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Dear Sir

Discussion Paper: Preliminary Views on Insurance Contracts

We are responding to your invitation to comment on the above Discussion Paper on behalf of PricewaterhouseCoopers.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on this Discussion Paper. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We welcome the opportunity to comment on the Board's preliminary views on this important topic. The development of a comprehensive standard for insurance contracts is essential since the transitional arrangements established in IFRS 4 do not provide the level of transparency and comparability necessary for the users of financial statements. Our research shows that investment analysts specialising in this sector lack confidence in the accounting information currently provided under IFRS 4 and therefore there is an urgent need for the development of an accounting model based on clear principles.

Introduction

The proposals in the Discussion Paper are complex and have significant implications both for the insurance sector and for non-insurance entities. In recognition of this, we address the following topics in this letter:

- The scope of the project and, in particular, the implications for non-insurance entities
- Involving the insurance industry, including the need for field testing
- Identifying the measurement objective
- A summary of the PwC proposals for changes to the core model, together with comments on other aspects of the proposals relating to participating contracts, performance reporting and disclosure.

We also attach two appendices to the letter addressing the following topics:

- Our responses to the specific questions raised in the Discussion Paper (Appendix A)
- Comments on the items listed in Appendix B of the Discussion Paper (Appendix B)

Scope of project

We recognise that a standard establishing accounting principles for insurance contracts will necessarily touch many of the fundamental questions that underpin other major Board projects. Given the innovative nature of the proposals in this Discussion Paper and the implementation challenges they will pose, it is important that any resulting accounting requirements stand the test of time. The Board should ensure that the approach it ultimately takes in an IFRS for insurance contracts is consistent with the direction proposed for these related projects or that any difference reflects a unique quality of insurance contracts. Where this is not the case, the Board should clearly justify the approach it has selected and set out how it proposes to deal with such matters in the future as the related projects are progressed.

In this context, we note that, given the timetable for developing an accounting standard for insurance contracts, inconsistencies will be created between insurance contract accounting and many existing accounting standards. There are two key areas where this could arise:

- a) where the Board addresses transactions typical to the insurance sector which would involve changes to the generally accepted accounting for similar transactions in other industries (e.g. the possible amendments to IAS 39 and IAS 18); and
- b) where an extension of the principles proposed for insurance contracts would require changes to the IASB Conceptual Framework (e.g. on the approach to revenue recognition or the definition of an asset and a liability)

Changes to these standards or principles will affect other industries whose constituents would not expect to be consulted through the medium of a discussion paper on insurance contracts. There is a conflict between the urgent need to improve transparency in insurance contract accounting under IFRS and the need to seek wider input from non-insurance constituents for those proposals that may have implications for the conceptual framework or for well-accepted accounting principles in other industries. The Board should not attempt to resolve this conflict at this stage. We therefore do not support significant revisions to the revenue recognition principles in IAS 18 or the measurement principles in IAS 39. A key decision for the Board is where to draw the line in this project: once the decision is taken to address all products issued by insurance companies, including non-discretionary investment contracts with no unique features, the resulting changes will have significant implications both for banks and investment management companies that issue similar products and for entities outside the financial services sector. It would be inappropriate to change well-established accounting for such entities solely on the basis of a need for greater transparency in accounting for insurance contracts.

Nonetheless, to the extent that the proposed changes to insurance contract accounting indicate the direction of the Board's thinking on these more fundamental questions, the Board should consult more widely with the affected parties.

Involving the insurance industry

We welcome the extent to which the Board has already involved the insurance industry in the debate prior to the publication of this Discussion Paper; a precedent that the Board should follow in other areas. Many of the proposals are innovative and the full implications are not yet clearly understood. It is important that the Board and the insurance industry develop a common understanding of the implications of the model before it is finalised.

We therefore recommend that the Board should work closely with the insurance industry to test its key proposals with real data as part of the next stage of this project. The European insurance industry has already had experience of such testing in the context of the Quantitative Impact Studies ('QISs') carried out to support the development of the new Solvency II regulations. This exercise demonstrated that selective field testing can enhance understanding of the proposals and identify problems of interpretation and implementation leading to more practical solutions. We would be willing to help facilitate a similar process to test the proposed accounting model.

Identifying the measurement objective

The primary focus of financial reporting is to meet the needs of current and potential capital market investors and lenders. Consequently any proposed accounting solution should be assessed against that benchmark. As part of our internal process to develop our response to this Discussion Paper, we have interviewed a number of insurance analysts around the world. While their support for the existing accounting models varies depending on the accounting framework within which they operate, there is a clear request for access to sufficient information about expected and actual cash flows from insurance contracts to enable them to assess management's judgement of risk and performance. This information needs to be both transparent and consistently determined to allow comparison of performance from one year to the next and between entities. At the same time, of course, the requirements should not create unnecessary complexity for preparers.

Any changes to the reporting model for insurance contracts should also meet the criteria of relevance and reliability. In particular, concern has been expressed about the reliability of data that is dependent on an assessment of a transaction in a hypothetical market. While recognising that reliability does not override other qualitative characteristics, the lack of any significant transactions in insurance contracts creates an additional concern about the robustness and reliability of any profit recognition based on unobservable data.

PwC proposals

Core model

We have compared the model proposed in the Discussion Paper with these objectives and we are not persuaded that they have been met to a sufficient extent. In particular, the proposed model adopts an approach described as current exit value. This is defined as the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. Insurers do not transfer insurance contracts in the normal course of business and therefore any assessment of the amount the insurer would expect to pay in those circumstances is hypothetical. This does not meet the needs of users for transparency, nor those of the preparers for simplicity. In the specific context of insurance contracts, the use of unobservable data to support profit recognition may cast doubt on the robustness of the income statement. For these reasons, we question the relevance of the current exit value approach in the context of meeting the needs of current and future capital providers to the insurance industry. In addition, by its emphasis on identifying separately rights and obligations from the same contract and the application of the guaranteed insurability test, the proposed model does not reflect all the cash flows implicit in a contract.

To address our concerns, we have adapted the proposed model, using the building blocks approach, to reflect all the expected cash inflows and outflows and an unbiased assessment of the risk associated with those cash flows. The primary focus of our proposed model is that an insurance contract should not be split into an insurance asset (the rights arising from the contract) and an insurance liability (the obligations arising under the contract) but rather viewed as a single contract. This model recognises the interrelationship of the cash inflows and outflows and the nature of the contractual relationship with the policyholder. An insurance company controls the contractual relationship as a whole inclusive of all its unconditional and conditional rights. If an independent third party values the contract it would base the valuation on its expectations of cash

inflows and outflows, including those arising from beneficial policyholder behaviour. An artificial split of the contract into a separate insurance asset and insurance liability, with different recognition criteria for each, is unlikely to provide meaningful data to the users of the financial statements about expected future cash flows.

We support the Board's proposal to base the measurement model on three building blocks but as noted with certain key differences from the model proposed in the standard:

1. *Current, unbiased, probability-weighted and explicit estimate of future contractual cash flows:* The objective of this building block is to measure the amounts and timing of the contractual cash flows using the most reliable sources available. We propose two changes to the model to meet this objective.

Firstly, the estimate of future contractual cash flows should include all those that have commercial substance. Cash flows with commercial substance are those that the insurer can expect to receive or pay during the period of the contract when it is in the policyholder's interests to continue to make payments.

