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29 November 2007

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Dear Sir

**Discussion Paper *Preliminary Views on Insurance Contracts***

We are pleased to submit our comments on the Discussion Paper *Preliminary Views on Insurance Contracts* (the DP) and appreciate the opportunity to contribute to the deliberations at this stage in the development of an insurance standard.

In this letter we make some general comments on the direction the International Accounting Standards Board (the Board) is taking in Phase II of the insurance project. Our responses to the detailed questions in the DP are set out in the Appendix to this letter.

*Implications of the DP proposals for the Framework and existing standards*

If the bases for the principal proposals in the DP (in particular, those relating to the recognition and measurement of insurance liabilities and of revenue and profit from insurance activities) were applied by analogy to activities other than insurance, they would fundamentally change the financial reporting practices of all entities that prepare IFRS financial statements. Accordingly, should the insurance project proceed at a faster pace than several of the IASB's other projects, such as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, IAS 18 *Revenue*, IAS 39 *Financial Instruments: Recognition and Measurement*, and indeed the Framework project, it would set precedents for the development of these accounting standards and the Framework. However, the DP does not discuss the principles on which it is based in a manner that enables entities, other than those engaged in insurance activities, to understand and assess the wider implications of the DP's proposals.

While we recognise the urgency of the need for fundamental improvements to insurance accounting, we are concerned that the DP and indeed any exposure draft on insurance contracts will be reviewed only by insurance entities, accounting firms and others with a direct interest in accounting for insurance contracts, and will be ignored by the business community at large. It is, in our view, essential that the main conceptual issues raised by the DP are subjected to wider debate before final decisions are made about insurance accounting, so that the implications for financial reporting by entities engaged in other activities are properly considered. To ensure that a wider debate of the main conceptual issues takes place, we believe the Board should accelerate work on certain aspects of its agenda, in particular the measurement phase of the conceptual framework project, the liabilities project, and the revenue recognition project.

When the Board reassesses its preliminary views, we believe it should reconsider its preliminary fundamental conclusion that users are best served by a current exit value measurement for insurance liabilities. Our view is that users are better served by a measurement attribute that reflects the actual cash flows resulting from insurance contracts with customers rather than one based on hypothetical transfers of rights and obligations to third parties. In addition, we believe the measurement of insurance liabilities must be consistent with the measurement principles applicable to contractual liabilities generally and that the Board's project to revise IAS 37 should be substantially completed before an exposure draft of an IFRS on insurance contracts is issued.

We believe the new insurance standard will be considered a success if it acknowledges that:

- The statement of financial performance (income statement) is just as important as the statement of financial position (balance sheet). The accounting model should provide information about the sources of earnings and that enables the quality of earnings to be assessed. This is particularly relevant when amounts recognised in the income statement are based on the movement between two judgementally determined balance sheet measurements.
- There are challenges around developing a single model for all insurance contracts when such a wide range of different products fall under the insurance contract umbrella. To the extent possible, the building blocks in the proposed standard need to be conceptually consistent with those used for the recognition and measurement of other liabilities and the recognition and measurement of revenue by entities not engaged in insurance activities. However, to the extent that faithful representation of the economic consequences of insurance contracts cannot be achieved by applying the same accounting principles that apply to other transactions, the Board will need to justify the divergence, identify relevant principles and explain how their application by insurance companies will result in financial reporting that does reflect the commercial substance of insurance transactions.

With these critical success factors in mind, we make the following comments on the DP.

*The arguments in the DP in support of a current exit value measurement for all circumstances are not persuasive.*

The DP defines current exit value as an estimate of the amount that an insurer would expect to pay, at the reporting date, to transfer its remaining rights and obligations immediately to a third party. Our concerns regarding current exit value for insurance echo the concerns we expressed in our comment letter on the Discussion Paper *Fair Value Measurements* dated 4 May 2007. In that letter we said, "the measurement of assets and liabilities at hypothetical exit values, in the knowledge that the assets concerned will continue to be held and not disposed of and the liabilities concerned will be settled and not transferred, represents, in our view, a form of 'discarded opportunity' –based accounting whereby the opportunity cost or benefit is the (generally hypothetical) market-based exit value. Performance reporting then becomes a matter of out-performance or under-performance against that benchmark." This approach to financial reporting is fundamentally different from the approach currently applied by preparers and fundamentally different from the way in which we believe that users view financial statements. And, as we have noted, we are concerned about an accounting model that fails to recognise the relationship of the parties to the actual transaction. We therefore do not understand how, especially in the absence of an active secondary market for insurance contracts, a current exit value measurement can be viewed as resulting in an improvement in the quality of financial information provided to users.

The DP acknowledges that in the absence of an active secondary market for the transfer of insurance contracts, readily observable market prices do not currently exist. Calculating an exit value as described in the DP would compel the insurer to hypothesise what its principal market would be in a transfer of a portfolio of contracts, when the insurer's principal market in fact is not with third parties but rather with its customer base. With a current exit value measurement, profit or loss will be sensitive to changes in estimates of market expectations that, in the absence of active markets, are not subject to precise determination. Insurers generally issue contracts with the expectation that they will manage and discharge their obligations according to the contractual terms agreed with their customers over time. Because insurance contract transfers are rare, we believe that the most relevant information about future cash flows will be derived from the insurer's relationship with its customers and not from a hypothetical portfolio transfer to an independent third party.

