Ref #445541

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International Accounting Standards Board
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Email: CommentLetters@iasb.org

Dear Sir/Madam

JOINT SAICA LONG-TERM INSURANCE PROJECT GROUP AND ACTUARIAL SOCIETY OF SOUTH AFRICA LIFE ASSURANCE COMMITTEE SUBMISSION ON EXPOSURE DRAFT ED/2013/7

In response to your request for comments on the IASB's Exposure Draft ED/2013/7 *A revision of ED/2010/8 Insurance Contracts*, attached is the joint comment letter prepared by the Long-term Insurance Project Group (LTIPG) of the South African Institute of Chartered Accountants (SAICA) and the Life Assurance Committee (LAC) of the Actuarial Society of South Africa (ASSA). This submission was prepared, based on input of preparers and auditors of financial statements from the long-term insurance industry in South Africa, in order to assess the impact that the proposals contained in the Exposure Draft (ED) will ultimately have on their financial reporting.

We thank you for the opportunity to provide comments on this document. Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

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GENERAL COMMENTS

With the exception of the mandatory use of Other Comprehensive Income (OCI), the South African long-term insurance industry and accounting and actuarial professions are generally in favour of most of the principles reflected in the revised ED. The individual proposals in isolation have some merit but we believe that it is in the interaction of the proposals that there are some substantial technical and practical issues. In particular we believe that:

- there is potential that significant accounting mismatches and resulting volatility in the income statement will be introduced for many insurers;
- there will be significant additional complexity in the calculations and in explaining the results to users; and
- there are likely to be significant additional costs that may not be justified by the benefits arising from some of the proposals.

In particular we note that South African insurer's traditionally fair value all their assets and measure liabilities at fair value or at current fulfilment value with changes in the valuation of assets and liabilities recognised in profit and loss (P&L) within the Statement of Comprehensive Income. The general business model followed by South African insurers is to broadly match their liabilities under insurance contracts with appropriate assets. Hedging strategies and derivatives are often used to further improve the matching between these assets and liabilities. Hence for South African insurers all sections of the standard which require certain components of revenue or changes in valuation to be separated and recognised in OCI both reduce the relevance of the resulting information communicated and make the preparation of the information more time consuming, complex and expensive.

Similarly, we believe that the requirement to retain original interest rates at inception of contracts and to perform calculations repeatedly using both current and initial interest rates to support some of the allocations between different components of the Statement of Comprehensive Income, add unnecessary complexity to performance reporting.

Further we are concerned that if analysts focus on the P&L (e.g. earnings per share) excluding OCI it could discourage insurers from hedging real risks, to the potential detriment of both policyholders and shareholders, as this hedging would result in volatility in profit excluding OCI. In the best case scenario, such insurers would continue to hedge real risks but struggle to explain their results to the market and incur substantial costs preparing numbers that were of little use to them.

We believe that many of the issues that arise could be addressed by allowing the use of OCI to be optional rather than mandated. To do so would remove a number of the complexities that arise as there would not be any artificial split in the Statement of Comprehensive Income between P&L and OCI.

SPECIFIC COMMENTS

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?

<u>Agree in principle with the proposal</u>

In principle we support the 'unlocking' of the contractual service margin (CSM) to reflect changes in future expectations. At its simplest level the CSM created at the issue of the portfolio of contracts is in essence the profit that would be expected to emerge over the life of the portfolio of contracts if the assumptions at inception were to be borne out in practice. Therefore it is conceptually consistent that changes in expected future cash flows relating to future coverage, and as a result, expected future profit should also be reflected in the CSM rather than directly in current period P&L leaving the original expected profit to emerge in the future. The proposed approach is generally considered to provide more relevant information to users of the financial statements and is consistent with a current measurement approach.

<u>Expand principle to risk adjustment</u>

There is a view that it would be conceptually appropriate to treat the changes in the risk adjustment in a similar manner. However there is recognition that the computational complexity involved would not be justified on a cost-benefit basis and the practical approach of taking changes in the risk adjustment directly to the P&L is appropriate.

<u>Movements from positive CSM to negative CSM</u>

We support the principle that an issuer should not be able to hold a negative CSM and that any change in the expected future cash flows that would make the CSM negative should be taken to P&L once the CSM has been exhausted. However it is not clear what should happen in the event that in a later period the CSM were to become positive again.