Secondly, market prices should be used to determine the expected future cash flows only where they are directly observable, that is primarily for financial risk inputs or where they will determine directly the actual cash flows (e.g. market prices for unit-linked contracts). Many inputs used in modelling expected future cash flows for an insurance contract are not directly observable and are, by their nature, portfolio and/or entity-specific (e.g. insurance risk and the future expenses that the insurer must incur to meet its obligations under the contract). From the perspective of a user of the financial statements, management's estimates of these cash flows, based on its own strategy and efficiency, will provide a more reliable source of data and thus more useful information than an estimate based on cash flows from hypothetical transactions that cannot be observed in the market place.

2. *Current market discount rates that adjust the estimated future cash flows for the time value of money.* We agree with this proposal other than that we do not believe that the discount rate should be adjusted to reflect liquidity risk. In our view liquidity risk in the context of liabilities is essentially the risk that the insurer will be required to settle the liability at an earlier date than anticipated. This risk is captured in defining the scenarios used to estimate the future cash flows.
3. *An explicit and unbiased estimate of the margin that an independent third party would require for bearing risk and for providing any other services.* This building block is likely to have a significant impact on the timing of profit recognition and needs further analysis for a number of reasons.

Firstly, this building block is the least observable input to the measurement model. Given its impact on profit recognition we are concerned that there is relatively little debate of the underlying principle in the Discussion Paper. For many insurers, particularly in less sophisticated jurisdictions, the selection of an unbiased risk margin will be challenging in the absence of objective evidence to support it.

Secondly, the Discussion Paper does not debate fully the rationale for determining the risk margin on a portfolio rather than an entity basis. Each approach is open to challenge: insurers manage risk by diversification and therefore determining the risk margin on a portfolio specific basis fails to recognise the way in which any independent third party would assess both risk and profitability. In addition, there is a lack of clarity over the definition of a portfolio of contracts with broadly similar risks that are managed together. Experience shows that insurers frequently include non-homogeneous risks in portfolios of contracts managed together in order to benefit from diversification. On the other hand, assessing risk margins at the entity level raises questions about the extent of diversification

that should be assumed and, in particular, whether it should be that of the reporting entity or of a hypothetical market participant.

Thirdly, we do not support the subdivision of the margin between a risk margin and a service margin as proposed in the Discussion Paper since this adds complexity without adding value.

In view of the impact of the risk margin on profit recognition, the availability of different actuarial models to determine it and the lack of clarity surrounding the unit of measurement, this should be a primary focus of the field testing we propose above. As indicated, we would be happy to help facilitate this process.

Participating contracts

Participating contracts contain distinctive features that are not adequately addressed in existing IFRS accounting literature and therefore the Board should address the principles of accounting for these common contracts in this standard, irrespective of whether they contain insurance risk. We believe that participating contracts should also be accounted for as single contracts using the same model as that described above for insurance contracts.

We note that both our proposed approach and the use of the constructive obligation model proposed in the Discussion Paper have implications for the ongoing debate on debt/equity classification. Consequently, we recommend that the implications of these proposals are considered in the forthcoming discussion paper related to that project.

Performance reporting

Performance reporting is fundamental to the determination of many of the issues raised in this Discussion Paper and therefore we are disappointed to note that the Board has not developed its preliminary views at this stage. Issues such as the recognition or derecognition of an insurance contract and the unbundling of significant deposit components have far more complex reporting consequences when the revenue of an insurer is based on the premiums from insurance contracts than they would in a deposit accounting model. The Board should consider what constitutes revenue for an insurer prior to developing an exposure draft on this topic. We set out our views on the appropriate performance reporting model in our responses to questions 18 and 19.

Disclosure

Our survey of insurance analysts reveals a desire for transparency in relation to the underlying assumptions. Therefore, as the Board formulates its model for insurance contract accounting, we would encourage them to reconsider the disclosures that are necessary to supplement the model. Risk and segmental disclosure will continue to be important to a user's understanding of the accounting. In other areas the Board should consider the development of new principles of disclosure reflecting the key characteristics of the new accounting model. This may lead to a reassessment of the need for current disclosure requirements in IFRS 4 since these were developed to compensate for the lack of comparability and adherence to the Framework permitted in that transitional standard.



Our responses to the specific questions in the Discussion Paper are attached in Appendix A to this letter.

If you have any questions on the content of this letter, please do not hesitate to contact Richard Keys, PwC Global Chief Accountant (+44 20 7802 4555), or Pauline Wallace (+44 20 7804 1283).

Yours faithfully

PricewaterhouseCoopers LLP

Appendix A – Detailed responses

Chapter 2

Question 1: *Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?*

Response: Not without modification. Insurance contracts combine elements that meet the definition of financial instruments with others that do not (i.e., the existence of significant insurance and service components). However the Discussion Paper proposes that insurance contracts are measured based on the underlying cash flows and are not treated as executory contracts. Consequently the principles in IAS 39 are relevant and should form the basis for the recognition and derecognition model subject to the modifications necessary to reflect the multiple element nature of insurance contracts.

We support the recognition of an insurance contract from the date on which the reporting entity becomes party to the contract. We believe that this approach is consistent with the recognition of a net day one gain or loss because this gain or loss results from agreeing the contractual terms and conditions and is independent of any release from risk. The latter begins at the contract inception date. We are aware that insurers' current underwriting systems do not always capture the signing date of insurance contracts issued and reinsurance contracts held. We therefore recommend that the practical implications of this initial recognition model are included in the field testing programme proposed in our covering letter.

In addition, market participants treat the contract as the unit of account in valuing a contract's cash flows. Therefore, we believe that a single set of principles for recognition and derecognition should be applied to an insurance contract in its entirety rather than separately to the rights and obligations, defined in the Discussion Paper as insurance assets and insurance liabilities, which may co-exist in a single contract. The accounting model in the Discussion Paper, which proposes different treatment for insurance assets and liabilities arising under the same contract, could result in derecognition of a contract's assets while its liabilities continue to be recognised. Such a presentation does not faithfully represent the interdependency of contractual rights and obligations nor is it likely to be understood by financial statement users.

If beneficial policyholder behaviour is taken into account in measuring an insurance contract, there will be a number of instances where insurance contracts are an asset upon initial recognition and subsequently change to a liability as premiums are collected or as a result of the occurrence of an insured event. The Board concluded in September 2006 that non-optional derivatives, which can also change classification at different stages during their lifetime, should be subject to both the asset and the liability derecognition criteria in IAS 39. We do not believe that a similar dual test should be applied to insurance contracts. Instead we propose that only the liability derecognition principles are relevant. The IAS 39 liability derecognition criteria are well understood by financial statement users and are more appropriate for a contract that incorporates a well-defined obligation. A model that requires derecognition when the reporting entity is no longer exposed to the rights and obligations of the contract best reflects the interrelationship of cash inflows and outflows under the contract as well as the economic reality of policyholder behaviour.

