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Mr Hans Hoogervorst, Chairman
International Accounting Standards Board (IASB)
30 Cannon Street
London EC4M 6XH
United Kingdom

October 25, 2013

Dear Mr Hoogervorst,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, we appreciate the opportunity to comment on the Exposure Draft ED/2013/7 *Insurance Contracts* (June 2013).

Principal authors of this comment letter were Daniela Bergmüller, Liane Hirner, Christoph Krischanitz, Andreas Rauter, Thomas Smrekar, Guido Sopp and Georg Weinberger.

GENERAL REMARKS

AFRAC welcomes the opportunity to comment on the new ED on insurance contracts. We appreciate the work that has been undertaken by the IASB on the re-exposure of the initial Exposure Draft for Insurance Contracts (“ED 2010”) to reflect the comments received from constituents and stakeholders.

Conceptually, we recognise that this project has resulted in significant improvements compared with ED 2010. However, there are a number of areas in the ED where we would like to comment and share our views with the IASB.

As a general point, the interaction between IFRS 4 and IFRS 9 must be borne in mind: this is a key issue for insurers (the issuers of contracts subject to IFRS 4), and needs be dealt with in greater detail. The relationship between assets and liabilities is the fundamental core of an insurer’s approach to managing its business and reporting its performance. We think the business model approach outlined in the ED does not sufficiently reflect the linkage between assets and insurance liabilities.

Consequently, we believe that the interaction between IFRS 4 and IFRS 9 needs to be improved to ultimately take account of ALM and avoid accounting mismatches. A comprehensive and consistent approach to FVOCI and Fair value through P&L (“FVPL”) measurement models for both assets and insurance liabilities is needed. We acknowledge that these issues are dealt with in DP/2013/1 *A Review of the Conceptual Framework for Financial Reporting* (July 2013), but want to emphasise that insurance contracts need to be considered in this respect.

We welcome the Board’s decision to introduce an OCI model in IFRS 4 and reintroduce FVOCI in IFRS 9, as we see OCI as a vital element in correctly reflecting the performance of certain insurance products in a current measurement environment. However, the OCI model as currently proposed would still result in many possible accounting mismatches. For example, accounting mismatches will occur where the insurer holds assets that cannot be measured at FVOCI, such as equities or real estate, where the insurer uses derivatives to mitigate risk in the insurance contracts, or where the insurer does not adopt ‘hold to collect’ or ‘hold to collect and sell’ business models for its assets.

IASB and FASB have both issued exposure drafts, and there are some key differences. We still support one global converged standard on accounting for insurance contracts. Nevertheless, we see the development of a comprehensive, transparent IFRS as more important in the near future.

SPECIFIC REMARKS

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?

AFRAC believes that the contractual service margin should represent the unearned profit in an insurance contract, as it considers that this results in decision-useful information.

As a result, AFRAC agrees with adjusting the contractual service margin as differences between the current and previous estimates of cash flows that relate to future coverage or services will affect the future profitability of the contracts. Such accounting would also avoid counterintuitive results of immediate recognition of adverse changes in estimates when contracts are profitable. In addition, it would be consistent with how the margin is determined at inception.

We acknowledge that interest accretion on the contractual service margin is required to maintain consistency with the revenue recognition proposals. However, the current requirement to use a locked-in discount rate to accrete interest is unduly complex, as it will require the unlocked contractual service margin to be tracked by cohort on a year-by-year basis in order to apply the appropriate locked-in rate. We believe that a practical expedient should be introduced to permit insurers to accrete interest at the current discount rate.

We support the requirement for the release of the contractual service margin to be in line with the pattern of services transferred under the contract. We believe that this is consistent with the definition of the contractual service margin as an amount representing the unearned profit under the contract.

However, no further guidance to determining the services provided under the insurance contract is given. AFRAC supports a clear statement in the standard so as to ensure that simplified techniques, such as an amortisation on a straight line basis, are also covered by the standard.

The ED requires that the contractual service margin should not be adjusted for changes in the risk adjustment, and that changes should instead be taken directly to profit or loss. This treatment is conceptually inconsistent with the unlocking of the contractual service margin for changes in the estimates of cash flows relating to future services. In our opinion, the change in risk margin cannot be seen as being separate from the change and the behaviour of future cash flows. Therefore, we believe the requirements should be amended so that the contractual service margin is also unlocked for changes in the risk adjustment that relate to changes in risk for future periods, in order to deal with both building blocks consistently.

