

03 March 2017

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Dear Nic

IFRS 17—completion of the insurance contracts Standard

I wish to take this opportunity to again thank you, Gérald Harlin and Dieter Wemmer for meeting with Sue Lloyd, Darrel Scott and me on 11 January 2017 and for the follow up letter dated 2 February 2017 sharing some editorial suggestions for the final drafting of the Standard.

I agree with you that it was helpful to discuss perspectives on the project. The external editorial review process focuses on the clarity of the drafting of the International Accounting Standards Board's (the Board) decision and to confirm that there are no internal inconsistencies in the draft Standard, or inconsistencies with other IFRS Standards. Due to its limited scope, we ask reviewers with specialist skills in reviewing technical accounting requirements (eg national standard-setters) to participate in their personal capacity. Nonetheless, the CFO Forum's engagement and contribution throughout the project's long history has been valuable to the development of a high quality Standard. I especially note your members' contribution to the four rounds of field work conducted on the operationality when applying the proposals which will form the basis of the new Standard. Also, I note that specific aspects of the draft Standard have been made available on our website.

I bring to your attention the decisions, and the accompanying agenda papers, from the IASB February 2017 meeting's discussion on the project. After consideration of the feedback received from you and others, the Board has revised some of its previous decisions and addressed many of the editorial points you raised.

Your letter noted three areas where you think further changes are necessary which I will address in turn.

Level of aggregation

At our meeting with you, we noted that we had previously considered the operational concerns raised on the unit of account and that it was one of the Board's considerations in amending the unit of account to a group of insurance contracts. We noted your comment that some may nonetheless be interpreting those revised requirements in such a way that it is more difficult to apply than intended. At the IASB February 2017 meeting, the Board acknowledged these comments and undertook to clarify those in the drafting of the final Standard. A current staff draft of the level of aggregation requirements was included in Agenda Paper 2C for the IASB February 2017 meeting (Agenda Paper 2C).

At our meeting with you, we also noted your concerns on the level of aggregation requirements when there are specific constraints of law or regulation on pricing. At the February 2017 meeting, the Board decided to provide an exemption to address those concerns.

Accounting mismatches

Your letter noted the concern that accounting mismatches may arise from applying the model.

The Board has noted that the development of an accounting model for insurance contracts will inevitably result in possible accounting mismatches because of the different basis of accounting measurement in other Standards. Nonetheless, the Board has sought to minimise the extent of accounting mismatch wherever possible. In particular, I note that this was one of the reasons for permitting an entity an accounting policy choice on presenting changes arising from financial market assumptions in profit or loss, or disaggregated between profit or loss and other comprehensive income (OCI). This was done even though the Board thinks that the use of options is less than ideal because it makes the financial statements users' analysis more difficult. This presentation option is in addition to the choices available in IFRS 9 *Financial Instruments* to address accounting mismatches

Your letter specifically notes mismatches in the context of hedging, re-insurance activities and the use of a locked-in discount rate.

On reinsurance, we noted that the Board has dealt with most of the mismatches that arise between re-insurance contracts and primary contracts. We consider that the remaining mismatch arise from economic reasons rather than accounting reasons. We note that the reinsurance contract is a separate contract from the underlying insurance contracts, and the allocation of profit from the reinsurance contract is therefore independent from the allocation of profit from the underlying insurance contract.

On hedging activities, the Board notes that entities could choose to avoid some accounting mismatches by using the general hedge accounting requirements in IFRS 9 (or IAS 39 *Financial Instruments: Recognition and Measurement*), or by deciding for which group of contracts to present in OCI some changes arising from financial market assumptions. The Board decided to reduce the accounting mismatches introduced by the variable fee approach by providing an option to align the overall effect of the variable fee approach more closely with the general model.

We note that any residual accounting mismatches between the assets and insurance contracts are similar to those faced by other IFRS preparers. The Board has noted that such residual mismatches are better addressed as part of the existing broader hedging project which will consider a common solution for all industries. As you are aware, this project has received considerable feedback, and is part of the Board's current research agenda. To some extent, such residual accounting mismatches are the inevitable result of a mixed measurement model. A mixed measurement model, including the measurement of insurance contracts, has broad consensus. We are comfortable that we have addressed the most serious instances of accounting mismatches in the Insurance Contracts project.

