ACTUARIAL SOCIETY OF SOUTH AFRICA

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International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
United Kingdom

Email: CommentLetters@iasb.org

Dear Sir/Madam

JOINT SAICA SHORT-TERM INSURANCE PROJECT GROUP AND ACTUARIAL SOCIETY OF SOUTH AFRICA SHORT-TERM INSURANCE 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 Short-term Insurance Project Group (STIPG) of the South African Institute of Chartered Accountants (SAICA) and the Short-term Insurance Committee (STIC) of the Actuarial Society of South Africa (ASSA). This submission was prepared, based on input of preparers and auditors of financial statements from the short-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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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?

We agree with proposals in the ED regarding the adjustments to the contractual service margin. We believe that it is appropriate that the contractual service margin (i.e. deferred profit) should be updated for changes in expected cash flows relating to the future coverage. We believe this will result in improved representation of the financial position and performance of entities.

We believe that unlocking the contractual service margin for changes in expected future cash flows relating to future coverage will align the building block approach closer to the premium allocation approach. If an insurance contract is not onerous, changes in expected future cash flows are not recognised in profit or loss immediately but over the coverage period based on the pattern of transfer of services.

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?

These types of contracts are generally not applicable to the short-term insurance industry in South Africa, therefore we have not provided comments.

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?

We agree that the financial statements of entities would provide relevant information if insurance contract revenue and expenses are presented and this presentation is in line with revenue recognition principles applied to non-insurance contracts with customers.

However, we do foresee that some short-term insurers will voluntary present volume information in the notes to the statement of profit or loss and other comprehensive income, for example gross written premium and combined ratios. This disclosure will be in addition to the insurance contract revenue presented on the face of the statement of profit or loss and other comprehensive income to provide additional information to users.

We agree that insurance contract revenue and incurred claims should exclude investment components that have not been separated (paragraph 58).

In the short-term insurance industry, paragraph 58 will specifically be applicable to an insurance contract with an experience account issued to an insured. In terms of such a contract, the insured will receive back the premium paid to the insurer (less a fee of for example 3%) either as a refund of the deposit component or through submission of insurance claims. The insurer may be required to pay claims to the value of for example 20% of the gross premium charged for the contract (i.e. after the initial premium has been paid back to the policyholder to settle claims).

Applying the proposals in the ED, the 3% fee will be reflected as insurance contract revenue as the insurer is exposed to insurance risk as possible claims to the value of 20% of the gross premium may be payable.

In the example above, the insurer would have underwritten the insurance component with the full knowledge that the insured's rights to the investment component (i.e. deposit component) would be void if a claim is submitted under the insurance component. The insurer would not have offered the same insurance benefits if the option to claw back the investment component did not exist. Therefore, there are short-term insurers that question whether the fee (in the example above) will reflect this interdependence.

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 with the proposal to recognise the differences between the locked-in interest rate on day one and the current rate in other comprehensive income (OCI) as this will add significant and unnecessary complexity. In addition, this will have an unnecessarily high demand on systems as the two interest curves (i.e. the curve which is applied upon initial recognition and the curve applicable at each reporting date) would need to be tracked consistently over each contract term. We believe that interest calculated using a current interest rate should be recognised in profit or loss. We therefore agree with the 2010 exposure draft proposals.

Short-term insurance contracts are often administered by intermediaries. This adds further operational complexity in terms of data requirements. The insurer would for example be required to obtain data about the inception dates of the policies from the intermediary to calculate the interest to be recognised in profit or loss and OCI. If a current rate is used, this would significantly reduce system complexities.

We propose that entities should be required to recognise interest (using current rates) in profit or loss. However, entities should be allowed (as an optional alternative) to recognise the effect of a change in discount rates on the carrying amount of the insurance contract in OCI. In our view, this will allow entities in other jurisdictions which prefer so, to recognise the difference in discount rates in OCI.

We acknowledge that the IASB indicated that in allowing an option it would result in a lack of comparability and it could reduce transparency across entities that issue insurance contracts (paragraph BC 143). However, we believe that by allowing accounting policy choices in other International Financial Reporting Standards (IFRS), the financial statements of different entities are also not comparable. Therefore, we do not agree with the IASB's reason for not allowing an option to recognise the changes in interest expense in profit or loss or OCI.

The recognition of the effect of different interest curves in OCI will address an accounting mismatch only in the event that the assets held to back the insurance contracts qualify for recognition at fair value through OCI. This could be the case if the assets held comprise 'vanilla' bonds (based on the proposed amendment to IFRS 9 *Financial Instruments* (IFRS 9)) or similar instruments. However, short-term insurers often hold cash or money market instruments to back the insurance liabilities which might not be measured at fair value through OCI. In this case, the entity would prefer recognition of the interest expense in profit or loss to match the treatment of the assets held by short-term insurers.