We note that while the ED itself does not specify a unit of account for subsequently releasing (in accordance with the services provided) the CSM to profit or loss, BC113 in the Basis for Conclusion implies that the IASB believes the level of aggregation in practice will be based on a lower unit of account than the one insurers use to manage contracts, referring to contracts with “similar contract inception dates, coverage periods and service profiles” or at “individual contract level”. This suggests a very low level of aggregation which will be burdensome to apply in practice due to the complexity of tracking the subsequent measurement of the CSM at that level.

The ED requirements for reinsurance contracts held, as set out in paragraph 41, result in the cedant’s deferral of both a net gain and a net loss through the reinsurance contractual service margin. We do not consider this to provide either relevant information or a faithful representation of an entity’s performance. From an economic perspective, a reinsurance contract is highly dependent on the underlying direct insurance contracts, and we believe this fact should be taken into consideration when measuring the corresponding reinsurance asset.

Consequently, we believe that gains or losses on reinsurance contracts written on an individual loss basis ought to be immediately recognised by the ceding party.

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?

AFRAC supports ‘mirroring’ as a principle and some aspects of the proposed mirroring approach, as it might help to reduce accounting mismatch. However, AFRAC believes the proposed requirements are not only too complex but are also not providing an appropriate basis for reporting performance from these contracts. The ED currently does not sufficiently explain how specifically to apply mirroring in practice. Furthermore, the rules in B83–B87 in the application guidance seem to be counterintuitive and not understandable. It is also not fully clear how the rule in paragraph 26(a) interacts with the mirroring approach as laid out in paragraph 34(a).

Concerning the use of replicating portfolios, we strongly believe that the complexity of this approach and the difficulties in identifying replicating portfolios means that this approach does not lead to increased transparency of insurance accounting.

We would greatly appreciate it if the IASB revised the draft standard on the basis of the alternative floating residual model (“FRM”), which was developed by the insurance industry. We believe this model would simplify the accounting requirements for participating contracts and produce a more faithful representation of performance. Briefly summarised, the approach shows value changes of liabilities (covered by assets) in OCI, while value changes caused by reinvestment assumptions are set against the contractual service margin (as long as it is positive) or go to profit or loss (when CSM is zero). The main advantages of this approach are the recalibration of CSM for reinvestment assumptions, the valuation of guarantees together with liabilities and the absence of bifurcation of cash flows. A further important advantage of this approach is the smoothing of the risk adjustment. The industry proposal builds on the Building Block Approach, but it does not require the complex and artificial splitting of cash flows.

Generally, the FRM seems to provide a more understandable, transparent and comprehensive method of insurance accounting than the methods proposed in the ED. Transition would also be much easier, as this approach is closer to current accounting practices.

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?

AFRAC notes that the presentation of insurance contracts revenue and expenses is one of the most controversial topics in the proposed standard. The current proposal is different from the summarised margin approach in the previous ED 2010, in response to the request for volume information. It is trying to produce a more consistent approach with general revenue recognition and the Premium Allocation Approach ("PAA"). However, paragraph 58 of the ED requires amounts relating to investment components that are not unbundled to be disaggregated from the revenue, and incurred claims to be presented in profit or loss.

We have two key concerns in relation to this requirement. First, as outlined above, we are concerned that the requirement to disaggregate investment components from the earned premium revenue will be unduly costly to implement, as the data required is not readily available and is inherently difficult to obtain. Thus the costs of disaggregation would probably outweigh the benefits of presenting a revenue measure. Secondly, to the extent that the requirement is retained in the final standard, we are concerned about the definition of an investment component – it is only very broadly defined in Appendix A of the ED. We believe the definition will capture a wide range of insurance contracts and their components. Thirdly, we do not see why such investment components are treated differently for profit or loss purposes (paragraph 58) and recognition purposes (paragraphs 9-11).