Further, the DP places constraints on certain assumptions used in measuring insurance liabilities. These constraints would result in insurance contracts being measured at an amount that is not truly a current exit value (i.e., not the amount that an insurer would pay a third party to transfer its remaining rights and obligations). These constraints include:

- limiting expected future beneficial cash flows to future premiums that policyholders would have to pay to maintain guaranteed insurability; and
- limiting risk margins to diversification benefit within a managed portfolio of insurance contracts with broadly similar risks

As these constraints result in the exclusion of cash flows that market participants would consider in pricing a block of insurance contracts, we do not believe that the term 'current exit value' is an appropriate label for the measurement model set out in the DP. Not only, therefore, is the Board suggesting an exit-value based model be applied in measuring all insurance liabilities when insurance liabilities are hardly ever transferred but the constraints placed by the DP on certain assumptions that would be made were insurance liabilities to be transferred means that the DP's measurement model will never reflect economic reality, even theoretically.

*Current estimates of future cash flows should use entity-specific information for expected cash flows as the contracts are expected to be settled over time, because this reflects the fact that most insurers intend to discharge obligations with policyholders directly rather than to transfer them to a third party.*

In general, liabilities are measured at the amount that an enterprise would rationally pay to settle its present obligations or to transfer them to a third party on the balance sheet date. Because insurance contract obligations are generally settled over time, we propose that the liability that is recognised should be the entity-specific ultimate settlement value. We emphasise that by entity-specific ultimate settlement value we do not mean a value that would be paid to settle the obligations at the valuation date, but rather the present value of the amount that would be required to meet the contractual obligations to policyholders in the ordinary course of business over time, including an entity-specific required margin to perform the necessary tasks to settle the obligation. Our definition of an entity-specific ultimate settlement value can be described as a value based on the cash flows that are expected to result from the contracts and the margins that have not been recognised in profit or loss at the valuation date. The model that we propose would be **dynamic** and not lock in any assumptions over the life of the insurance contract. We believe that ultimate settlement value is more representationally faithful and more helpful to users in assisting them to predict future cash flows than current exit value.

In our proposed ultimate settlement model, insurers would update all assumptions at each balance sheet date, incorporating current estimates of the full range of possible future cash flows, including embedded options and guarantees. The principal assumptions that would meet our criteria and, therefore, would be entity specific would be those items that are operational in nature (e.g., internal costs, overhead). Those that are market related (e.g., interest rates, inflation rates, factors relating to certain expected claims/losses) would have to be consistent with observable data. Our proposal would permit entities to use their own entity-specific data, even when market observable data may exist, provided that the entity *has tangible evidence* that market observable data is not consistent with the anticipated entity-specific cash flows. While the entity-specific ultimate settlement view we propose differs conceptually from the transfer view favoured by the Board in the DP, we believe that in practice estimates of future underlying cash flows under each of the two bases may not differ significantly.

We believe that a measurement basis which considers insurance contracts as bundles of cash flows representing a variety of interrelated rights and obligations is consistent with the pricing of contracts and would result in faithful representation of the arrangements concerned. In order to reflect fairly the value of the insurance liability an insurer must make assumptions about the receipt of future premiums. In our view an insurer cannot properly measure the liability for future payments without recognising an asset for future premiums, and that they should not be artificially separated. For insurance contracts, this principle should be applied on a portfolio basis because insurance relies on the concept of the pooling of risk, and this is how it is priced.

Regardless of whether an ultimate settlement or current exit value measurement model is applied, we therefore believe that all expected cash flows from policyholder behaviour should be recognised in measuring insurance assets and liabilities. We acknowledge the difficulty of reconciling this approach with asset recognition principles in current accounting standards but believe that it is the approach that best portrays the economic consequences of insurance contracts. The ‘guaranteed insurability’ criterion proposed in the DP might provide a more objective yardstick in measuring the asset that an insurer would recognise in respect of beneficial policyholder behaviour but it seems to us that it neither sits comfortably with asset recognition principles in current IFRS standards nor reflects the way in which insurers manage their businesses.

The DP proposes what we would describe as a “matching” approach to policyholder participation rights insofar as it would require the cash flows used in measuring a participating insurance liability to incorporate all the policyholder dividends that are expected to be paid from resources that are recognised in the financial statements, ie policyholder surplus, other recognised gains, and future premiums that are included in the cash flow scenario. We agree with this approach, although, as explained above, under the ultimate settlement model we propose the future premiums included in the cash flow scenario would not be limited to those that pass the guaranteed insurability test but would be comprised of all expected cash flows from policyholder behaviour. It would therefore be necessary to include in the cash flow scenario all the policyholder dividends that are expected to be paid from all the future premiums that are expected to be received from existing participating contracts.

Because our proposed model is based on the premise that obligations will most often be paid by the reporting entity and only rarely transferred to a third party, an entity would not be able to assume that it could unilaterally settle at an amount lower than the contractual amount unless and until the entity legally negotiates a lower settlement amount. Accordingly, our model would not consider credit characteristics in the valuation of the liability.

