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ED/2013/7 Insurance Contracts

Grant Thornton International Ltd is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft ED 2013/7 *Insurance Contracts* (the 2013 ED). We have considered the 2013 ED as well as the accompanying draft Basis for Conclusions.

Our main comments are set out below. Our responses to the questions included in the 2013 ED are set out in the Appendix to this letter.

General comments

We support the Board's reasons for developing an IFRS on insurance contracts and welcome the publication of the 2013 ED as a major step towards the finalisation of that goal. We concur with the Board's view that there is an unacceptable degree of diversity in insurance accounting practices around the world and that the transparency of the effects of insurance contracts on an entity's financial position can be improved.

Producing a standard that can be applied to a wide variety of risk management products is inevitably a difficult task that will have far-reaching consequences. We were therefore pleased the Board decided to re-expose selected portions of the proposed accounting standard.

Support for the building block approach

In our comment letter on the earlier 2010 Exposure Draft (the 2010 ED), we supported the Board's proposed 'building block' approach but expressed some concerns over its application in some circumstances. We continue to support the building block approach, noting that it now takes into account:

- a contractual service margin (ie the expected contract profit), and
- fulfilment cash flows (that are determined from (i) a current, explicit and market consistent estimate of future cash flows (ii) the time value of money via discount rates, and (iii) an explicit risk adjustment).

We note and support here the change that has been made to include all the cash flows that relate directly to the fulfilment of a portfolio of contracts, including an allocation of fixed and variable overheads that are directly attributable to fulfilling that portfolio. Given this, the proposed change contained in the 2013 ED that will now require acquisition costs to be determined at the portfolio level (for both successful and

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unsuccessful efforts) rather than at the individual contract level appears a sensible one to make. In our comment letter on the 2010 ED, we had expressed a desire to see more guidance on determining the unit of account and we therefore welcome this change.

Concern over the appropriateness of a single accounting model

Despite our support for the Board's objectives and efforts to meet them, we have concerns that in attempting to develop a single accounting model that can be applied to a wide variety of risk management products, the Board has introduced an unnecessary, and in some instances an almost unworkable, level of complexity.

We explain our main concerns, and our suggestions on the direction that the Board's future work on insurance accounting should take, in the following paragraphs.

In our response to the 2010 ED we acknowledged to the Board that, in our opinion, there is currently an unacceptable diversity in insurance accounting practices around the world thus making the financial statements of many insurers complex and difficult to understand. While the one size fits all approach that the Board (and its predecessor) has favoured over the last 15 years might be regarded as the best way to reduce this diversity, this comes at a cost of introducing substantial complexity and associated compliance costs. In our view these costs may outweigh the benefits.

We also note that other projects that started with the goal of a single model to be applied to all circumstances have had to be flexed in order to be more operational in practice. We note the Board's recent proposals on the classification and measurement of financial instruments under IFRS 9 and the soon to be released standard on revenue recognition as examples.

In relation to insurance contracts, we believe the key to preventing undue complexity in the final standard is for the Board to focus on developing an accounting approach that will allow entities to more accurately reflect the differing economics of insurance contracts and insurers' business processes that exist in practice around the world. We see here an essential difference according to whether benefits payable to policyholders are based on: (a) benefits that are paid relative to fair value; or (b) benefits that are paid relative to amortised cost. We acknowledge that introducing a delineation based on this distinction will inevitably require accounting judgments to be made around the contract boundary. That said however, we believe similar problems are encountered in other areas of IFRS and experience has shown that they are capable of being overcome.

To illustrate the issue in more detail, we see at least five quite distinct insurance contract models in operation around the world:

1. Risk products under which the policyholder receives a benefit that is independent of the issuer's accounting measurement model, if the insured event happens within the term of the policy but nothing if the event does not happen. UK life term assurance is an obvious example, as is most general insurance (GI) business. The GI benefit depends on the severity of the event but this is not affected by the accounting measurement model.

2. Risk products under which the policyholder gets a benefit which is in part dependent on the accounting measurement model if the event occurs, but nothing if it does not. German term assurance plans are an example; they pay a small dividend each year which depends in part on the measure of investment gain for accounting purposes. The measure of investment gain for

accounting purposes as we understand it, is based on a combination of realised gains or losses and the increase in value of the underlying assets that are held as backing, which is measured on an amortised cost basis.

3. Risk products which make some payment to policyholders in most circumstances and where the payment is based wholly on the fair value of the backing assets. Unit linked savings plans are an example.