It is not uncommon for insurers to offer existing policyholders the opportunity to replace or modify existing contracts for various reasons, such as increasing administrative efficiency and improving the competitive position of the contract to enhance policyholder satisfaction and retention. Additionally, policyholders often request insurers to make changes to their existing contracts. Under the criteria in IAS 39 the cancellation of one financial liability and its replacement with another or the substantial modification of an existing contract results in derecognition (IAS 39, paragraph 40). We believe that this principle should apply equally to insurance contracts so that the substantial modification of a contract is accounted for in the same manner as the extinguishment

and issuance of a new contract. This approach is helpful if the Board accepts our proposal that insurance premiums are accounted for as deposits (see our response to question 18). However if the Board concludes that insurance premiums should be presented as revenue, consideration will need to be given to the treatment of substantial modifications to avoid the risk of double counting of revenue.

Chapter 3

Question 2: *Should an insurer measure all its insurance liabilities using the following three building blocks:*

- (a) *explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,*
- (b) *current market discount rates that adjust the estimated future cash flows for the time value of money, and*
- (c) *an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?*

If not, what approach do you propose, and why?

Response: We support the use of a building blocks approach since a key objective of financial reporting is to present financial information that is relevant and that enables the users of financial statements to understand the amounts, timing and uncertainty of cash flows from insurance contracts and the associated performance and financial position of the insurers that issued them. Measurement based on these three building blocks achieves this and promotes comparability and understandability of management's performance in the absence of observable market transactions. For these reasons, we support the proposal in principle.

However, we do not agree with all the detailed elements of the building blocks model that are set out in the Discussion Paper.

In the absence of a market to transfer insurance contracts a requirement to use market-consistent data for each of the blocks is not practical, will not generate reliable numbers for accounting purposes and will not provide users with the information about future cash flows that they need. Even where contracts have been transferred, the three building blocks have not been individually observable because the price for those transactions has been negotiated in total rather than on the basis of separate explicit components.

To provide information about the uncertainty of amounts and timing of the future cash flows from insurance contracts, the data used should be current, unbiased and probability weighted. However it also needs to be reliable and supported by observable data.

We believe that the estimate of cash flows should reflect entity specific rather than hypothetical cash flows. We support the use of objective information (e.g., financial variables) when available as a means to remove bias. Absent reliable observable market inputs, however, we believe estimates of cash flows based upon entity specific strategy and efficiency are more relevant and more faithfully reflect the economics of the contracts.

Current market interest rates are likely to be consistently observable as far as currency and duration of the underlying cash flows are concerned and therefore are appropriate as a basis for choosing discount rates. However, we believe that the selected interest rates should not be adjusted for liquidity risk. This is because the risk that the insurer will be required to settle the liability at an earlier date is already captured in defining each of the scenarios used to estimate the

future cash flows (first block). The resulting uncertainty is considered in the determination of the margin (third block). Thus adjusting the discount rate for liquidity risk would result in double counting.

In relation to the Board's proposal for the third block we support the use of an explicit and unbiased estimate of the margin that an independent third party would require for bearing risk and for providing other services. However we have three major recommendations.

Firstly we agree that the margin should be current and unbiased but this not require a reference to a hypothetical market. Insurers should determine margins in the context of the reward that an independent third party would demand taking into account the uncertainty of the cash flows and the nature or the future services associated with the portfolio of insurance contracts being measured. As explained in our response to question 4, this does not mean that they are only based on the premium negotiated with the policyholder.

Secondly the Discussion Paper does not debate fully the rationale for determining the risk margin on a portfolio rather than an entity basis. We discuss this in our response to question 11.

Thirdly we recommend that the Board does not require separate risk and service margins. We believe that the margin should incorporate a reward for providing services but we do not believe that separate margins should be measured for these contractual elements. We believe that such a split is arbitrary in a bundled contract (e.g., why distinguish between the service of providing risk from other services, such as the collection of premiums and the management of assets purchased with those premiums).

Question 3: *Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?*

Response: While it is useful to have a detailed discussion of the methods used to estimate cash flows and determine risk margins at the discussion paper stage, any guidance within the standard itself should be at a high level, focusing on the principles on which estimates of future cash flows and the determination of margins would be based. Any such guidance should address the objectives of the model rather than its detailed implementation.

In particular, the principles should identify the objectives underlying the measurement of margins so that preparers of financial statements are better equipped to calculate them and users are better able to understand them. Certain of the content in appendices E and F obscures these principles and the manner in which they should be applied to produce consistent results.

For example, paragraph F9 of the Discussion Paper identifies eight techniques for determining risk margins. Most of these techniques are compatible with the underlying market-consistency principle only if they are used to estimate the cost associated with a transfer of a portfolio of insurance contracts. The application of one of the more significant of these techniques, the confidence interval approach, creates the same level of margin for the same obligation regardless of the capital needs of a company and allows that margin to be released as the risk decreases (assuming similar inputs and assumptions are used). In contrast, the application of a cost of capital method results in margins that vary depending on the capital market associated with the jurisdiction where the company legally operates and a release of risk that includes the effect of changes in the cost of funding capital. These appear to be fundamentally different measurement bases for the same portfolio of contracts.

We believe that accounting standards should focus on high level principles. Consequently, we agree with the Board that the final standard should not prescribe a technique, but rather clarify the

objectives underlying measurement and the characteristics that should determine the measurement attribute. This would permit flexibility in the detailed methods that insurers might use in satisfying these principles while ensuring that the selection of the relevant method is founded on the same underlying objective and characteristics. We also recommend that the standard does not identify any specific technique. Otherwise there is a risk that practitioners will interpret its inclusion as an indication that it is a more appropriate technique. Actuarial methods are continually evolving and the standard should encourage rather than impede this progress.

We have one detailed concern about the guidance. Appendix E states that investment returns and income tax payments are not relevant in estimating the current exit value of existing insurance liabilities but that the measurement of the insurance liability is increased by any interest that is credited to the policyholders' benefit. We believe that the measurement of the insurance liability should also be adjusted by any liability cash flows that depend on future tax cash flows. In particular, if the policyholders' benefits are dependent on future net of tax investment returns then it should be the net of tax rather than the gross of tax investment return cash flows that are included in the measurement of these benefits. Whilst the measurement of the insurance liability will not include future tax cash flows, the valuation of the benefits may, as described above, reflect cash flows that depend on future taxation. As a result, the market discount rate applicable to this liability may reflect the tax rates applicable to such cash flows.

Question 4: *What role should the actual premium charged by the insurer play in the calibration of margins, and why?*

- (a) *The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.*
- (b) *There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?*
- (c) *The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.*
- (d) *Other (please specify).*

Response: We believe that the actual premium charged is relevant in determining the risk margin but consider that other evidence should also be taken into account with equal status. Accordingly, we support view (c).

Prices charged by insurers for similar products covering policyholders with comparable risk exposures have historically varied, sometimes significantly so. To calibrate the margins for two contracts with comparable uncertainty in cash flows to different reference points is inconsistent with the definition of an unbiased margin determined for a portfolio of contracts (see our response on question 11 on the issue of determining the appropriate portfolio). When the unit of measurement is determined the margin should reflect the reward an independent third party would demand to bear the risk of the uncertainty of the estimated cash flows and to provide services under the contracts included in that unit of measurement.