One of our concerns with the application of current exit value in measuring insurance liabilities is that by suggesting that it is a market-determined value when in fact it is not, it implies that the financial statements of different entities will be far more comparable than will in fact be the case. If the current proposals are implemented without change, insurers will use data based on their own experience and their own expectations where relevant market-observable data does not exist. Indeed, the DP acknowledges that in many cases an insurer would use its own internal data as a surrogate for the data that a hypothetical market participant would use. Because an entity-specific ultimate settlement approach uses the entity's own inputs, calculating future cash flows on this basis should be more practicable than a transfer approach which requires the estimation of inputs from the perspective of a hypothetical market participant.

We are aware that IAS 37 requires provisions to be measured on a current settlement basis as opposed to an ultimate settlement basis. However, IAS 37 views provisions in terms of obligations that give rise to costs (even when, as in the case of warranties, the provision could alternatively be viewed as an element of the sale transaction in which the warranty was given) and does not address liabilities that represent consideration receivable for services. In the case of insurers, the rights and obligations created by insurance contracts obligations are inextricably connected with the revenue and profit or loss from those contracts. We therefore view this as a question of reconciling IAS 37 with IAS 18. The Board implicitly acknowledges in the DP, specifically in its proposed approach to the service margin, that the two standards cannot be reconciled. This issue is not, however, confined to accounting for insurance contracts but arises in connection with any liability associated with consideration for the sale of goods or the rendering of services. The Board therefore needs to progress its liabilities and revenue recognition projects towards completion before it can conclude on its approach to the measurement and revenue recognition of insurance liabilities.

*We believe users' needs are best met by reflecting the economics of insurance business whilst also recognising revenue using principles consistent with other industries.*

A contentious issue raised in the DP concerns the recognition and measurement of margins in insurance contract liabilities. In our view the Board the DP does not explain in sufficiently precise terms the concept of the margin, is not sufficiently clear about the objective and purpose of the "risk and service margin" and does not provide sufficient guidance on how it would be accounted for, despite the supplemental "Frequently asked questions: service margins" document recently issued by the IASB Staff and recently posted to the IASB's website.

The DP defines the risk margin as the quantified difference between (1) a liability of a certain amount and timing of settlement, and (2) a liability with uncertain cash flows. It goes on to state that the IASB's preliminary view is that risk margins are compensation for bearing risk, that is, the margin that another party would require if it took over the insurer's current or remaining contractual rights and obligations. As the DP acknowledges, the risk margin cannot typically be observed in the market, and the variety of possible approaches to determining risk margins described in Appendix F to the DP suggests that estimates of risk margins will vary greatly in amount depending on the approach that is applied.

Under an ultimate settlement, as opposed to a transfer, approach the margin is in our view more appropriately viewed not as a risk margin but as required profit from the provision of insurance and other services. Insurance contracts involve the provision of services to policyholders, chiefly the assumption of risk. However, insurers often do much more than pay claims; they also adjudicate losses, and frequently provide legal or other assistance to claimants in coping with their losses.

Insurers also maximise the value of savings-oriented contracts through asset management services. In return for providing these services, insurers expect to earn a margin.

On this basis, the financial reporting issue becomes one of revenue (or profit) recognition and not one of liability measurement. The DP makes no attempt to reconcile its liability measurement approach with the requirements of IAS 18. However, it seems to us to be essential for any standard on accounting for insurance contracts to deal with revenue recognition. We can see no reason why the revenue recognition model to be applied generally in IFRS should not be applied by insurers and, as we have stated above, we believe that the Board should accelerate its work on the revenue recognition project to enable further progress to be made with regard to insurance accounting.

*Financial statements serve users best when the balance sheet represents the economics of settlement and the income statement reflects the profitability of the contractual relationship that exists between the insurer and its customers. Financial statements should help explain how well the insurer manages its business.*

The ultimate aim of financial reporting must be to provide the most useful information to users. Financial reporting therefore turns entirely on the information needs of users and how to communicate information that is responsive to those needs in a manner that can be understood by users. In our view, estimated ultimate settlement value together with the unrecognised margin provides more useful information to users of financial reports of insurance activities than a constrained hypothetical exit value regarding the amounts, timing and uncertainty of future cash flows, while information about the margins recognised in the period and changes in the ultimate settlement value are a more useful basis for assessing performance in relation to insurance activities than changes during the period in a constrained hypothetical exit value. Estimated ultimate settlement value is also more likely to relate closely to the manner in which the business is managed than the exit value approach proposed in the DP.

*Presentation and disclosure matters should be considered at the same time as recognition and measurement.*

Presentation and disclosure are critical aspects of any standard. Discussions regarding presentation and disclosure will provide further insights into the implications of the choice of measurement approach. Additionally, we believe that the Board will garner much greater support for the ultimate standard if users and insurance companies can view the proposed presentation and disclosures. We believe, therefore, that the Board should not settle on a measurement approach for insurance contracts before it has deliberated matters of presentation and disclosure.

In our view, the elimination of accounting mismatches is a particularly important objective in relation to insurance contract accounting to ensure the financial statements represent faithfully the economic consequences of the underlying commercial arrangements as a whole. In our view, rather than introduce special rules for unit-linked insurance contracts, the Board should assess whether it is possible to refine the underlying accounting principles, perhaps acknowledging that the economic function of an item rather than merely its form should be taken into account in determining how it is measured and classified. If, however, it proves impossible to eliminate all of the significant accounting mismatches that insurance entities currently experience by refining the underlying accounting principles, it may be necessary to highlight the impact of such mismatches in the income statement in such a way that they can be easily identified and adjusted by users of the financial statements.