For example if a CSM of 100 was held and a change in the expected future cash flows (e.g. due to an increase in expected mortality following an analysis of experience) has an impact of negative 160, the CSM would be reduced to zero and 60 would be charged to the P&L. In the subsequent year a further experience analysis results in a change in future expected cash flows that has a positive impact of 90. It is not clear if the 90 should now be created as a new CSM, recognised in full in P&L, or if the previous 60 loss in P&L should be reversed in P&L and a new CSM of 30 be created.

Application where investment and risk components of a contract are linked to the value of underlying assets

Certain contracts issued in South Africa contain an investment component, based on either market linked indicators or including discretionary participating features, and a risk component that are inextricably intertwined. The value of the investment component of the contract is determined by the value of the underlying assets the insurer is required to hold. The policy also contains a risk component that provides a mortality benefit equal to the difference between the cover amount and the value of the investment component. The risk component therefore varies continuously based on the market value of the underlying investments. The annual policy charge comprises of a fee based on the value of the investment component as well as a charge based on the difference between the cover amount and the investment component (i.e. based on the amount of effective risk cover the policy provides at that point in time). These contracts are referred to as Universal Life in South Africa and are not unbundled due to the direct link between the investment and risk components. When there is good market performance the future net cash inflows increase and there would be a reduction in the present value of the cash flows relating to the risk portion. Paragraph B68(d) indicates that this would not generate an increase in the CSM but B68(e) seems to indicate that it would. We recommend that the CSM should be adjusted for the impact of market movements of the investment component on the value of future policy charge cash flows directly or indirectly linked to the investment component as set out in paragraph B68(e).

Interaction between 'unlocking principle' and other aspects of the exposure draft

The comments in response to question 1 provided above are given in isolation to the other aspects of the exposure draft such as 'mirroring', the inclusion of some items in P&L and others in OCI. These interactions are not insignificant and there are aspects of these where it is unclear what portions of change are recognised in each of P&L, OCI and CSM.

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 support the proposal in principle, but more guidance is required to ensure consistent application.

However, from a South African perspective the mirroring approach has less merit if the current mandatory requirement to recognise the impact of discount rate changes in OCI is removed or if the requirement becomes optional. For most insurers assets (backing contracts where the mirroring approach may typically be applied) are valued using a fair value through P&L approach and therefore if the OCI approach is removed or becomes optional then accounting mismatches with the liability measurement can be avoided. However, the mirroring approach remains appropriate for products with discretionary participation features.

We recommend that if the mirroring approach falls away for some reason, that the treatment of treasury shares and of owner occupied property in respect of discretionary participation business (where the investment risk is largely borne by policyholders) is changed to be consistent with the treatment for linked business.

<u>Definition of requirement to hold underlying assets</u>

The definition of when an insurer is required to hold the underlying assets is too restrictive (paragraph 33(a) and (b)), specifically the section stating: "... requires the entity to hold underlying items". Although in South Africa many contracts with discretionary participation features and Universal Life products (described in Q1 above) specify a link between policyholder payments and returns on an underlying portfolio of investments, and operationally the underlying items are held, there is not a contractual requirement to hold specific underlying assets, i.e. the policyholder specifies the type of exposure he/she wants (equities, balanced, etc.) but does not specify the specific investments that must be held in the portfolio. For these types of products, insurers tend to match the cash flows very precisely in order to avoid economic mismatches (paragraph BC 46), even though this may not be required by the contract.

It is our interpretation that these products will not meet the requirements of this section in many instances. Insurers will thus not be able to apply the proposed mirroring approach in the exposure draft despite the fact that asset and liability cash flows are matched. The proposals in the ED will therefore introduce accounting mismatches in the treatment of such contracts if these contracts are valued according to the building block approach (paragraph 18). An example is the impact of the change in discount rate on the liability that will be recognised in OCI while the impact on the assets (for example fair value changes) may be recognised differently (for example in P&L).

We recommend that the measurement approach set out in paragraph 34 be permitted for all portfolios where the business model requires asset liability management to avoid economic mismatches which implies an operational requirement to hold the underlying assets, even if there is not a contractual requirement to hold the underlying assets.

<u>Treatment of asset based fees</u>

Paragraph 34(a) requires that fulfilment cash flows that are expected to vary directly with returns on underlying items should be measured with reference to the carrying amount of the underlying items. We believe that the future asset based fees that vary directly with the value of underlying items should be included in the measurement of directly varying cash flows.