On the use of a fixed discount rate for the accretion of interest on the contractual service margin (CSM) under the general model, the balance of the CSM represents unearned profits, and does not give rise to future cash flows. Accordingly, to the extent that the CSM balance is backed by assets, any mismatches arising between the CSM balance and such assets gives rise to an economic mismatch. Such assets have risks (eg interest rate risk) that are not present in the CSM. The Board's view is that the reporting of economic mismatches is an important objective of financial reporting. While being backed by assets, the CSM does not result in any cash flows. In addition, we note that the use of a current rate is likely to result in different operational complexities.

Allocation of the CSM

Your letter noted your concern on the allocation of the CSM.

The CSM represents the profit the entity expects to earn for the services it provides and consequently should be allocated according to the services provided.


The Board explored requiring entities to define the various services provided under the contract, and then to allocate the contractual service margin according to the delivery of those services. However, based on the feedback we received, the Board concluded that this approach would be operationally difficult. Consequently, we decided to require that the allocation of the contractual service margin be on the basis of the defining service provided by an insurance contract, which is insurance coverage. Insurance coverage is delivered on the basis of coverage units and accordingly the CSM is allocated on that basis. The Board concluded that the least complex and subjective approach would be to require entities to recognise the contractual service margin for all insurance contracts on the same basis.

Editorial comments

The Board discussed the editorial comments raised in your letter, along with other editorial comments received, at the February 2017 Board meeting. We have addressed these issues as summarised in the Appendix to this letter.

I appreciate your offer of assistance on the finalisation of the Standard. We also look forward to your support in implementing the Standard.

Yours sincerely



Hans Hoogervorst
Chairman

Copy:

Gérald Harlin, Chief Financial Officer, AXA Group
Dieter Wemmer, Chief Financial Officer, Allianz SE
All other CFO Forum members
Olav Jones, Deputy Director General, Insurance Europe

Appendix: Editorial comments outlined in your letter

Level of aggregation

Paragraph 14

Your letter noted concerns on the specific product types provided as examples in paragraph 14. The examples of specific product types will be revised (See Agenda Paper 2C, Appendix B).

Paragraph 16

Your letter noted concerns on the drafting on paragraph 16. The drafting has been amended in consideration of your concerns, and the amended wording was set out in Agenda Paper 2C, Appendix B.

Paragraph 19: Requirement for groups of contracts to be issued 'no more than one year apart'

Your letter questioned the relevance of the requirement that contracts that are issued more than a year apart should not be grouped (cohorts). The Board noted that the relevance of that requirement should be considered in the context of the other requirements for grouping contracts. Grouping contracts into cohorts preserves the Board's objective for the tracking of margin development over time, while alleviating the need for more granular tracking of contracts with dissimilar terms or profitability.

Also, we noted in the January meeting with you that the use of the term 'mutualisation' is likely to result in confusion because of the differences in which this term is used in practice. In the February 2017 Board Meeting, the Board considered cross-generational 'mutualisation'. I refer to Agenda Paper 2C which shares staff drafting on the level of aggregation and 'mutualisation'. That paper also notes that the Board intends to include some discussion on this topic in the Basis for Conclusions of the Standard.

Changes in estimate-experience variances

Your letter noted that it would be more appropriate for the variances related to the future period cash flows to be taken to the CSM. At our February 2017 meeting, the Board agreed that that variances related to future period cash flows, including those caused by experience adjustments, should be adjusted against the CSM.

Scope of the variable fee approach

Your letter noted that 'contracts can be written, oral or implied by an entity's customary business practices', and that consideration of this should be included in the final drafting of the Standard. I draw your attention to paragraph B8 in Agenda Paper 2C. The Board agreed that clarification on the meaning of 'contracts' should be included in the final drafting and would apply throughout the Standard.

Scope of premium allocation approach (PAA)

Your letter noted a concern on the scope of the premium allocation approach, specifically when applied to contracts including investment components. In the February 2017 Board meeting, the Board clarified that the contracts with investment components could be considered for the premium allocation approach subject to those contracts meeting the specified criterion.

Hedging

Your letter noted a concern on the hedge accounting solution. This is discussed in the main body of the letter.