Question 5: *This paper proposes that the measurement attribute for insurance liabilities should be ‘the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute ‘current exit value’.*

- (a) *Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?*
- (b) *Is ‘current exit value’ the best label for that measurement attribute? Why or why not?*

Response:

- (a) No. The measurement of an insurance contract should be based on how the issuer can, in practice, extinguish the contractual obligations, which will usually be through settlement of the insurance obligation or performance of the service obligations, if any. As discussed in our response to Question 2, we believe that the objective of the measurement attribute should be to provide an unbiased current estimate of the amounts, timing and uncertainty of cash flows from insurance contracts. Because insurance contracts are generally not settled by means of a transfer to another entity, a measurement attribute as defined in Question 5 does not achieve this objective.
- (b) We note that the Board considers the model proposed in the Discussion Paper similar in concept to the current exit price methodology defined in the recent discussion paper on fair value measurement. We have noted three differences:
1. The fair value discussion paper offers three valuation techniques to measure fair value (market approach, income approach and replacement cost approach). The measurement model for insurance contracts in this Discussion Paper is based on a single income approach using the three building blocks described in Chapter 3.
 2. Insurance contracts are measured with a limitation on the inclusion of future cash inflows (the guaranteed insurability criterion) and future cash outflows (the constructive obligation applicable to insurance contracts with participating rights).
 3. The fair value discussion paper outlines a three level hierarchy which sets the order of preference for data and assumptions upon which to base the valuation. Overall, this hierarchy places greater weight on the use of market observable inputs, but permits the use of unobservable inputs in the absence of market data, including the entity’s own data if that would be used by a market participant. This Discussion Paper places greater emphasis on the use of market observable inputs despite an explicit statement that there may rarely, if ever, be persuasive evidence to depart from the insurer’s own estimates of some variables.

In the light of these differences, we would prefer the Board not to use the term “current exit value” to describe the proposed measurement attribute. Since the large majority of insurance contracts are never transferred to another entity, a description of the measurement attribute as current exit value is likely to be confusing to a financial statement user.

Chapter 4

Question 6: *In this paper, beneficial policyholder behaviour refers to a policyholder’s exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:*

- (a) *incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?*
- (b) *incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?*
- (c) *not recognise them? Why or why not?*

Response: We believe that an insurer should reflect the expected net economic benefits arising from beneficial policyholder behaviour under existing contracts as part of the measurement of those insurance contracts. This has a similar effect to the proposal under option (b) above, but does not depend on separate recognition of insurance assets and liabilities in the context of a single contract.

An independent third party would price an insurance contract as a whole, taking into account all expected cash flows under the contract that have commercial substance, including the expected cash flows resulting from beneficial policyholder behaviour (see our response to question 7 for a discussion of what constitutes commercial substance in this context). They would not regard the contract as comprising a separate customer relationship asset and an insurance liability. Similarly, financial statement users typically are interested in understanding the total expected cash flows arising from contracts in force at the reporting date. For these reasons, and because a contract's cash inflows and outflows are inextricably linked, we support the recognition of the contract as a single series of cash flows, rather than giving separate consideration to the recognition of its individual components. The determination of the value of the future cash flows resulting from beneficial policyholder behaviour then becomes a measurement issue rather than a recognition issue as the carrying value of the contract as a whole will comprise all relevant cash flows.

We understand that the Board has previously considered whether it is appropriate to recognise a contract in its entirety rather than individual cash flows arising from contractual rights and obligations and that a reason for rejecting such a view was based upon concerns that the recognition of a contract in its entirety would reflect value associated with customer relationship intangible assets that might not otherwise be recognisable under IFRS. We also understand that the concepts of the unit of account (i.e. a contract or its separate rights and obligations) and the unit of measurement (i.e. a single transaction or a portfolio of transactions) are being reconsidered within the framework.

We disagree with the Board's approach and believe that the contract is the appropriate unit of account. Market participants, management, and policyholders each view the contract in its entirety when placing a value on the contract and making decisions regarding that contract. Such an approach is also consistent with accounting for financial instruments where the recognition of a financial asset or a financial liability is the result of the measurement of all the relevant cash flows of the instrument rather than its separate rights and obligations.

As observed in the response to Question 1, the net cash flows arising from an insurance contract may result in its classification as an asset for part of its life and a liability at other times.

Question 7: *A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?*

- (a) *Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits*

continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.

- (b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?*
- (c) All cash flows that arise from those terms of existing contracts that have commercial substance (ie have a discernible effect on the economics of the contract by modifying significantly the risk, amount or timing of the cash flows).*
- (d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.*
- (e) No cash flows that result from beneficial policyholder behaviour.*
- (f) Other (please specify).*

Response: We support criterion (c) above: all cash flows that arise from those terms of existing contracts that have commercial substance. In our view, cash flows with commercial substance are those that the insurer can expect to receive or pay during the period of the contract when it is in the interests of the policyholder to continue to make payments.

The guaranteed insurability test that the Board proposes in the Discussion Paper is only one example of where it would be in the interests of the policyholder to continue to make payments; in this case there is a pricing advantage in relation to the transfer of insurance risk. However there are other reasons why it would be in the policyholder's interests to continue to pay premiums. Policyholder behaviour is driven by the individual policyholder's cost/benefit analysis of the cost of insurance versus his individual perception of his current and future insurability, as well as other factors unique to insurance such as his investment appetite and tax position. For example it may be in the policyholder's interests to continue to pay premiums to maintain other forms of guarantee (such as financial guarantees or in relation to the price of a service), to avoid the application of penalties or incurring transaction costs or to maintain a right to participate in a distributable surplus. It is not appropriate to restrict the recognition of future premiums to those that must be paid to maintain only one particular contractual right.

Inclusion of all contractual cash flows with commercial substance most faithfully represents the cash flows that users of financial statements want to understand.

Recognition of cash flows resulting from beneficial policyholder behaviour is consistent with current guidance within IFRS. For example, under IAS 39, future economic benefits resulting from beneficial policyholder behaviour are recognised for servicing rights retained in a sale of a portfolio of receivables. Such servicing rights are sometimes subject to cancellation by the counterparty and, in those circumstances, are comparable to the right to future policyholder premium for insurance contracts.

Furthermore, the Discussion Paper proposes a consistent approach to insurance and reinsurance contracts. For example a reinsurer that issues a quota share reinsurance contract to a cedant will have an unconditional right to receive from the cedant all future premiums from the reinsured contracts during the contract term as soon as they are collected from the cedant's policyholders. The cash inflows under the quota share contract arise from an enforceable right and therefore meet the control test for an asset even if there is no underlying guaranteed insurability. Accordingly,

these cash inflows will be reflected in a reinsurer's measurement of its reinsurance contract. However the related cash inflows from reinsured direct policies that the insurance company expects to collect will not be recognised if they do not pass the guaranteed insurability test. This creates an accounting mismatch. Therefore we recommend that the conditionality of the contractual cash flows for both insurance and reinsurance contracts is addressed through measurement not recognition.

The recognition of all contractual cash flows with commercial substance would increase the probability of a net day one gain, defined as the difference between the premium received and the sum of the amount measured under the three building blocks and the component of acquisition costs for which the premium implicitly reimburses the insurer. Accordingly, circumstances in which a day one gain might be recognised would include the following situations:

1. there would be a "dealer profit" if the contract could be transferred to another entity profitably;
2. the insurer has not reflected all the benefits of its strategy and efficiency in the premium it has agreed with the policyholder;
3. the insurer has added value by assembling a portfolio of contracts with similar risks that are not reflected in the premium the policyholder must pay to acquire the contract;
4. the insurer has added value by generating diversification benefits from assembling portfolios of contracts that are not reflected in a lower price charged to the policyholder. The size of this gain depends on the Board's final decision on the appropriate unit of measurement as explained in our response to question 11; and
5. the additional price that an insurer can receive from the policyholder for bundling different components in a single contract.