*It is more important to ensure that a workable standard is ultimately produced than to rush the development of a new standard.*

We hope that the Board will reassess its preliminary views and adopt an approach that is more in line with the approach we are proposing. In any event, however, we recommend that the Board work with the insurance industry to field test the approach it decides to pursue after reviewing the responses to the DP and before an exposure draft is developed. Field testing will provide the Board with an understanding of the impact of the chosen measurement approach on insurers' balance sheets, income statements, and notes to those statements, will highlight the practical issues that insurers will confront in implementing the Board's proposals, and should be used to provide an opportunity to enable users to assess the usefulness of the information reported.

We note that the quantitative impact studies carried out in developing the European Union's Solvency II proposals generated a favourable response from the industry and resulted in improvements being made to the proposals. A similar result emerged in Australia and New Zealand before they introduced their fair value-based insurance standards more than a decade ago.

Areas that we believe need to be explored during field testing include:

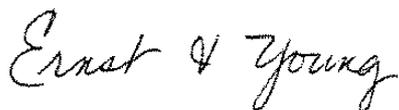
- the differences between liabilities determined on a transfer and on a current and ultimate settlement basis;
- the approaches to and methods for the calculation of risk and service margins;
- the practicality and benefits of unbundling insurance contracts into separate deposit and service components; and
- how the income statement can reveal the sources of earnings and clearly identify the movement in liabilities.

We recognise that the development of a new accounting standard on insurance contracts is a challenging project as several independently difficult accounting issues (e.g., revenue recognition, performance measurement, and liability measurement) need to be incorporated in a coherent manner into one comprehensive standard. Although we have proposed an alternative model to the preliminary views expressed in the DP, we fully support the Board in its efforts to develop an insurance contract standard. We believe that this project should not be rushed even though IFRS desperately needs an update to IFRS 4. We therefore encourage the Board to take the time needed to ensure that the update to IFRS 4 will be the right standard that will serve the financial community for many years, without continuous amendments to address unintended consequences.

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Should you wish to discuss the contents of this letter with us, please contact James Dean on +44 20 7951 1404, or Leo van der Tas, on +31 10 406 8114.

Yours faithfully



## APPENDIX

### 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?*

Insurance contracts often include features of financial instruments, such as options and deposit components, as well as features of service contracts, including the assumption of risk and assistance to claimants in dealing with their losses. On balance, we believe that the rights and obligations created by an insurance contract should be recognised when the insurer becomes party to the contract, consistent with IAS 39, rather than when risk coverage commences, as would be the case were insurance contracts to be accounted for in the same way as executory contracts. We agree that insurance contracts should be derecognised only when the insurer has extinguished its obligations.

However, guidance on recognition of an insurance contract in the proposed standard needs to address not only *when* a contract is recognised, but also *what* is being recognised. The key challenge for the Board will be to link what needs to be recognised with *how* the measurement of an insurance contract is consistent with other IFRS standards; more specifically IAS 39, IAS 18 *Revenues* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Our concern is that limiting recognition and derecognition considerations solely to IAS 39 may lead to the conclusion that premiums are deposits and benefits are withdrawals; that is, claims are not expenses. As noted in our cover letter, we believe the insurance standard needs to be aligned with IAS 37 and IAS 18 which may result in a completely different accounting outcome: that premiums are revenue and claims are expenses.

### 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?*

In our covering letter we propose an alternative measurement model that utilises entity-specific assumptions rather than market observable cash flows or margins, provided that the entity can demonstrate that its entity-specific assumptions are the best representations of the actual transaction with a customer and the margin the entity requires for the provision of insurance and other services. While we do not believe that market-based building blocks provide the appropriate measurement model, we believe that the structure of the blocks, namely: (i) probability weighted estimates of future cash flows, (ii) time value of money, and (iii) a required margin for insurance and other services, is an appropriate way of viewing the measurement of a liability. We suggest that, regardless of the ultimate model selected (i.e., our ultimate settlement model or the Board's exit

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value model), the proposed standard should restrict itself to describing the objectives of the measurement process and the measurement basis, while details of the building blocks would be included in implementation guidance rather than the standard. This approach would provide preparers with the benefits of guidance when a detailed probability-weighted model is the best way to estimate the liability but would also give preparers flexibility if they believed they could meet the measurement objectives other than by means of the specifics of the building blocks.

If the Board elects to proceed with an exit value model using the building blocks, we believe that it may be more appropriate to apply a hierarchy concept where readily available market information (e.g., a rate on line or a replicating model) could be used instead.

We are concerned that the definition and purposes of the margins in the building blocks is not clear, even with the additional guidance in Appendix F and the supplemental “Frequently asked questions: service margins” document recently issued by the IASB Staff. The division of the margin into two separate components, insurance risk and service margin, has not been properly rationalised in the DP, and we are not clear whether the service margin would cover profits embedded in insurance contracts other than those that market participants would require to bear risk, or only specific services.

### 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?*

Although the Appendix F guidance is reasonable, it suggests that there are many different possible approaches to determining risk margins and that these different approaches could lead to very different liability values for substantially the same risks. Unless the conceptual basis and the purpose of margins are fully explained within the standard, too much variation may result in practice.