4. Risk products which make some payment to policyholders in most circumstances where the payment is based wholly or in part on the accounting measure of the investment gain where, as noted above, the gain is based on realised gains or losses and the increase in asset values under an amortised cost measurement model. Endowments found in European insurers are the key examples here. For example, Italian endowments consist of a proportion of the interest earnings plus a proportion (say 40%) of the realised gains. So if the accounting model does not report changes in the fair value through profit or loss, the policyholder does not receive a share of those changes.

5. Risk products which have some payment to policyholders in most circumstances where the payment is partly or wholly discretionary depending on what proportion of the underlying fair value growth or decrease of the assets is brought through to the policyholder accounts. UK, New Zealand and Australian with-profits insurance contracts are prominent examples of this type of product.

Our observation is that the approach proposed in the 2010 ED, with its option of fair value through profit or loss (FVTPL) for both assets and liabilities, would be operational for insurance contract models 1 and 3. The approach proposed in the 2013 ED would however create an almost unworkable approach to the profit or loss for such entities.

By way of contrast, the 2013 ED approach with fair value through other comprehensive income (OCI) is preferable for those entities which operate under models 2 and 4 above. The approach in the 2010 ED was problematic for them as it would undermine the stability of policyholder payments.

Insurance contract model 5 might have worked under the 2010 ED had the insurers been permitted to adopt a variable contact service margin (CSM) that could absorb the volatility of future payouts to shareholders in situations where such payments are themselves based on payments to policyholders (commonly known as '90:10 plans'). Our actuarial insurance specialists have indicated that it will be very demanding to provide the numbers under the proposals in the 2013 ED for entities that operate under such models.

Suggested course of action

Our recommendation is that the Board should acknowledge that at least two distinct insurance models exist when finalising its work on the project. We would expect all insurance products (including the five insurance contracts models noted above) to fall into one of these models where either: (a) the policyholder benefits are partly determined in line with accounting measures based on an amortised cost approach; or (b) the benefits paid to policyholders recognise in part the unrecognised gains and losses on the related assets (essentially a fair value approach).

In doing so, we suggest the Board could consider adapting the guidance that is now contained in IFRS 9 *Financial Instruments*, which reflects the presence of multiple business models. Should the Board move in this

direction, we believe it would be necessary for the standard to require appropriate disclosure of the accounting judgements that have been made to justify the use of a particular insurance accounting model.

Having done this the Board could determine that insurance contract models 1, 3 and 5 noted above would operate under the 2010 ED approach while insurance contract models 2 and 4 retain the 2013 ED approach. While not as elegant a solution as a single accounting model approach, the recognition of two related, but in many ways quite distinct, insurance contract models would be a pragmatic solution and one which we believe will give users of the financial statements the information they need to properly evaluate both life and non-life insurance contract arrangements.

Other matters

Firstly, despite our desire to see the Board alter its approach in order to reflect the differing economics of insurance contracts and insurers' business processes that exist around the world, we do not believe it is necessary for the Board to re-expose the proposed standard. The Board has already consulted extensively, having issued a Discussion Paper and two Exposure Drafts on the subject since first publishing IFRS 4 *Insurance Contracts*. Our suggested course of action is a mixture of the approaches already discussed in those documents, so we would hope that it would not result in substantial new work. We do believe however that it would be useful for the Board to release a 'Review Draft' (as it has done for the hedge accounting chapter of IFRS 9) prior to issuing the final Standard. Having such a document available for an extended period of say 180 days would be beneficial in that it would allow any 'fatal flaws' to be removed before issuing the Standard.

Secondly, we understand that field testing of the proposed standard in its latest configuration is currently underway. It would be most helpful to receive detailed feedback on this, before such a Review Draft is issued and also during the period that such a document is publicly available.

Thirdly, in our submission on the 2010 ED we specifically commented on discount rates and are pleased to now see two approaches (ie top-down and bottom-up) being outlined by the Board in the 2013 ED. Our view is that sufficient guidance has now been presented to provide actuaries with the direction they will need to determine the liabilities that should be reflected in the financial statements of insurers.

Fourthly, we were pleased to see the 2013 ED specifically addressing insurance contracts when a reinsurance contract is deemed to transfer a significant amount of insurance risk.

Fifthly, we would ask the Board to see if they can find a way forward that moves away from the variable CSM (proposed in the 2013 ED) and reverts back to the 'locked in' approach that was proposed in the 2010 ED. While the rationale for the proposed change made in the 2013 ED cannot be faulted, our view is that it has introduced yet another layer of complexity (and compliance cost) for those having to account for insurance contracts for what many would perceive is only a marginal benefit.