A day one gain would exclude the component of the expected profit representing the margin for bearing risk and providing services that will be recognised through profit or loss over the period risk is borne and services are provided.

Question 8: *Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?*

Response: Yes. We believe acquisition costs should be recognised in current earnings and not deferred provided that the future premiums under the contract which implicitly reimburse the insurer for these costs are reflected as a component of the measurement of an insurance contract's liability. Such costs do not represent part of an insurance contract and, accordingly, should not be recognised as such.

Any positive economic benefit that arises out of past acquisition costs relates to purchased intangible assets. Since the value to an entity of such an intangible asset is not determined by the amount of acquisition costs but rather by the expected future economic benefits that the entity will recognise, deferral of the costs incurred and measurement of such an asset based on the costs incurred would not faithfully represent either the past transaction or the financial position of the entity.

Nonetheless if acquisition costs are expensed, it is important that the full economic benefits of the contract are recognised, including the effect of beneficial policyholder behaviours discussed in our response to question 7 above.

We note that the issue of acquisition costs is also relevant for investment contracts with or without participating rights. We recommend that all contracts with participating rights are accounted for in the same way as insurance contracts. However, we have explained in our covering letter that we do not, at this stage, recommend any significant amendments to IAS 39 and IAS 18 aimed at the

elimination of differences between the proposed measurement for insurance contracts and these accounting standards. For this reason we recommend the retention of the current treatment of origination costs under IAS 18, Appendix paragraph 14(b) (iii) for investment contracts with no participating rights and for investment management service contracts.

Question 9: *Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?*

Response:

Business Combinations

An IFRS for insurance contracts that does not permit the expanded presentation, as a concept, rests on the assertion that there is no significant difference between fair value (as per the discussion paper 'Fair Value Measurement') and current exit value for insurance contracts (paragraph 104 of the Discussion Paper). This in turn depends on several particular assumptions:

- the fair value of the portions of the insurance asset measured under guaranteed insurability and the insurance liability under constructive obligation for participating rights would be identical to the amount recognised under the Discussion Paper's proposed model; and
- the remaining cash flows are captured in other assets and liabilities recognised in a business combination such as customer type assets.

We do not agree this conclusion. We believe that under IAS 39 and business combinations accounting the appropriate unit of account is the individual insurance contract and not the cash flow components of the Board's approach. The limitations on the recognition of future contractual cash flows will create a significant difference as a fair value measurement would not arbitrarily limit the measurement of cash flows arising from the contracts acquired. This difference is likely to be significant for certain contracts such as unit-linked and participating contracts with regular premiums.

Adoption of the model we recommend would make the expanded presentation redundant because the accounting at initial recognition and subsequently would be substantially the same. The Board's proposal to measure the separate components would result in creation (recognition) of a customer intangible that would not be measured subsequently under current exit value.

We believe that recognition of customer related intangible assets for cross selling and renewals would be no different under our model or the Board's model. The renewal options in short term contracts that do not offer any form of guarantee to the policy holder do not have commercial substance. These renewal options do not influence the fair value of the portfolio or individual insurance contracts but are customer relationship type assets under IAS 38 and should be recognised as such.

Portfolio Transfers

The discussion paper expresses a preference for immediate recognition of income or expense on the difference between the consideration given for the acquired portfolio and current exit value (see paragraph 172 c). We agree that this is appropriate and is consistent with the concept of recognising a day one gain at initial recognition. However, this approach is in conflict with the existing requirements of IFRS 3.4. We suggest that IFRS 3.4 be amended to exclude groups of assets consisting only of contracts that will subsequently be measured at current exit value or fair value through profit or loss.

Chapter 5

Question 10: *Do you have any comments on the measurement of assets held to back insurance liabilities?*

Response: We do not support the introduction of different measurement attributes for assets held to back insurance liabilities other than for treasury shares held in investment-linked structures discussed in question 17.

One of the most frequent implementation issues associated with the introduction of IFRS 4 was the creation of accounting mismatches where insurance liabilities are matched by assets accounted for on a different basis. The introduction of a market-consistent measurement basis for the financial risk inputs to the valuation model for insurance liabilities and the use of the fair value option in IAS 39 will minimise the impact of accounting mismatches. However, we recognise that there are still a number of situations where different measurement models are applied to the underlying assets. We therefore draw the Board's attention to the risk that in those circumstances the financial statements will reflect artificial volatility that may occasionally result in the presentation of misleading information. This is particularly relevant in the context of investment-linked structures discussed in question 17.

Finally we would recommend that the Board grants a transitional provision to allow the reclassification of financial assets into the category of financial instruments at fair value through profit or loss. This transitional provision is necessary to achieve the Board's objective of recognising all changes in the carrying amount of insurance contracts through profit and loss without retaining the shadow accounting practice currently permitted under IFRS 4 paragraph 30.

Question 11: *Should risk margins:*

- (a) *be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?*
- (b) *reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?*

Response: We are disappointed to note that the Board has not fully analysed the implications of the unit of measurement for insurance contracts. In our view the arguments presented in the Discussion Paper are insufficient to support a conclusion on the appropriate unit of measurement.

This is not a trivial matter and the extent of the debate and the controversy that it has generated demand a deeper consideration of the arguments in favour of the two alternatives presented in the Discussion Paper. Our firm is committed to continue the debate on this key issue and to share the results with the Board in due course.

We have included below our preliminary compilation of the arguments in favour of both alternatives that we have considered in our internal debates to date.

In addition to the arguments set out in paragraphs 190-199 of the Discussion Paper, we have considered the following arguments in favour of a portfolio-based unit of measurement:

- Measurement reflecting diversification between all of an entity's portfolios would result in measurement of additional intangible assets, in essence more of a value of the business than a value of the contracts themselves. Because the objective of measuring contracts should not be to capture synergies inherent in a business the unit of measurement of the

margin should not aggregate such intangible assets into the carrying value of insurance contracts.

- Investors use segment and product data in preference to data from general purpose financial statements in valuing insurance companies. Measurement on this basis, supported by quantitative disclosure of the diversification benefits by portfolio, may enhance comparability between insurers by enabling financial statement users to isolate diversification benefit assumptions and match these up against other market participants' assumptions.