With regard to Appendix E, although we do not agree with the Board’s preliminary view on the use of exit value, we do believe that Appendix E is at the right level of detail for implementation guidance if an exit value model is adopted. However, we do not support the statement in the Appendix that expense estimates should not be entity specific. Rather we believe that a standard cost approach, like that used in pricing inventories, should be applied.

### Question 4

*What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.*

- (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*

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*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).*

As we note in our covering letter, we believe a gain at inception, if any, must be based on a concept of revenue recognition that is consistent with the principles that will emerge from the Board's revenue recognition project.

Whichever alternative the Board decides ultimately to use in the insurance standard, we believe it is critical that the Board addresses the unit of account question before it decides on whether or not there needs to be a calibration of margin. Entities often will accept anticipated losses on a specific product because those losses will be offset by profits generated on other products. So requiring the calibration of the margin at a lower (i.e., more disaggregated) level than assumed in pricing can lead to the recognition of losses at the inception of one product and delayed profit recognition for another. This approach could cause the financial statements not to represent faithfully the economics of the relationship with customers.

Please see our response to Question 11 as that question also relates to the unit of account issue.

**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?*

No. As we state in our covering letter, we are not convinced that a current exit value measurement best serves users' needs. It is not relevant to the economics of the business because transfers seldom occur; the reliability of the estimates of exit value will be questionable because there is so little market information on which to base inputs. Moreover, as a result of the constraints placed by the DP on the amounts that can be included in the estimate of future cash flows, the measurement attribute is not in fact the amount that the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. We recommend an approach that reflects:

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- the settlement value of contracts over time ('the ultimate settlement value') because this is more representationally faithful and more helpful in assisting users to predict future cash flows, and
- the significant service component of insurance contracts by recognising pricing margins as revenue.

*(b) Is 'current exit value' the best label for that measurement attribute? Why or why not?*

The constraints imposed by the DP on the valuation of liabilities will result in insurance contracts being shown at a value that is not truly a current exit value (i.e., not the amount that an insurer would pay a third party to transfer its remaining rights and obligations). These constraints include:

- limiting expected future beneficial cash flows to include only future premiums that policyholders would have to pay to maintain guaranteed insurability; and
- limiting risk margins to diversification benefit within a managed portfolio of insurance contracts with broadly similar risks.

As these constraints result in the exclusion of cash flows that market participants would consider in pricing a block of insurance contracts, the term current exit value is not an appropriate label for the measurement model set out in the DP. Not only, therefore, is the Board suggesting an exit-value based model be applied in measuring all insurance liabilities when insurance liabilities are hardly ever transferred but the constraints placed by the DP on certain assumptions that would be made were insurance liabilities to be transferred means that the DP's measurement model will never reflect economic reality, even theoretically.

### 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:*

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

The initial pricing of insurance contracts includes assumptions about policyholder behaviour regardless of whether that behaviour is a benefit or cost to the insurer. And when an entity provides a quote to assume business under reinsurance contracts or purchase another insurance entity, it also assumes policyholder behaviour. Therefore, we believe that any measurement model should incorporate beneficial policyholder behaviour as well and that option (b) would be the preferable approach.

We believe that it is necessary to consider the effects of policyholder behaviour, whether favourable or unfavourable, in order to make an unbiased estimate of future cash flows. For example, an insurer

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may have a portfolio of 20-year term life contracts that policyholders typically surrender after year ten. If a standard were to incorporate the surrender option as a separately recognised customer relationship asset (option (a)), the fair value of the liability would assume the liability through 20 years and an asset would need to be recognised for the difference in expected ultimate cash payments for policies that surrender after year 10. The liability is overstated and this overstatement is effectively corrected by the recognition of an asset. We do not believe that such a financial reporting outcome would be a faithful representation of the economic consequences of the transactions concerned.

Although it might sometimes be possible for the effects of favourable policyholder behaviour to be separately identified, it is generally not practical. Policyholder behaviour is not always favourable and identifying those situations in which it is favourable would require extensive analysis. The analysis would have to be updated periodically because the conclusions can change, for example with the ageing of contracts and with changes in interest rates. Stripping out the effects of favourable behaviour entails a “with and without” calculation, doubling the valuation effort. Furthermore, as assumptions are interdependent, mortality, expense and perhaps other assumptions would have to differ between the “with” and the “without” calculations.

Our response to Question 7 is also relevant to this topic.

### 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 (i.e., have a discernible effect on the economics of the contract by significantly modifying 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).*

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We believe that a measurement basis which considers insurance contracts as bundles of cash flows representing a variety of interrelated rights and obligations is consistent with the pricing of contracts and would result in faithful representation of the arrangements concerned. In order to reflect fairly the value of the insurance liability an insurer must make assumptions about the receipt of future premiums. We believe that an insurer cannot properly measure the liability for future payments without recognising the asset for future premiums, and that they should not be artificially separated. For insurance contracts this principle should be applied on a portfolio basis because insurance relies on the concept of the pooling of risk, and this is how it is priced. Regardless of whether an ultimate settlement or current exit value measurement model is applied, we therefore believe that criterion (c) comes closest to capturing the expected cash flows from beneficial policyholder behaviour and is the approach that best portrays the economic consequences of insurance contracts.