True elimination of an accounting mismatch would only be achieved if the underlying assets are interest bearing. In the event that the insurer holds equity instruments, these may be measured at fair value through OCI but offset of the amounts recognised in OCI (i.e. relating to the equity instruments and insurance liability) would not be achieved owing to different valuation bases.

A further complication arises as the amount recognised in OCI is required to be recycled to profit or loss upon termination of the policy. In the short-term insurance industry, in most instances only long-tail claims liabilities will be discounted. Given the inherent uncertainty of the payment date of these claims and the fact that only incurred claims will be discounted in most cases, the exact timing of when these cash flows will happen is very difficult to estimate compared to a homogeneous portfolio and therefore tracking on a policy level will be required. However amounts recognised in OCI will not necessarily reverse over time (as indicated in paragraph BC 121(a)), especially where timing differ significantly from that estimated in previous periods. In addition when contracts are derecognised as a result of contract modifications or portfolio transfers, the amounts recognised in OCI will not reverse over time. If changes in discount rates are recognised in profit or loss this will simplify the accounting.

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 that the proposed approach to transition would balance comparability with verifiability. We agree with the proposal that unearned profits on contracts should be recognised on transition as part of the insurance contract liability and not as a retained earnings adjustment as proposed under the 2010 exposure draft (building block cash flows with a risk adjustment but no contractual service margin).

However, the transition arrangements are largely not applicable to the South African short-term insurance industry.

We would prefer the alignment of the effective dates of the future standard on insurance contracts and IFRS 9 as we believe it will simplify the implementation process. Alternatively in our view, insurers should be allowed to adopt IFRS 9 at the same time as the new insurance 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 believe that the disclosures proposed in the ED will improve the transparency in the financial statements of the effects of insurance contracts. The measurement models will improve the comparability between financial statements of different entities that issue insurance contracts.

We believe that the costs of complying with the majority of the proposals in the ED are justified by the benefits that the information will provide.

Proposal in ED	**Analysis of benefits and costs**
Adjusting the contractual service margin	The insurer will be required to incur ongoing costs to keep track of the contractual service margin (which might be required to be done on a contract by contract level).
Presentation of insurance contract revenue and expenses	We do not believe that short-term insurers will be required to incur significant additional costs to present insurance contract revenue and expenses.
Interest expense in profit or loss	We do not agree that the benefits outweigh the costs of this proposal. We are of the view that significant additional costs would need to be incurred to develop, implement and maintain a system that distinguishes between the interest rate at inception and subsequent changes in such an interest rate for insurance contracts. If the interest expense is recognised in profit or loss, those short-term insurers for which the effect of discounting will be material, will incur fewer costs under our proposal than when the proposals in the ED is followed.
Effective date and transition	We believe that some entities will be required to incur additional costs on transition (in applying the transition requirements or in updating existing systems and processes). However, we believe it will be justified as the costs will be incurred once-off.

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 in the ED are clearly drafted but have the following comments:

<u>Fixed-fee service contracts</u>

Paragraph 7(e) indicates that fixed-fee service contracts that have as their primary purpose the provision of services and that meet certain conditions will be outside the scope of the insurance standard. Generally insurance companies could be seen as providing services, for example legal assistance business which does meet the definition of an insurance contract but have been excluded from the scope of the proposed standard.

We therefore recommend that entities that issue these fixed-fee service contracts should not be required to apply the revenue standard, i.e. they should be provided with an exemption from applying the revenue standard. Such an exemption will allow these entities to still apply the robust insurance standard if their business model is that of an insurer, especially if they deem these to be insurance.

<u>Financial guarantee contracts</u>

Paragraph 7(f) states that financial guarantee contracts are outside the scope of the insurance standard unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts.

This will imply that new insurers issuing financial guarantee contracts will be required to apply IFRS 9 to these contracts. In addition, no entity that previously accounted for financial guarantee contracts in terms of IAS 39 *Financial Instruments: Recognition and Measurement* can on adoption of the new insurance standard elect to account for these contracts as insurance contracts.

We would recommend that insurers (new and existing) should be able to make an election on adoption of the new standard, to account for financial guarantee contracts as insurance contracts or in terms of IFRS 9.

<u>Reinsurance contracts held</u>

Paragraph 41(a)(i) states that an entity shall recognise a reinsurance contract held from the beginning of the coverage period of the reinsurance contract if the reinsurance contract provides coverage for the aggregate losses of a portfolio of underlying contracts.

We would recommend that aggregate losses are defined.