On the other hand, the following arguments support the use of an entity-based unit of measurement in addition to those set out in paragraphs 200 and 201 of the Discussion Paper:

- Users of financial statements are interested in the risks faced by the entity as a whole. The benefit of diversification between portfolios is an economic reality that should be reflected in the accounting for insurance contracts. The margin should reflect all factors that a market participant considers in determining the consideration required to accept the transfer of another entity's insurance contracts. A market participant will consider the diversification benefits to its own business that would be achieved by assuming these contracts. A similar logic also applies in an entry value model since an insurer considers the diversification benefits it has achieved when determining the price that it demands to accept the transfer of risk from a policyholder.
- Insurers often price their insurance contracts to transfer to their policyholders the entity-wide diversification benefits they have achieved. A portfolio-based margin in these circumstances would produce a higher liability (or a lower asset) resulting in initial losses that would be reversed in subsequent measurement when the entity recognises the actual cash flows and the actual degree of uncertainty of cash flows arising from the entity's combined portfolios emerges. Such initial loss and subsequent gains do not reflect the economics of the transaction and would not provide users with relevant and reliable information on the insurer's performance.
- Current exit value accounting accepts that accounting for insurance contracts should reflect the logic of a reporting entity assembling a portfolio of insurance contracts. There is no logical reason to restrict the unit of measurement to a portion of the reporting entity's contracts without creating bright lines. In particular the application of a portfolio definition as proposed in the Discussion Paper is more open to interpretation than one based on the reporting entity. There are a number of jurisdictions (e.g. the UK) where the concept of "managed together" has been applied in practice for years. The assessment from these jurisdictions is that such concept has been inconsistently applied and has been criticised by users.
- Insurers may arrive at different combinations of contracts when constructing portfolios. For example, one entity, because of its size and state of development, may divide its contracts into X and Y portfolios, whereas the market might always see XY as the portfolio.

Question 12:

- Should a cedant measure reinsurance assets at current exit value? Why or why not?*
- Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?*

- (i) *A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract*
- (ii) *An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.*
- (iii) *If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.*

Response:

- (a) A cedant's measurement of reinsurance contracts should be based on the same principles that are applied to the measurement of direct insurance contracts. Therefore the unit of measurement for combined insurance contracts and related reinsurance contracts should reflect the related reinsurance protection leading to a margin that is net of reinsurance. A significant benefit of a reinsurance contract to the cedant is the reduction in the variability of the net cash flows resulting from rights and obligations on underlying insurance contracts. Furthermore, application of the same principles will reduce the motivation for using reinsurance transactions to exploit divergences between the measurement of related assets and liabilities that are not representative of their economic substance.
- (b)- (i) We agree with the statements in paragraph 206 of the Discussion Paper that, in general, margins reduce the current exit value of an asset. However, we also believe that the assumption of a simultaneous transfer of the rights and obligations resulting from a reinsurance contract and related insurance contracts should be reflected in the measurement of reinsurance contracts since a reinsurance contract is unlikely to be transferred without the related insurance contracts. We agree that, as set out in paragraph 208 of the Discussion Paper, a reinsurance contract typically has its maximum value only for the cedant because a claim under the contract generally requires the claimant to have an insurable interest in the underlying insurance contract. It follows that the reinsurance contract is most likely to transfer to the party that would most benefit from it.
- (b)- (ii) We believe that an expected loss model is preferable to an incurred loss model for the recognition of defaults and disputes. This is consistent with our view that the contract is the most appropriate unit of account as explained in our earlier responses.
- (b)- (iii) We believe that a cedant's contractual right to be entitled to reinsurance protection over losses that will arise from contracts that it has not yet issued should be part of the measurement of the reinsurance contract held. This is consistent with our view of the contract as the appropriate unit of account. This contractual right may be a material asset in certain circumstances. For example, the terms of an excess of loss reinsurance agreement might lock in the price of coverage per unit of risk at an amount that may not always subsequently reflect the uncertainty of the contractual cash flows.

Question 13: *If an insurance contract contains deposit or service components, should the insurer unbundle them? Why or why not?*

Response: In principle, we support the same accounting treatment and presentation for transactions that are economically similar. However we believe it is premature to conclude that deposit or service components should be unbundled from the obligation to stand ready to pay insurance claims. There are several projects in progress whose outcome is relevant to this decision: in particular the discussion on multiple elements accounting for revenue recognition and

performance reporting. We do not believe it is appropriate to pre-empt the outcomes of those projects in the context of insurance contract accounting.

The Board could achieve its objective of comparability using a more pragmatic approach. Performance reporting of insurance entities can be made more comparable to other financial institutions if the Board adopts the deposit accounting presentation we recommend in our response to question 18. In addition the Board could meet the needs of users by requiring an analysis of the margins that an insurer earns from all of the components bundled together in the insurance contracts it issues using the three building blocks that underpin the Discussion Paper accounting model. Our response to question 19 offers a possible way of achieving this.

These proposals would enhance comparability of performance without requiring the unbundling of any of the components of an insurance contract.

If an unbundling principle is incorporated into the standard, we would make the following observations. Firstly, we believe practitioners and financial statement users would welcome additional clarity surrounding the unbundling criteria. In particular, the meaning of the terms 'interdependent' and 'arbitrary' are not well understood (for example, some believe that the components of nearly all contracts can be measured on a basis that is not arbitrary). Secondly, we believe that a presentation of the insurance component as the difference between the deposit component under IAS 39 and the measurement of the entire contract under the proposed model for insurance contracts is not useful in communicating any additional information about the insurance component than would be communicated without unbundling. Thirdly the Board should not introduce unbundling on an optional basis as currently permitted under IFRS 4. An optional unbundling regime would conflict with the objective of enhancing comparability of insurers' financial statements with those of other entities.

Question 14:

- (a) *Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?*
- (b) *Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?*

Response:

- (a) We agree that a market-consistent exit value is the price for a transfer that neither improves nor impairs its credit characteristics where there is evidence that market participants consider credit risk when determining the value.
- (b) As indicated above, our proposed model differs in some key respects from an exit value model. In this model the risk of the entity being unable to satisfy its contractual obligations is included in the first building block with an associated probability weighting. In non-performance scenarios, the cash flows to be considered are net of the funding that policyholder protection schemes would pay as a result of the insurer's default. The risk margin will reflect the uncertainty of all scenarios, including those where the insurer is unable to perform. In this way, therefore, the credit characteristics of a portfolio will be reflected in the balance sheet measurement. We note that there is concern that movements in credit risk could mask the underlying operational performance and therefore we believe that the impact of changes in credit risk on the measurement of insurance liabilities should be prominently disclosed. In situations when a significant portion of the change in insurance contracts' carrying value is attributable to a change in the contracts' credit risk, there should be clear disclosure of the

reasons for and amount of such gains or losses, and the fact that they may not be realisable by the issuer.

Question 15: *Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?*

Response: In our opinion, contracts with similar economic consequences should be accounted for similarly. However, the elimination of differences in the accounting treatment between the proposed model for insurance contracts and IAS 39 and IAS 18 cannot be fully achieved for two main reasons: the option to use amortised cost as a measurement attribute under IAS 39 and the absence of a fair value option for the recognition of service revenue.

We accept that there are inconsistencies between the proposed measurement model for insurance contracts and the IAS 39 model that is applied for investment contracts but we do not recommend that these differences are removed at this stage. Any changes to IAS 39 will have significant implications for other entities, particularly banks, which issue similar products and such changes should not be implemented without wider consultation. Currently only the removal of the prohibition of day-one gains and losses is the subject of such a consultation process.

At present, IAS 39 and IAS 18 are applied separately to investment contracts. Service rights and obligations that are sold with the investment contract are accounted for under IAS 18. This is consistent with the treatment of investment management contracts by non-insurance entities. We therefore recommend that no amendment is made to IAS 18 at this stage. Any future amendment to IAS 18 to eliminate the differences with the Discussion Paper's proposals should be addressed as part of the revenue recognition project where the full implications of the change can be properly assessed.

We set out in Appendix B to this letter our comments on each of the items discussed in Appendix B to the Discussion Paper.