Asset based fees are implicitly allowed for in the difference between gross premium inflow and benefit outgo (as the investment component of benefit outgo is net of the asset based fees) when applying the building block approach (paragraphs 18 to 27) to an insurance contract with an investment component. This would therefore (correctly) result in a lower value of future fulfilment cash flows and a concomitantly higher CSM (i.e. CSM includes the present value of future asset based fees). Therefore, in order to ensure that the mirroring approach and the standard building block approach measures insurance contracts on a consistent basis it is important to recognise asset based fees as part of the fulfilment cash flows in the mirroring approach.

It is therefore recommended that the carrying value of fulfilment cash flows that are expected to vary directly with returns on underlying items should be net of the expected value of future asset based fees. This would ensure that the CSM established for contracts measured in terms of paragraph 34 would include the value of future asset based fees and therefore appropriately reflect the expected future profitability of the contract. There is no difference in principle between receiving a percentage of the assets under management or an amount per year from the policyholder. If asset based cash flows are not included as fulfilment cash flows for the purpose of valuing directly linked cash flows then many contracts with investment components may be onerous as future asset based fee income represents a significant portion of the revenue on such contracts and in many cases recover fixed outflows like expenses.

<u>Complexity of distinguishing between various cash flows</u>

The requirement to decompose the cash flows is open to several different interpretations and may reduce comparability of financial statements between different companies. As illustrated in the accompanying examples to the ED, there are often several different ways to decompose the cash flows. However, it is not always as clear cut as in the examples in the exposure draft on how to apply paragraph B85.

The requirement to distinguish between cash flows that vary indirectly with the returns on the underlying assets and cash flows that are not expected to vary with the returns on the underlying assets adds further complexity. We understand that indirectly linked cash flows generally include those cash flows resulting from options and guarantees embedded in insurance contracts. However, for Universal Life type business in South Africa many of the insurance cash flows also have a link to the return on the underlying assets as the sum at risk for the insurer is often the difference between a fixed sum assured and the value of the units.

These insurance cash flows may be considered to vary indirectly with the returns on the underlying assets and even though the proposals in the ED require that such cash flows are valued using the building block approach, the changes in such cash flows are recognised in P&L. This is different to other contracts/components for which the building block approach is applied where changes in future cash flows adjust the CSM. We believe the CSM should be adjusted for changes in future cash flows as set out in the paragraph above. Furthermore, it should be clarified that only changes in future indirectly linked cash flows relating to options and guarantees embedded in insurance contracts should be recognised in P&L.

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?

There is not a clear consensus in the South African long-term insurance industry and profession that the proposed presentation is more useful and meaningful for life insurance companies compared to the summarised margin approach.

However, there is strong consensus that the newly added requirements in the current exposure draft to recognise changes in discount rates in OCI would greatly increase the complexity of preparation of the revenue account to be presented and hence preparation costs. In addition, we believe that the proposed OCI requirements would make the information presented less meaningful and harder to understand for insurers who have opted to value assets matching insurance liabilities at fair value. We are hence recommending the following changes to the proposed standard:

- That the use of OCI for the impact of discount rate changes is a choice or only required for insurers valuing assets backing a portfolio using amortised cost or the fair value through OCI category;
- CSM brought forward is accreted interest at the current discount rates; and
- Changes to future expected cash flows taken to the CSM are also calculated using current discount rates.

We feel that these modifications are appropriate for an insurer managing and valuing a portfolio of insurance contacts and its backing assets using a fair value or current value approach. Provided that these modifications are made to the standard, we believe that presenting the gross performance will be reasonably feasible and not add greatly to the implementation costs of the standard. We also believe that these modifications would make the numbers presented in the revenue account more meaningful and easier to understand for insurers who value assets backing insurance business at fair value. In addition, these modifications would also assist with the consistency of IFRS reporting for groups with varied financial services lines.

Proponents of the proposed presentation relative to the summarised margin feel that it does give volume/ revenue information which is useful. It also avoids having to distinguish and exclude from the statement of comprehensive income expenses that are incurred for insurance contracts (excluded from the statement of comprehensive income under the summarised margin approach) from those incurred to administer investment contracts (included in the statement of comprehensive income). It also ensures more consistent disclosure for composite insurers that include long-term insurance, short-term insurance, investment management and other advice business.

Certain participants however still prefer the summarised margin approach as contained in the previous ED since this clearly showed the profits or losses arising from CSM changes, risk adjustment changes and experience adjustments separately, which they believe is more relevant information.