Criteria (a) to (d) in Question 7 would all involve the recognition of contractual options held by policyholders and the question arises whether a separate customer relationship asset should be presented in respect of the benefits from policyholder behaviour. As the DP points out, IAS 38 *Intangible Assets* prohibits the recognition of internally generated customer relationships. Moreover, IAS 38 would prohibit application of the revaluation model due to the absence of an active market for such an intangible and this would prevent the application both of the ultimate settlement approach we propose and of the quasi-exit value approach proposed in the DP. Since the amounts relating to policyholder behaviour are, from the insurer's standpoint, inextricably linked with its contractual rights and obligations, we believe that it is more appropriate to include amounts recognised in respect of policyholder behaviour in the measurement of the insurance liability.

### Question 8

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

We believe that, regardless of the measurement objective, acquisition costs should be expensed when incurred. However, if acquisition costs are to be expensed when incurred, it will be essential at the same time to recognise the future premiums from which insurers recover the acquisition costs, in order to represent faithfully the economic substance of insurance activities. We recognise that this issue is relevant to the Board's liabilities and revenue recognition projects and that the approach adopted for insurance contract accounting needs to be consistent with the approach adopted in those projects.

### Question 9

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

We believe that insurance contracts obtained in either a business combination or in a portfolio transfer should initially be measured at fair value, consistent with the principles of IFRS 3. Under the ultimate settlement measurement model we are proposing, an insurance contract acquired in either a business combination or portfolio transfer should follow the same accounting. We recognise that this could, in certain circumstances, differ from the purchaser's estimate of ultimate settlement

## APPENDIX (continued)

value but our suggested settlement model results in measurements of insurance liabilities that are closer to fair value than the measurement model described in the DP.

The DP refers to the possible continuation of “the expanded presentation for insurance contracts acquired in a business combination or portfolio transfer” that results in an intangible asset that is difficult to distinguish from goodwill. However, we would apply the same approach to the measurement of acquired insurance liabilities as to an insurer’s “own” insurance liabilities, for the same reasons, as described in our response to Question 7 and would therefore not split the fair value of acquired insurance contracts (whether in a business combination or a portfolio transfer) into two components.

### Question 10

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

We agree with those who believe that the elimination of accounting mismatches should be a major objective of phase II of the project on insurance contracts. However, we agree with the Board that accounting mismatches for insurers arise today more from unsatisfactory measurements of insurance liabilities than from deficient measurements of insurance assets. We are not in favour of applying different measurement principles for assets depending on whether or not they are held to back insurance liabilities. Our response to Question 17 addresses this issue further.

We note, however, that the adoption of a new measurement basis for insurance contracts may cause insurers to re-consider decisions made regarding the classification of financial assets into the different categories prescribed IAS 39. The Board should also provide insurers with the option of re-designating their financial assets on the adoption of the new insurance standard.

### 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?*

We believe that in any insurance liability model the determination of a liability, including a margin, has to be on a portfolio basis, because the pooling of risk and reliance on the law of large numbers is inherent in the nature of insurance business. Pricing of insurance, whether for individual contracts sold in retail markets or for blocks of business in a transfer of liabilities, reflects this fact. Therefore, the measurement of liabilities for financial reporting purposes should likewise be based on portfolios of contracts.

We consider that any risk margin which is adopted in the final standard, including any diversification benefit outlined in (b) below should be determined in the context of the IFRS 4 definition of portfolios.

## APPENDIX (continued)

*(b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?*

Diversification of risk cannot be ignored as pricing relies on it. Companies are in the business of making profits and manage at an overall enterprise level. This allows for diversification of risk across the underlying contracts sold. Contracts are sold anticipating gains or losses with the goal that the result for the cumulative individual contracts is a gain. In addition, one portfolio could be generating significant profits where another portfolio could have marginal losses, with the assumption that the overall business will generate profits. Diversification is reflective of management's ability to balance exposures to adverse and positive future events, as well as companies' ability to manage costs including administrative and claim adjudication costs. Therefore, companies should be allowed to consider diversification when measuring liabilities to the extent that they can demonstrate the effectiveness of the diversification in reducing the overall risk exposure they have.

Based on the foregoing comments, we believe that any risk margins adopted in the final standard should take account of diversification benefits between portfolios and that this diversification benefit should be separately disclosed. Particularly if a market-based measurement approach is adopted then the Board should avoid prescribing how diversification benefits should be measured.

### Question 12

*(a) Should a cedant measure reinsurance assets at current exit value? Why or why not?*

The measurement basis for a cedant's reinsurance asset should be the same as the basis for direct liabilities. As there is seldom an observable market for reinsurance assets, our concerns about the ability to reliably measure reinsurance assets at a current exit value are the same as those we have expressed regarding insurance liabilities. We would prefer the measurement of the asset to take account of all the factors that the insurer would consider in negotiating the price of the reinsurance.

*(b) 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.*

We agree that, conceptually, a risk margin increases the measurement of the reinsurance asset. A risk margin in a reinsurance asset in fact reflects the benefit of realising a larger recovery if insurance claims experience deteriorates.