Chapter 6

Question 16:

- (a) *For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?*
- (b) *An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247-253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?*

Response: The Discussion Paper does not constitute a comprehensive accounting model for contracts with participating features. The Discussion Paper addresses only two issues in this context: the analysis of the nature of the obligations that an issuer of participating contracts should consider when accounting for them and the issue of the accounting mismatch created by the accounting treatment of certain items purchased to fund unit-linked contracts. Our views on the latter issue are included in our response to question 17.

In responding to this question it should be noted that the issues associated with participating contracts are independent from the accounting for insurance contracts. This is because

participating contractual terms are also included in contracts that do not transfer any insurance risk and their accounting is not dependent on the presence or absence of significant insurance risk. However we acknowledge that the insurance industry is the sector where these contractual terms have been observed with the highest frequency and therefore agree that this should be addressed as part of this project.

We believe that a participating contract should be viewed as a single unit of account and that all of the cash flows arising from the contractual terms should be included in the measurement of the contract to the extent that they have commercial substance. We believe that this recognition basis is logical because it applies consistently to both cash inflows and outflows.

The principle we propose for cash inflows is identical to that applied to insurance contracts without participating contracts. The application of the principle of commercial substance to the contractual cash outflows avoids the application of the concept of constructive obligation to transactions which are entirely contractual in nature and makes the accounting model for contracts with participating rights consistent with the way in which the insurer, the policyholder and an independent third party would value the contract.

We believe that the problems associated with the accounting for participating contracts are inextricably linked with the definitions and classification of liabilities and equity. Both our proposal of accounting for the contract as a whole using a recognition principle based on commercial substance and the Board's proposal to use a constructive obligation approach would introduce new models for the classification of debt and equity. Consequently, the Board's deliberations on this topic should be incorporated into their consideration of the liability/equity project.

If our arguments are not accepted we suggest that the Board considers a separate category of equity for all amounts associated with participating contracts that do not meet the current definition of a liability under IAS 32. Information regarding investment performance from the perspective of the parent company's shareholders is of critical importance to users of financial statements. Accordingly, we recommend that the conceptual framework be enhanced to include another category of equity representing the interests of investors in participating contracts that are still subject to the discretionary decisions of the issuer.

Question 17: *Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?*

- (a) *Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).*
- (b) *Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).*
- (c) *Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).*
- (d) *Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).*

Response: As noted in our response to question 10 one of the most frequent implementation issues associated with the introduction of IFRS 4 was the creation of accounting mismatches where insurance liabilities are matched by assets accounted for on a different basis. We welcome

the introduction of a market-consistent measurement basis for the financial risk inputs to the valuation model for insurance liabilities and the availability of the fair value option in IAS 39 which will minimise the impact of such mismatches. However, there are still a number of situations where different measurement models are applied to the underlying assets. If these mismatches are not resolved, there remains a risk that the financial statements may reflect artificial volatility resulting in the presentation of misleading information. We have reached our views on the individual items below by comparing the relative merits of retaining the normal accounting principles for assets and liabilities with the impact of the resulting accounting mismatch.

- (a) We support the designation of treasury shares as financial assets in limited circumstances only: that is when they are held in investment-linked funds that exist solely to pay or fund those liabilities that are directly affected by the fair value of the assets held in such funds. Such a designation should be limited to treasury shares that are traded in an active market. A similar precedent already exists in IAS 40 where an entity that accounts for its investment properties at cost can designate certain investment properties to be measured at fair value when they back liabilities that pay a return linked directly to the fair value of those properties (IAS 40 paragraphs 32A and 32B).
- (b) No. Although we support the elimination of such accounting mismatches, we do not wish to do so at the cost of creating inconsistency and non-comparability in accounting with entities who do not issue such unit-linked insurance contracts. Recording a subsidiary only partially held to back unit-linked liabilities at fair value would result in internally generated goodwill in excess of that required to eliminate any accounting mismatch that might otherwise exist and, because of the current prohibition of internally generated goodwill, would reduce comparability of the company with other entities.
- (c) No. Consistent with our response to alternative (b), we do not believe that insurers should be permitted or required to measure assets at fair value through profit or loss if they are held to back a unit-linked liability if IFRS does not permit that treatment for identical assets held for another purpose.
- (d) No. For the reasons stated in previous responses, we believe that a liability measured using the three building blocks described in Question 2 produces relevant financial information to enable the users of financial statements to understand the amounts, timing and uncertainty of cash flows from insurance contracts. Adjustment of the measurement objective of the liability so that this information is no longer transparent to the users of the financial statements would detract from the decision usefulness of the contract measurement. Therefore, we do not support the exclusion of any differences between the carrying amount of the assets held to back that liability and their fair value from the measurement of a unit-linked liability.

Chapter 7

Question 18: *Should an insurer present premiums as revenue or as deposits? Why or why not?*

Response:

We believe that premiums should be presented as deposits rather than revenue because the acceptance of insurance risk is more similar to the writing of options or accepting deposits than it is to providing a service. Such an approach would make the unbundling of the deposit component redundant and avoid the issues associated with the arbitrary split that we have commented on in question 13.

The concept of rendering a service is based on an entity performing certain non-contingent contractual activities over a period of time. This feature is used in IAS 18 to determine the stage of completion of the service provided and is the current IFRS basis for the recognition of the associated revenue. Standing ready to pay valid insurance claims appears to require contractual activities that are contingent on the insured event occurring. This is not a service any more than writing a financial option is a service. Under IAS 39 the requirement to account for a financial option at fair value through the income statement does not result in the recognition of revenue for the cash received. We recommend that the same accounting presentation is used for insurance contracts.

Financial statement users have indicated to us that they are interested in information on the gross cash flows received and paid under insurance contracts and that they find cash flow statements prepared using the indirect method less useful. We recommend presenting these gross cash flows in a cash flow statement prepared using the direct method. To ensure comparability as well as relevance to users we suggest that an insurer's cash flow statement should be prepared using the direct method.

Question 19: *Which items of income and expense should an insurer present separately on the face of its income statement? Why?*

Response:

We do not support the introduction of mandatory requirements for income statement presentation. Instead we recommend that the Board should establish high level principles which reflect the building block approach used for measurement of insurance contracts. We set out below one possible way in which an insurer could apply such principles.

Under this approach, the income statement would present lines that reflect how the three building blocks affect the insurer's performance. Professional investors have indicated their interest in understanding the margins that the insurer is able to earn. To address this need the income statement would present at least three subtotals: a subtotal displaying the result from bearing insurance risk and providing services, a subtotal displaying the result of selling new insurance contracts and a subtotal presenting the investment margin the insurer has earned.

Sub-total displaying the result from bearing insurance risk and providing services

This subtotal would include the following lines:

Income from Changes in margin

Income or expense from Changes in the cash flow estimate

The income from changes in margin is linked to the third building block and includes:

- The assessment of the release from risk and service obligations since the previous reporting date (income). The margin is the insurer's reward for bearing insurance risk and delivering services. Thus the release from those obligations is recorded as the primary income component of the income statement.
- The increase (expense) or decrease (income) of the margin for the contracts in force at the reporting date compared to the previous date caused by changes in the price and/or quantity of risk and future service obligations. If the reward for the residual risk and service obligations changes, it is appropriate to reflect it in the same line as the release from risk.