Finally, we believe it would be helpful if the Board sought to provide more explicit recognition in the final standard to the principles that underlie insurance in Islamic finance. We comment on this in more detail in the appendix.

Future work on insurance accounting

We acknowledge that at this late stage modifying the single accounting model approach that has been proposed will be challenging. However, we believe that reflecting the differing economics of insurance contracts and insurers' business processes that exist around the world is vital if the final standard is to achieve the significant improvements to insurance accounting that the Board is seeking.

While a great deal of complexity surrounds many longer term insurance contracts, we believe the Board should be able to draw on the findings of the research it has already carried out in order to now move towards issuing a final standard on insurance contracts. While it may be necessary to make certain compromises in order to finalise this project, we believe this will be outweighed by the benefits to be gained from increasing the comparability of various types of insurance contracts without introducing an undue level of complexity for preparers.

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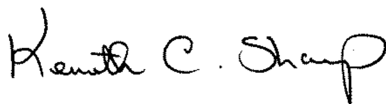
If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gti.gt.com or + 44 207 391 9510), on behalf of Grant Thornton International Ltd.

Yours sincerely,



Kenneth C. Sharp
Global Leader - Assurance Services
On behalf of Grant Thornton International Ltd

Appendix: Responses to Invitation to Comment questions

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:

(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?

In our covering letter we indicated that we would like the Board to consider two separate accounting models to cover the five different insurance contract arrangements we have identified. There may be others. Depending on the accounting model involved, the significance of adjusting the CSM could end up being quite different.

While we acknowledge that in our response to the 2010 comment letter we had questioned whether locking in the residual margin at inception would produce the most relevant information, our subsequent internal discussions have made us aware of the significant costs that would be required to comply with the approach proposed in the 2013 ED.

While we agree with the approach proposed in the 2013 ED from a technical perspective then, we are still attracted by the simplicity in locking in the CSM at inception and then releasing it systematically over the life of the contract. We encourage the Board to reassess the trade-off between technical purity and operationality in this area.

If the proposals in the 2013 ED are accepted, we see little merit in accreting interest on the CSM at a locked-in rate when all the other elements of the cash flows from insurance liabilities will be discounted using current rates. Our view is that this will add to the complexity of the calculations to be performed but will add little value for users of financial statements.

We agree that the CSM cannot be negative, so that changes in the CSM that are greater than the remaining contractual service margin should be recognised in profit or loss.

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

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

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

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

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

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

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

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

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

We agree that the mirroring approach is reasonable when an insurance contract requires the insurer to hold underlying items and there are direct links between the payments to the policyholder and the returns on those underlying items. However, there are some significant practical difficulties with this approach, particularly with regard to participating and with profit contracts.

Our concern is the amount of work required to disaggregate these contractual cash flows between those that are expected to vary directly with returns on the underlying financial assets will be extensive for both insurers and reinsurers. For example, although we accept it is technically possible to mirror the portion of the liability where cash flows vary with underlying items, when evaluating insurance contracts that in some instances were issued well over 50 years ago, putting the 2013 ED requirements into place for many entities is going to be very challenging.

To solve this, our recommendation to the IASB is to consider giving entities the option of mirroring if the insurer considers it relevant to their particular circumstances, much like the proposals in the 2010 ED.

And while some may view the change in terminology from 'unbundling' to 'separating components from an insurance contract' in the 2013 ED as simply semantics, now having clear direction to separate out (a) embedded derivatives, if they meet certain criteria (b) distinct investment components and (c) performance obligations to provide goods and services, is a useful refinement.

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?

In our response to the 2010 ED we supported the summarised margin approach. However we did make the comment that the request for volume information and alignment of revenue with other industries cannot be ignored. Our suggestion is that insurance companies be given a presentation option. The presentation option selected would need to be justified in the notes to the financial statements and once an entity has selected a particular presentation they would be obliged to continue with it unless the nature of their business was to change. This suggestion reflects our desire for the final standard to permit two accounting models depending on the characteristics of the insurance contracts they have issued.

Expanding on this suggestion, we believe the best outcome would be for the final standard to require the summarised margin approach to be used for insurance contracts where the policyholder receives a minimum benefit of premiums paid less incidental expenses. In situations where the policyholder does not expect a significant return from the contract unless an insured event occurs however, the earned revenue approach should be applied.