A reinsurance contract and the underlying insurance contracts to which it relates are independent contracts and should be separately measured. While the measurement of these independent contracts will share critical cash flow data, other aspects of the valuation models can differ. We therefore do not agree that the risk margin on the reinsurance asset should always equal the risk margin on the underlying insurance contracts, although we would expect these margins often to be the same in our ultimate settlement model.

## APPENDIX (continued)

*(ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.*

We can see that an expected loss model may be more consistent with the exit value measurement basis for reinsurance assets than an incurred loss model. However, we do not agree that exit value is the appropriate measurement basis for reinsurance assets, and in any event believe that there would be major practical difficulties in estimating reliably the probability of reinsurers not paying claims when due. As disputes are very contract specific and settled confidentially between the parties, we cannot see how there could ever be market-observable data for disputes. Therefore, any impact that disputes have on the expected cash flows will have to be entity specific. In our view, this is another good reason why an exit value model should not be adopted.

A measurement basis that considers the value in settlement would reflect disputes and defaults when they affect the expected cash flows from the reinsurer. Companies do not anticipate that the reinsurer will default or dispute a claim, although both events sometimes occur. We believe that the accounting treatment should reflect defaults and disputes when it becomes apparent that expected payments under the reinsurance contract are unlikely to be received.

*(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.*

Under an exit value model we generally agree that the right to purchase reinsurance on contracts not yet issued is not likely to have a significant value as the term of the guarantee does not extend far into the future. Where any futures rights under reinsurance contracts are considered to be options they should be accounted for in accordance with IAS 39.

Under the ultimate settlement model we propose, the right to obtain reinsurance for contracts a cedant has not yet issued is not relevant to the measurement of reinsurance assets.

### Question 13

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

The DP proposes a new accounting model for all contracts that meet the current definition of insurance in IFRS 4 *Insurance Contracts*. This definition is focused on the existence of significant insurance risk. Many different types of contract qualify to be classified as insurance contracts under this definition. Insurance contracts occupy different positions along a continuum, stretching from contracts containing a large service component and a small financial instrument component, to those that contain a small service component and a large financial instrument component. While there is no doubt that many contracts, long duration contracts in particular, have significant deposit components and therefore an argument to unbundle them has theoretical merit, insurers have pointed out that unbundling in this way poses significant practical challenges. These include difficulties with how to split premiums and cash flows into the separate components, and challenges around how meaningful and therefore how useful the unbundled information would be.

## APPENDIX (continued)

The desire to have contracts unbundled seems to stem from two concerns, namely that:

- a significant deposit feature may not be recognised if contracts are not unbundled, and
- the deposit element may be measured differently from financial instruments.

We have concerns about several of the implications of the unbundling as proposed in the DP.

The DP suggests that a contract containing both service and deposit components can be valued by measuring the deposit component under IAS 39 and presenting the difference between this amount and the value of the liability for the entire contract (on a current exit value basis) as the insurance component. We believe that because a bundled set of cash flows is not necessarily priced the same as the sum of the components priced separately, such an approach may distort the value of the insurance component; it may even be negative. Some contracts that have explicit fees and separate account assets lend themselves to unbundling. For other contracts, unbundling requires artificial allocations of cash flows between the insurance and deposit components.

Unbundling raises the possibility that the two components may be separate units of account. The insurance component may be measured considering a portfolio of contracts as the unit of account. The deposit component, if measured under IAS 39, may have the individual contract as a unit of account. The measure of the deposit component can also be no less than the minimum deposit floor under IAS 39, notwithstanding the preliminary decision by the Board that the floor does not apply to the measurement of insurance contracts.

The DP does not discuss how the margin should be split between the service margin and the risk margin when a contract is unbundled.

We are concerned that the unbundling of insurance contracts would set a precedent for the wider application of this approach – for example to treat all prepayments as separate deposit components. In our view it is not appropriate to introduce such a requirement for insurance contracts before addressing the broader issue of principle and its practical application.

### 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?*

Based on the definition of current exit value used in the DP, the current exit price of a liability is in theory the price for a transfer that neither improves nor impairs its credit characteristics. However, this is purely a matter of definition; the key issue is whether this is a relevant and useful measurement basis.

*(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?*

In our view, a measurement of a liability that takes account of the risk of non-performance by the creditor has nothing to do with real market participants as no one in the real world would assume another party's liability for an amount that reflected that party's credit risk. We therefore do not understand how a liability that takes non-performance risk by the creditor into account can possibly

## APPENDIX (continued)

be described as “the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations to another entity” and do not understand how the DP can claim that such a measurement “represents faithfully a real-world economic attribute of the asset or liability being measured”. We believe that changes in credit characteristics should be reflected only to the extent that they affect expectations about real future cash flows.

We are not aware of any commonly accepted approaches to quantifying the effects of credit standing on the pricing of insurance contracts or on the measurement of insurance liabilities. Our view is that any amounts disclosed as relating to credit characteristics and changes in credit standing will have little credibility; we believe that analysts would reverse out the effect of credit risk while individual shareholders could be misled by the gains recognised by companies whose credit-worthiness is deteriorating, as such gains would neither be realised nor capable of being realised.

### 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?*

As we do not support the exit value measurement model proposed in the DP for insurance liabilities, the comparison with the treatment of financial liabilities under IAS 39 is not particularly relevant for us.