South African long-term insurers and insurance analysts have traditionally placed emphasis on summarised margin information. There is therefore a view that some readers may find information prepared by insurers for other purposes more relevant than the proposed revenue information in the IFRS accounts. Using the summarised margin approach will ensure better alignment between IFRS and internal MI in the view of some insurers.

In addition to the above overriding comments there are certain aspects of clarity and practical issues that the proposed presentation generates.

It appears potentially large items such as the impact of changes in expected future cash flows (where the CSM cannot absorb these) will flow through “actual claims and expenses” which may limit the usefulness of the numbers presented. Please clarify where it is intended such items be included.

While on balance there is a leaning towards support for the definition of insurance contract revenue in a period as set out in the ED, we recommend that the Board continues to work with preparers and users during its re-deliberations to determine whether the inclusion of revenue and expenses in the statement of comprehensive income will provide useful information.

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 do not agree that financial statements will provide relevant information that faithfully represents the entity's financial performance if the entity is required to segregate the effects of underwriting performance from the effects of changes in discount rates, as it will effectively prescribe different disclosure formats for the main risks undertaken by an insurer. This will reduce the usefulness of financial statements and increase the risk that users of financial statements do not fully appreciate the risks that the insurer is exposed to. It also significantly increases the complexity and cost of preparing financial statements.

The business of insurance requires the taking of various risks broadly split between performance of investment markets, including time value of money, and the occurrence of uncertain events for which the insurer is prepared to create contracted obligations. Best practice dictates that both risks require constant monitoring and, as best possible, the application of risk limits in the conduct of the insurer's business to maximise value creation within acceptable overall business risk. Consequently in our opinion the most appropriate measure of the insurer's performance in a reporting period is to reflect the outcome of the combined risk management through P&L. By segregating out discount rate changes to the liability we believe this creates a distortion between operating profit and the insurer's business model. This view is further supported by the following:

1) The proposed disclosure model will hide deliberate mismatching of assets and liabilities in OCI. Mismatching, whether deliberate or forced upon the insurer due to unavailability of matching assets, is a risk that users of the financial statements should be aware of and should be recognised in P&L as a consequence of the business model of the insurer. Where a policy of matching assets and liabilities is followed, the impact of interest rate changes will be muted and any remaining volatility can and should be explained to users of the financial statements.

2) Certain insurers hedge elements of interest rate exposure normally through derivative contracts. For such insurers, application of the proposed criteria combined with hedging principles in IFRS 9 is likely to be difficult and therefore artificial reporting mismatches are likely to occur and could end up in significant gross ups between P&L (derivative fair value measurement change) and discount rate change in OCI.

3) In most jurisdictions insurers are subject to solvency regulation which by its nature is aimed at capital preservation to protect policyholders and reduce the risk of business failure. The principles of combining fair values of assets and present values of liability obligations to determine excess capital are in many cases entrenched in this regulation. Changes in discount rates are not seen as a non-performance item but in reality the best view of the present value of the future net expected cash flows. The entity is obliged to manage the capital position on a current basis and this further supports our argument that interest rate management is integral (in fact critical) to the insurer's sustainable business model. The management of the capital position often influences the user's perception of the insurer's ability to efficiently utilise capital and understand net risk exposures. Therefore the result of this active management is important to assess and reporting faithfully the financial result, we believe, is best achieved through P&L.

4) The argument that the interest rate environment as it pertains to discounting best estimate future cash flows creates "excessive" volatility in the performance reporting that is not aligned to a "through the cycle" view of interest rates is flawed in our opinion as there is comprehensive evidence in many jurisdictions of fundamental shifts in interest rates environments that have extended for long periods of time.

5) The interaction with assets held to back liabilities (e.g. IFRS 9 *Financial Instruments*, IAS 40 *Investment Property,* etc.) is very important to avoid unintended reporting mismatches. Insurers in South Africa generally have comprehensive asset liability matching governance and hold appropriate portfolios of assets to match future contract obligations. These assets are designated as at fair value through P&L to interact with the current value liability measurement as currently applied. This has proven to be the best practical matching option to produce a reliable net P&L. To highlight this point are two examples:

   - Life Annuities – these cash flows are often matched with a basket of assets, typically debt instruments, through the use of swaps, investment properties, interest rate derivatives and equities. This is because capital markets at longer durations often (as is the case in South Africa) do not have debt instruments that are practical to purchase to match the cash outflow obligations. The proposed treatment of changes in discount rates will lead to substantial undesired volatility in P&L as it is very unlikely that the application of the proposed IFRS 9 classification, measurement and hedging requirements in these cases will result in the desired matching in P&L. Assets most likely will not have the same duration or may be sold to rebalance the asset/liability cash flow profile (with gains/losses on the assets recycled to the income statement) without a corresponding effect on insurance liabilities.
   - Products that have investment components that remain measured under IFRS 4, which do not meet the “mirroring“ criteria, will also probably result in undesirable accounting mismatch volatility in P&L under the proposed presentation. It is our opinion that under the current definition the bulk of South African contracts will not meet the “mirroring” criteria.

6) Adding the OCI component as compulsory is adding significant complexity in tracking measurement components across assets and liabilities that would be considerably simpler if not required. In addition, we believe the need to maintain the CSM at original discount rates would not be required if the OCI split is not applicable. Complexity also arises with order of attribution, for example are best estimate cash flow changes due to changes in demographic assumptions to be calculated before or after the discount rate change impact. Guidance would be required. The complexity will result in significant additional preparation cost without any additional benefit to users of the financial statements.

7) We are comfortable with the disclosure of the impact of discount rate changes to the insurance contracts measurement, which in any event would be needed in the reconciliation of movements in the various components of the insurance liability/ asset financial presentation disclosures.

We are strongly recommending that the compulsory recommended treatment of separating out impacts of discount rate changes into OCI be removed for the reasons articulated above. We support a fair value approach. In summary, management of expected future contracted cash flows is fundamental to the insurance model and measurement of these cash flows to current values is in our opinion critical to effective performance, risk and capital management. We do not support the argument that reporting interest charges/income at original contracted values in P&L is a better reflection of performance than adjusting to current prevailing interest rates. As a principle, we recommend accounting of performance should reflect economic reality, as represented by appropriate liquid capital markets, as best possible. This in our opinion will lead to better decision making and a more robust industry as it encourages better management of the true underlying risks. Accounting standards should avoid the possibility of insurance businesses being managed in a sub-optimal way.

If the IASB in their further deliberations is divided on this issue then we would advocate choice on the treatment to avoid prejudicing jurisdictions like South Africa that have for many years reported on the basis that all insurance liability measurement changes (current measurement basis) are reported through P&L. Not allowing for such a choice will mean a backward step for South African insurers from the current approach. Where an insurer has then opted to value financial instruments on a fair value through OCI basis (when allowed), that insurer should be required to reflect changes in values of insurance liabilities matched by these assets in OCI. This election should be allowed to differ across portfolios. This treatment should minimise the impact of accounting mismatches in the P&L account and simultaneously, ensure that no insurer's accounts are made unnecessarily complicated.

One other point under this topic although not directly related to the question is that the reporting of matching assets and the related insurance liabilities reflects the net outcome of asset liability management. Therefore as best possible measurement and presentation of each component should be consistent. This is important for the IASB to consider when completing both the IFRS 9 and IFRS 4 standards. To achieve this, and as applicable, we recommend that choice of measurement and presentation (between fair value through P&L and fair value through OCI) be included to allow preparers that have insurance businesses to avoid unintentional mismatch reporting. This choice, as applicable, can be introduced at portfolio of insurance contracts and matching assets level to avoid inconsistency in the application of IFRS 9 to other industries.

In this regard, the application of IFRS 3 business acquisitions in relation to insurance should also be considered to ensure that on acquisition of insurance businesses reporting entities should be able to achieve consistent application of asset and insurance contract measurement and presentation both at the consolidated group reporting level and at the acquired business level if separate IFRS compliant financial statements are reported.

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 consider a 3 year period between date of publication of the standard and required first application to be a fair period to implement the new standard.

We support and welcome the change to set up contractual service margins for existing portfolios on transition. Furthermore, the provision made for pragmatic approaches and the use of simplifications to calculate the CSM on transition is also welcomed.

<u>Retrospective calculation of CSM</u>

Our understanding is that in terms of paragraph C6 the CSM at initial recognition should be estimated using a combination of future expected cash flows at the beginning of the earliest period presented, together with cash flows that are known to have occurred between initial recognition and beginning of the earliest period presented, but it would be helpful to clarify this approach by a simple example.