We also note that while the earned premium approach makes sense it will require a lot of work for some types of insurance. We do question the true value of providing information in that form to the users of the financial statements. We therefore ask the Board in its field testing leading up to the final release of this standard to seek specific feedback from preparers on this matter.

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?

We disagree with the proposal on cost-benefit grounds. Moving away from what was proposed in the 2010 ED, in accordance with which the effects of updating the discount rate were recognised in profit or loss, would introduce significant complexity for preparers. Our view is that accounting for the differences between discounted cash flows using current market rates and the discount rates at initial recognition in OCI will require preparers to make extensive changes to their systems in order to capture all the required data points that are needed to perform the calculations. While the conceptual reasons for proposing that movement in the discount rates be reflected in OCI is sound, our concern is that the level of effort required to bring this about will in many instances exceed the usefulness of the resulting information.

In relation to this point we note that for the last decade both New Zealand and Australia have been accounting for changes in the discount rate through profit or loss. Insurers in both jurisdictions have shown that over the longer term, this pragmatic basis of accounting has worked well and has provided sensible results for both internal and external decision makers.

As many commentators on the 2013 ED have noted, the proposed change will increase volatility where assets are measured at fair value and this is a consequence that concerns us.

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?

In our comment letter on the 2010 ED we encouraged the Board to consider retrospective application, and we are pleased to see the Board has done this. However, we would not be alone in saying that the 2013 ED proposals bring with them a considerable compliance cost for a benefit that is at best, difficult to assess.

Operationally there have been some very unusual market circumstances in the last decade (eg global interest rates at all-time lows, and in some instances, negative) that introduce another layer of complexity in terms of arriving at the amounts that should be reported in financial statements. Bearing this in mind, we would ask the Board to consider whether the option presented in the 2010 ED was untenable. Our view is that it was not; attempting to retrospectively reinvent the history of insurance contracts would add little value for the users of the financial statements.

Finally, in our previous submission to the Board we said we agreed that the complete version of IFRS 9 and the new insurance standard should have the same effective date. We continue to hold this view. Failure to align the full introduction of these two standards will introduce yet another layer of financial reporting complexity for those reporting entities that issue both insurance contracts and financial instruments and will put them through two rounds of major changes in a short period.

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.

Both the 2010 ED and the 2013 ED proposals have their relative strengths and weaknesses. Ideally we would like to see a blended approach of both in the final standard, in recognition that a one size fits all approach is unlikely to work well around the world, and even within

countries, given the diversity of insurance contracts that currently exist. We are not convinced then that the proposals in the 2013 ED will by themselves provide users with all the relevant information they need.

We believe that it will only be possible to evaluate the costs and benefits of implementing the 2013 ED's proposals when the results of the field testing that is currently underway in a number of countries around the world are known. Our feeling however is that the 2013 ED will significantly increase compliance costs for preparers because of the extensive changes that they will need to make to their information systems and the new disclosures that are proposed.

We recommend the Board to be aware of this when finalising the project and to look to introduce practical expedients where possible in order to keep the accounting for insurance contracts as simple as is practically possible.

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?

We agree that the proposals have been drafted clearly and are consistent with the decisions the IASB has made since the 2010 ED was issued. However, as noted in our covering letter, we do not agree with all the proposals contained in the 2013 ED.

Other matters – Islamic finance

As noted in our cover letter we believe it would be helpful if the Board sought to provide more explicit recognition in the proposed standard to **takaful** and the principles that underlie insurance in Islamic finance. Papers that have been presented at various meetings of the Asian-Oceanian Accounting Standard Setters Group are, in our opinion, helpful in recognising that:

- takaful differs from conventional insurance in that there is no sale and purchase of a policy between an insurance company and a participant

- takaful is often characterised by **tabarru**, a donation to a pool of funds, and **ta'awun**, mutual assistance among participants to the fund, and so exhibit features which are also shared by mutual insurance entities, and

- takaful operates as pools of participants' funds managed by a takaful operator and any 'top-up' of a fund which is in deficit, is an interest-free loan, **qard**[1]**.**

[1] In classical texts, **qard** would be provided out of benevolence and the provider would generally not expect repayment.

We would be pleased to share with the Board some of the application issues that currently exist with IFRS 4, and are likely to emerge with the issue of a new standard, in Islamic finance. We would be pleased to direct both IASB staff and Board members to experienced partners within our firm who are dealing with these matters.