The income or expense from changes in the cash flow estimate is linked to the first block and includes:

- The difference between the estimated and the actual net cash flows received and paid in the period inclusive of actual expenses incurred as a result of contractual obligations that do not result in cash outflows towards the policyholder (e.g. claims handling expenses).
- Changes in the estimate of the first block following the updated information that the insurer receives from all its sources. This can be either income or expense.

The insurance and service expenses include the expenses that are incurred to render the contractual services to the customer and would include claims handling, policy administration, asset management and other expenses for benefits paid in kind to the policyholder (e.g. roadside assistance).

Subtotal displaying the result from selling new insurance contracts

This margin is the difference between the gross day one gain and the acquisition expenses incurred to secure the contracts.

The gross day one gain arises from the difference between the initial measurement of the contract and the cash received from the policyholder. All three building blocks contribute to this figure. The recognition of the day one gain should receive a prominent position in the income statement. Because it is associated with the origination of an insurance contract it should be presented as a “new business” result representing the insurer’s performance at the point of sale.

Acquisition expenses would be reported as incurred. A comparison between the day one gain and acquisition expenses is necessary to reflect performance.

Subtotal displaying the investment margin the insurer has earned

This margin would represent the difference between the income arising from any investments (such as financial assets or investment properties) held by the insurer and the expense arising from the unwinding of the discount rate used to measure the insurance contract (second block). This expense line would also include the effect of changes in the market interest rates used to derive the relevant discount rates.

Question 20: *Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?*

Response: Yes, shadow accounting has been a useful expedient to reduce accounting mismatches in the period leading to the finalisation of the Board’s work on a comprehensive IFRS for insurance contract. However this practice should not be carried forward in the new reporting standard.

Question 21: *Do you have other comments on this paper?*

Response:

Disclosure

As the Board formulates its model for insurance contract accounting, it should reconsider the disclosures that are necessary to supplement the model. The current disclosure requirements in IFRS 4 are very extensive to compensate for the lack of comparability and adherence to the Framework permitted in that transitional standard. We recognise that risk and segmental disclosure will continue to be important to a user’s understanding of the accounting but we

recommend that the Board consider new disclosure principles that reflect the key characteristics of the new accounting model. For example we would recommend that the Board develops disclosure principles based on the three building blocks and that both the estimate of cash flows and the margin are explicit. Another example would be the development of disclosure principles in relation to the discount rates used for the measurement of insurance contracts.

Based on our discussions with the analyst community, we understand that they seek transparency in accounting judgments and the related impact on performance measurement and financial position. They would also like actual and expected cash flows to be presented in a manner that permits comparison and validation of past estimates. Accordingly, we support the disclosure of assumptions and the impact of changes in those assumptions.

Policyholder accounting

IFRS includes guidance on accounting for insurance contracts that are owned by pension plans and investment companies. That guidance seems consistent with the objectives of the users of those financial statements, and, therefore, we do not see a current need to reconsider it. The premiums and reimbursements for claims relating to insurance purchased by other entities are generally not as significant to the financial position or performance of non-insurance companies as they are to insurance companies. For this reason, and because guidance already exists for policyholder accounting, we believe it is more important to provide timely guidance for insurance entities' accounting for insurance contracts. Accordingly, we believe the Board should only include policyholder accounting within the current project to the extent that its inclusion does not delay issuance of a standard for insurers. We are also concerned that the proper level of interest in policyholder accounting may not be attained from policyholders if this topic is a small part of this large project primarily directed at issuers of insurance contracts.

Scope of the future IFRS

The Board decided to exclude from the Discussion Paper the scope of the new IFRS. Any decision to extend the scope of IFRS 4 is likely to affect companies outside the insurance industry and therefore should be subject to appropriate consultation with interested parties.

In particular we note that the Discussion Paper does not address the issue of financial guarantee contracts, an example of an insurance contract that is currently scoped out of IFRS 4. The Board indicated in the basis for conclusions to IAS 39 (paragraph BC23A) that they had deferred to a later stage their work on assessing the implications of cancellation and renewal rights and profit-sharing features with respect to the accounting of financial guarantee contracts. We recommend that this matter is dealt with in the next stage of the Board's discussion and that it is subjected to wider consultation.

Appendix B – Comments on the items listed in Appendix B to the Discussion Paper

Item 1 – Initial measurement

We do not propose any changes to the amortised cost model in IAS 39 as a result of differences between that model and the model for insurance contract accounting. We accept that there are inconsistencies between the proposed measurement model for insurance contracts and the IAS 39 model that is applied for investment contracts but we do not recommend that these differences are removed at this stage. Any changes to IAS 39 will have significant implications for other entities, particularly banks, which issue similar products and such changes should not be implemented without wider consultation. Currently only the removal of the prohibition of day-one gains and losses is the subject of such a consultation process.

Item 2 – Gain or loss at inception

The deferral of day-one gains and losses, such as is currently required for certain financial assets and liabilities under IAS 39.AG76, is inconsistent with their subsequent measurement at FVTPL which incorporates changes in all variables used in the valuation model, including those which are unobservable. The resulting carrying value represents neither an exit nor an entry price for the underlying instrument. For these reasons we recommend that IAS 39 is amended to eliminate the restrictions on the recognition of day 1 gain and loss.

Item 3 – Subsequent measurement

We do not propose any changes to the amortised cost model in IAS 39 as a result of differences between that model and the model for insurance contract accounting. In our response to question 5 we identify the differences that we believe exist between the exit value approach proposed in this Discussion Paper and an exit price approach to fair value. We do not believe that IAS 39 should be amended to eliminate any of these differences at this stage. If the decision is subsequently taken to address these issues, the Board should do so as a separate project that is subject to wider consultation.

Item 4 – Surrender value floor and policyholder behaviour

To address these differences would have a significant effect on accounting for financial liabilities under IAS 39. As indicated above, we do not support any consequential amendments to IAS 39 at this stage as they would have widespread implications for products issued by non-insurance entities and should therefore be subject to wider consultation as part of a separate project.

Item 5 – Unit of account

IAS 39 does not currently preclude a portfolio approach to valuation of identifiable risks of instruments considered in aggregate rather than the valuation of individual instruments. The unit of measurement guidance in IAS 39 is not explicit other than for instruments quoted in active markets. In practice, entities typically use a portfolio approach in valuing financial instruments that are not quoted in an active market. Furthermore, as discussed in our response to question 11, we do not think the Board has yet fully analysed the possibility of a different unit of measurement for insurance contracts.

We note that the issue of the appropriate unit of measurement for financial instruments is already the subject of a wider consultation exercise in the context of the discussion paper on fair value measurement. We recommend that any decision to amend IAS 39 is driven by the outcome of that consultation rather than in reaction to comments received in response to this Discussion Paper.

Item 6 – Presentation of premiums

The adoption of our recommendation in response to question 18 would eliminate the difference in the presentation of investment and insurance contracts.

Item 7 – Separation of investment management component

Item 7(a) – Investment management component – Origination costs

In relation to the accounting for investment management services we recommend that the Board does not eliminate the difference by amending IAS 18 at this stage. As explained in our response to question 15 and in our covering letter we believe that this difference should be dealt with in the context of the revenue recognition project.

Item 7(b) – Service fee revenue

See our response to item 7(a).