In the South African industry there are still significant books of business that were written 20-30 years ago. Information of historic cash flows on these books is not available for more than 3-10 years. Historic regulatory returns do not provide cash flows at the level of granularity that will be required to calculate retrospective contractual margins for portfolios. The reality is therefore that the data to perform even the modified retrospective application is unlikely to be available and is likely to be unreliable.

Furthermore, in order to perform these retrospective CSM calculations for a tranche of business (say for a specific portfolio written in 2003) one would require actual historic cash flows, i.e. expenses, benefits, etc. in respect of the tranche it relates to. At the moment it is unlikely that this information would be available as accounting information is not split by tranche of business. This would mean that the only practical solution would be to base cash flows between initial recognition and beginning of the earliest period presented on estimates.

We recommend that the standard should be slightly less prescriptive regarding the simplified methodology that should be used to calculate the retrospective CSM and should allow other methodologies that would materially reproduce the same outcome as set out in the ED, but only where the retrospective contractual margin calculation cannot be performed due to a lack of data. Any approach adopted should be subject to the same disclosure requirements set out in the ED.

It is unclear whether the CSM would be unlocked for changes in future cash flows directly linked to investment components. For example, for contracts with investment components that have asset based cash flows (for example asset management fees) we have historically seen significant growth on the underlying investment components which have far exceeded the expected growth at initial recognition. This resulted in the expected value of future asset management fees being significantly higher than that expected at initial recognition. We recommend that it should be explicitly clarified that the CSM should be unlocked for changes in future directly linked cash flows. This would ensure that the CSM on transition would reliably capture the value of the unearned future profit for services still to be provided. We believe this is implicit in the requirements of paragraph C6 (a) that requires expected future cash flows at the beginning of the earliest period presented to be used, which would be based on the current value of investment components, but we believe that this should be clarified.

<u>Effective date of new insurance standard</u>

If the effective dates of IFRS 9 and the new insurance standard were to be different, we recommend that insurance groups should be allowed to reassess on adoption of the insurance standard whether their business models under IFRS 9 have changed due to the insurance contract accounting changes. This should ensure that decisions regarding the designation of assets can be made that would enhance and improve the information provided in financial statements and avoid accounting mismatches.

<u>Specific points</u>

The rationale and benefit of recognising separately in equity the cumulative effect of the difference between the expected present value of future cash flows at the earliest period presented using current discount rates and discount rates when the portfolios were initially recognized is not clear (Paragraph C3 (e)). If the carrying value of fulfillment cash flows is to be valued at current discount rates in the statement of financial position it is not clear why this split is required. Is there a requirement to present this difference in equity in subsequent reporting periods? It does not appear to be a requirement, the only requirement is in paragraph 64 and this only requires the recognition in OCI of the difference between the expected present value of future cash flows at the current discount rates and discount rates when the portfolios were initially recognised with no mention of the accumulated impact to be presented in equity.

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.

Overall, we believe that the costs of complying with the proposed requirements are justified by the benefits that the information will provide, apart from the presentation of the impact of interest rate changes in OCI and not measuring the CSM at current interest rates. Entities transitioning to the final standard may incur significant costs to comply with the new requirements. However, we believe the need for a global comprehensive standard for the accounting for insurance contracts outweighs these costs.

We believe that the proposals in the revised ED, except for the proposals on the changes in discount rates to be recognised in OCI, will provide significantly more transparency and comparability for users of financial statements of insurers. We also believe that our proposal to provide entities a choice to recognise changes in discount rates within P&L or directly in OCI will be less costly and complex to apply than the current proposals in the revised ED. We believe the proposals for OCI create significant complexity and that the costs of compiling this information significantly exceed any benefits.

<u>CSM</u>

We anticipate that for most South African insurers the calculations of the liabilities will be performed at a policy level but policies will need to be aggregated into ‘portfolios’ in order to determine the CSM at initial inception and monitoring it thereafter. We believe that this will require significant levels of additional information to be held and calculations to be performed, compared to the current approach in South Africa.

The extent of the additional information will further be impacted by how widely or narrowly the ‘portfolios’ are interpreted. These ‘portfolios’ will at a minimum be dependent on the date of issue and need to be separated into at least annual tranches/ cohorts (dependent on changes in yield curves in a period) of policies since the original discount rate at inception must be used for the determination of the change in the CSM.

Some of this complexity and cost implications may be removed if the changes in the CSM are based on current interest rates that are reset at each valuation date which may allow portfolios/ cohorts to be effectively aggregated over time.

