rate used to unwind the liabilities is unchanged, but the interest received on the assets in future is now greater than before. So the "net" interest margin is higher in each period; and hence
- Going forward, the impact is a reduced contribution to P&L from the CSM offset by an increase in the interest rate margin.

The reported profit impact based on the 2013 ED proposals does not appear correct when economically the liability and backing asset are matched.

Example 2: Order of event
Actuarial experience in preparing an analysis of the change in liabilities highlights that the order in which changes are stepped through impacts the size of each explanatory item. In the 2013 ED, this is important as not all items are presented directly in profit or loss, so the ordering will impact performance reporting, both profit for the period and equity. There is no guidance on the order to adopt which will lead to inconsistent application.

6.2 Complexity of the proposals and implementation guidance

We believe the 2013 ED is complex and the insurance industry would welcome implementation guidance to be developed between now and the implementation of the standard, and for a period afterwards. We recommend an implementation guidance working group be formed to assist the industry with non-binding guidance, and offer our support for such a working group.

6.3 Measurement of the estate for UK-style "with-profits" contracts

For UK-style with-profits contracts, we understand that the intention of the 2013 ED is that the policyholders' share of the undistributed surplus (commonly known as the "estate") is treated as a liability. We believe the wording of the 2013 ED needs clarification in this regard, in particular given the combination of B66(k) (which refers to both "existing contracts" and "payments … made to current and future policyholders"), paragraphs 12 to 16 on recognition and paragraphs 23 and 24 on the contract boundary.

At a minimum, it would be useful to distinguish in the disclosures between the estate liability and other liabilities. We believe this would be of benefit to both mutual and proprietary insurers.

6.4 Risk Adjustment Confidence Interval Disclosure

We believe the proposal to require the risk adjustment to be re-calibrated to a confidence interval is impractical and of little theoretical benefit. It would require additional modelling for many companies that otherwise would have no need for such a technique.

A confidence interval as proposed may itself give a misleading impression even where it could be calculated. This is because it ignores the fact that the use of market-consistent financial assumptions incorporates a margin above a mean best estimate outcome. In addition, the methodology and assumptions used to determine the underlying risk distributions result in differences in the confidence level even if there are no differences in the risk adjustment between entities (and vice versa).

We believe that the IASB's desire for comparability across risk adjustments may be better addressed by requiring companies to disclose qualitative and quantitative information akin to IFRS 7 *Financial Instruments: Disclosures* requirements, for example comparing the risk adjustment with sensitivities showing the impact on the present value of fulfilment cash flows of different assumed best estimate assumptions for key non-economic risks.

6.5 Compliance costs

Our response deliberately does not cover Question 6(b) on compliance costs as this is likely more relevant for preparers under any standard to respond directly on. We also refer you to the comments set out in the IAA response.

<u>Q7. Clarity of drafting</u>

Wording matters that we have identified related to the topics covered by Questions 1 to 5 are covered under those sections of this response and we set out some drafting points relating to the discount rate and policyholder taxation below.

7.1 Discount rate

We welcome the clarification from the 2010 ED that both a "top-down" and "bottom-up" approach (paragraph B70) are permitted when setting the discount rate. We have a number of remarks on the supporting guidance:

- Paragraph B72: The implication from this paragraph is that the discount rate curves for cash flows which do not vary with the returns on underlying items should be the same for all liabilities in a given currency, and that this discount rate curve would be that which represented "an illiquid risk free curve". This would be true for all perfectly illiquid cash flows, but does not reflect the underlying characteristics of different liability cash flows which will have varying degrees of illiquidity. We recommend that the text is revised to reflect this.

- Paragraphs B70 and B74: In general, B74 is a prescriptive version of the guidance given under B70. It appears to introduce (when taken together with the final sentence B70(a)(i)) the elimination of all risk premiums in a top-down discount rate approach. We believe that this is not in line with the principles set out in paragraphs 25 and 26 of the ED. In our view, the IASB staff papers published in April and December 2011 more clearly articulate the principles of the ED.

  The prescriptive rules in B74 and in the final sentence of B70(a)(i) are unnecessary in light of the guidance in B70 regarding eliminating factors that are not relevant to the insurance contract when calculating a top-down discount rate. We suggest B74 and the final sentence of B70(a)(i) are removed.

- The extrapolation of market data (where reliable) to determine the full discount rate curve will be an important methodology for insurers adopting the new standard. We support the principles based approach set out in the 2013 ED (notably, paragraph B71 and general references to IFRS 13).

7.2 Policyholder taxation

We welcome the introduction of paragraph B66(i) which allows the fulfilment cash flows to include payments by the insurer in a fiduciary capacity to meet taxation obligations incurred by the policyholder. However, for some contracts written in the UK and in a number of other countries with similar taxation regimes, taxation is payable on investment returns that are entirely for the benefit of the policyholder (e.g. taxation payable on the returns in a unit linked or with profits fund where policyholder balances are adjusted to allow for the payment of such taxation). To include the gross return, without the taxation that will be suffered by the policyholder, will overstate the policyholder liability. We do not believe this scenario is captured within this paragraph and would suggest that adding an example on this topic in the final standard may help clarify IASB's intent in this area and confirm such scenarios are captured.

We would also contrast the wording in paragraph B66(i) with the wording in the Solvency II draft implementing measures which require best estimate cash flows to include taxation payments charged to policyholders or required to settle an insurance or reinsurance obligation. Solvency II best estimate liabilities would therefore include UK taxation payable on policyholder investment returns, in contrast to the possible outcome of the 2013 ED.