We believe that the final standard should clearly communicate insurers' business performance to investors. We are not convinced that the proposals in the ED for the presentation of revenue and expenses provide insurance companies with the ability to do so. The formula-driven approach for deriving top line revenue will be difficult to explain to users, as it is very different from what entities are presenting today.

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?

AFRAC agrees with the IASB's proposal to present effects of changes in the discount rate in the insurance contracts liabilities as part of OCI and welcomes the Board's decision to introduce an OCI model in IFRS 4 and reintroduce FVOCI in IFRS 9, as we see OCI as a vital element in adequately reflecting the performance of certain insurance products in a current measurement environment. However, the OCI model as proposed in the ED would still result in many possible accounting mismatches. For example, accounting mismatches will occur where the insurer holds assets that cannot be measured at FVOCI, such as equities or real estate, where the insurer uses derivatives to mitigate risk in the insurance contracts, or where the insurer does not adopt 'hold to collect' or 'hold to collect and sell' business models for its assets.

The potential scale of these accounting mismatches demonstrates that it would always be crucial to make current value measurement through profit and loss available through a fair value option on both the asset and the liability side to eliminate or significantly reduce accounting mismatches. We believe that mandatory OCI presentation would give rise to misleading performance reporting for certain types of insurance transactions. Whilst we understand the IASB's desire for consistency, the mandatory OCI requirement has to be reconsidered to ensure meaningful performance reporting for insurance companies.

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?

We agree with the proposed modified retrospective approach for transition, as we understand that in many circumstances entities will be able be to generate reasonable estimates of the remaining contractual service margin based on historic public and internal information about the various portfolios.

We also believe that insurers should not be required, but should be permitted, to adopt IFRS 9 before the mandatory effective date of IFRS 4. Otherwise it may bring the usefulness of financial reporting for users in the period between IFRS 9 and IFRS 4 adoption into question, as users will experience two major changes in an insurer's financial statements in short succession. A staggered adoption would not result in improved financial reporting for insurers in the period between adoption of IFRS 9 and IFRS 4 due to the fundamental interaction of financial assets and insurance liabilities for insurers.

If an entity voluntarily applies IFRS 9 for financial instruments relating to insurance contracts before IFRS 4 comes into force, the entity should have full freedom to redesignate such financial instruments within IFRS 9 at the time IFRS 4 has to be implemented.

We strongly support the IASB's decision to introduce a fully retrospective application of the insurance contracts standard. We believe the most appropriate conceptual approach to transition is to require the determination of a contractual service margin on transition – even if it requires insurers to employ estimation techniques.

While we acknowledge that a full retrospective application is more complicated to apply in practice, the benefits of this approach vastly outweigh the costs of its implementation. Without fully retrospective application, inconsistent accounting models would be introduced for existing contracts and new business done after the transition date. We believe that the simplifications introduced by the IASB in the transition requirements achieve a good balance between reducing complexity while also ensuring that the valuation of the insurance contract liability on transition is appropriate.

We recommend a three year implementation period starting from the date of publication of the new insurance contracts standard.

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?

We note that the IASB believes that the revised proposals will result in more faithful representation and more relevant and timely information about insurance contracts than in the case of the 2010 Exposure Draft proposals and IFRS 4. Nonetheless, we would argue for comprehensive field-testing activities, especially with respect to the ED and its interaction with IFRS 9. The feedback to be expected from constituents and stakeholders could be very helpful in fully understanding problems concerning the interaction of these two standards as early as possible.

We should like to express our general doubt that – as a result of the ED'S high degree of complexity – the standard will lead to significantly more transparent financial statements of insurance companies. Especially the proposals on the long-term non-life business and the ones using the mirroring approach seem to leave room for improvements.

Taking into account the enormous effort of storing so much information for future reference and the increased time needed to perform multiple runs to adjust future cash flows with the current and updated discount rate for each portfolio, we expect that the ED's approach will lead to a significant cost burden for the insurance industry. We are not convinced that the benefits of the standard outweigh these costs.

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?

It is clear that it will always take time to understand a new principles-based standard. In the following cases, however, we consider that the ED needs clarification and more guidance:

- contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (see our comments on question 2); and
- presentation of insurance contract revenue and expenses (see our comments on question 3).

Generally, we would welcome inclusion of a comprehensive example in the illustrative financial statements.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl,

Chairman