<u>Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items</u>

We believe that there are several practical difficulties when applying the standard which are as follows:

- Separating different cash flows from the same contract is in many instances not consistent with the way insurers manage these books of business.
- Insurers will have to do multiple valuation runs and keep track of the movement in various components in order to value the different components and present them in the financial statements.

<u>Presenting insurance contract revenue</u>

The cost of preparing suitable revenue disclosure could exceed the benefits of this information, particularly for old-fashioned bundled structures. It is possible that some simpler and easier to provide disclosure, such as expected risk premiums for the year would better meet analysts needs and save on preparation costs.

For the purpose of preparing the statement of financial position, it is not necessary to unbundle insurance contracts with investment features where the insurance and investment components are closely linked. However the proposed disclosure now makes it necessary for insurers to do this unbundling for the statement of comprehensive income. This may be difficult (if not impossible) for certain contracts such as reversionary bonus contracts.

Splitting out the investment components of claims incurred in-between valuation dates can be problematic. Currently for many products with inter-related benefits (such as where on death the client receives the maximum of account balance and a fixed sum assured) it is not important to capture the investment components separate from the death benefit component for accounting purposes. Systems were therefore not designed to capture this separately, although this info is available at valuation dates. It will be costly to change systems to capture this. For some products like Reversionary bonus it is impossible to know what the investment component is.

<u>OCI</u>

South African insurers traditionally fair value all their assets and measure liabilities at fair value or a current value with movements in value reflected in the income statement. They would tend to select assets to at least broadly match their liabilities under insurance contracts. They often use hedging strategies and derivatives to further improve the match between their assets and liabilities. Hence for South African insurers all sections of the standard which require certain bits of revenue to be split out and shown separately in OCI both reduce the relevance of the resulting information communicated, and make the preparation of the information more time consuming and expensive.

If analysts focus on the P&L excluding OCI, this could discourage insurers from hedging real risks as this hedging would lead to volatility in profit excluding OCI. In the best case scenario, such insurers would continue to hedge real risks but have to struggle to explain their results to the market and incur substantial costs preparing numbers that were of little use to them.

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?

In our response to questions 1 to 5 we have included comments on sections of the proposed standard we found unclear. In addition, we believe the following proposals are not clearly drafted and have included our recommended changes:

Combination of insurance contracts (Paragraph 8)

We believe that the reference to "insurance contract" should not be that narrow, i.e. the paragraph should only refer to "contracts' as it could be possible when two contracts are considered together, that they do not meet the criteria to be classified as an insurance contract. Based on the change proposed it is further proposed to change the reference from "policyholder" to "counterparty" as in many fronting arrangements different party would be perceived to be the policyholder.

The paragraph currently refers to "contracts entered into at or near the same time". We would like to propose that the IASB also include the following wording: "or contracts that are otherwise interdependent". The proposed wording will ensure that even contracts that have not been entered into at or near the same time are still considered with other interdependent contracts and accounted for as one contract where appropriate.

Recycling from OCI to P&L (Paragraph 65)

Recycling is proposed for any remaining amounts in OCI when an entity derecognises insurance contracts. We believe that recycling is only necessary when a portfolio transfer/ disposal occurs. In all other scenarios any amounts recognised in OCI will materially reverse in OCI before de-recognition of the insurance contracts.

Disclosure (Paragraph 74)

The requirement to distinguish between portfolios of insurance contracts which are in an asset position from those which are in a liability position (as required by paragraph 54) will add complexity. This will especially be the case when the portfolio switches from being in an asset to a liability position from one period to the next. A similar comment applies to the disclosure in respect of reinsurance contracts (paragraph 55). Doing this split is not a problem for statements of financial position reporting but becomes problematic for any disclosures requiring a build-up to be done from the opening to the closing position. Allowing insurers to prepare build-up disclosures using net balances would avoid build-up problems.

Significant insurance risk

Under the current guidance in IFRS 4, where an insurer sells a contract where the benefit is defined as the value of the investment, subject to a guaranteed minimum benefit on death of a return of all contributions, this contract is considered to be an insurance contract on the basis that it is quite possible for a negative return to be earned over certain period on this contract and in these circumstances there would definitely be a sum assured at risk.

It is unclear whether under the guidance proposed in B19 (which does not currently exist in IFRS 4) these contracts should still be classified as insurance. The Board should provide clarity whether it was the intention to change the definition of an insurance contract by the application guidance in B19.