The inconsistencies identified in Appendix B highlight the need for the IASB to resolve the future direction of liability measurement and revenue recognition. Furthermore, any measurement differences between financial instruments and insurance contracts which the Board might retain highlight a need for the Board to be confident that the definition of an insurance contract is robust.

Please see our response to Question 7(a) that addresses expensing acquisition costs as they are incurred.

### 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?*

Participation features, whether contractual obligations or not, are considered in the pricing of contracts and are considered in estimating the value of contracts in a potential business combination transaction.

The crediting of dividends to participating contracts generally happens after the earnings occur in the underlying investment portfolio, so the liability measurement model for insurance contracts has to incorporate future participating dividends if it is to reflect the expected cash flows with the policyholder. Under the current exit value measurement model proposed in the DP, the liability will not represent the amount that would be paid in a transfer to another party if expected future

## APPENDIX (continued)

dividends are not incorporated as it would fall short of the amount the other party would demand to assume the contract.

Regardless of the measurement model selected there is no question that dividends that satisfy a legal obligation should be in the estimated cash flows. Although, constructive obligation dividends can be subjective and difficult to determine, we believe that those too should be included in the expected cash flows of whatever measurement model that is selected.

If the Board is unable to conclude that expected cash flow estimates are part of the liability as no constructive obligation exists, it should consider how to characterise the value of these future payments, (e.g., as equity) and how to present the payments when they are made; that is, whether they should be presented as expenses or as distributions of equity.

*(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?*

Payments on participation contracts are impacted not only by past practices or published policies, but also by regulatory influences, which may or may not be legal requirements. The proposed changes to IAS 37 do not address how regulatory influences should be considered in the determination of a constructive obligation. Accordingly, we believe that for participating contracts additional guidance will be needed beyond the new definition of constructive obligation.

We are concerned that the most recent ED on IAS 37 appears to be narrowing the notion of constructive obligation. If this is done it could significantly restrict the participating dividends that can be included in the measurement of participating insurance contract liabilities and the resulting accounting would not reflect the underlying economics of the contract.

### 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).*

## APPENDIX (continued)

The elimination of accounting mismatches is a particularly important objective in relation to insurance contract accounting as such mismatches, including some of those referred to in this question, result in recognition and measurement that does not represent faithfully the economic consequences of the underlying commercial arrangements, and undermines the credibility of the financial reporting of insurance activities. However, in our view, rather than introduce special rules for unit-linked insurance contracts, the Board should assess whether it is possible to refine the underlying accounting principles, perhaps acknowledging that the economic function of an item rather than merely its form should be taken into account in determining how it is measured and classified. The accounting mismatch that arises, for example, in respect of treasury shares held within policyholder portfolios, does not reflect the true economics of the fact that the investments are being held on behalf of policyholders, rather than for the entity's shareholders. An approach that explicitly recognises the economic purpose for which the assets are held might provide a legitimate rationale for the approaches described in (a), (b), and (c) above.

We cannot see any legitimate basis for the treatment described in (d) above, however, as it would result in a purely arbitrary measurement of the liability.

### Question 18

*Should an insurer present premiums as revenue or as deposits? Why?*

The DP reports that the Board believes that it matters whether an insurer treats premiums as revenue or as deposits. This being the case, we find it surprising that the DP sets out the reasons why benefit payments to policyholders can in substance be regarded as repayments of deposits but does not set out any rationale for regarding premiums as revenue. We suggest that the Board prepares a more balanced discussion of this issue and obtains input from constituents on the basis of it.

Subject to whatever might emerge from such discussion, we cannot see any grounds in current standards for treating premiums as deposits except to the extent that the insurer is in substance providing an investment management service rather than providing insurance. We can therefore see more reason to treat some part of the premiums on, for example, participating contracts as deposits than premiums on general insurance.

### Question 19

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

We hesitate to suggest specific items that should be presented on the face of an insurer's income statement as we believe that this question needs to be addressed in the context of financial statement presentation as a whole, which is the subject of a forthcoming IASB discussion paper, and we can see no reason why the principles of presentation applied to insurance activities should be different from those that apply generally. However, we are opposed to excessive prescription in the specific items to be presented on the face of the income statements and believe that disclosure principles should be developed that require companies to determine the information to be disclosed based on its relevance to an understanding of the entity's performance, as currently required by IAS 1. The objective of the income statement and of related disclosures is to allow the reader to understand the

**APPENDIX (continued)**

key drivers of profit or loss. We do not believe that this can be achieved by prescribing the disclosure of particular items but it might be appropriate to include one or more examples of how this objective might be met in implementation guidance.

**Question 20**

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

Similar to our response to Question 19, we see no reason why the presentation and disclosure principles that apply generally should not apply to insurance, and therefore would prefer to consider this question in conjunction with the Board's forthcoming discussion paper on financial statement presentation. The particular concern which has given rise to this question in the case of insurance appears to relate to accounting mismatches. As we have already said, we believe that it should be a key priority of the Board to eliminate accounting mismatches but where the issue is one of volatility in the short-term measurement of assets backing long-term liabilities, rather than looking for ways of omitting items from the income statement it may be necessary to highlight the impact of such mismatches on the income statement in such a way that they can be easily identified and adjusted by users of the financial statements.

**Question 20**

*Do you have other comments on this paper?*

Our key points are contained in our cover letter.