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Dear Richard

ED/2013/7 *Insurance Contracts*

Overleaf we set out in writing the summary feedback on the International Accounting Standard Board's Exposure Draft *Insurance Contracts* previously sent to you via email.

As always, we would be pleased to discuss our comments and concerns in more detail if this would be helpful.

Yours sincerely

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Incorporated in England with limited liability.

Summary of HSBC's insurance manufacturing business

Financial products sold by HSBC include insurance contracts, which we provide through an integrated bancassurance model principally for customers with whom we have a banking relationship. We have life insurance manufacturing operations delivering a wide range of wealth and protection products in Asia, Europe, Latin America and the Middle-East.

Summary financial information (relating to the consolidated insurance manufacturing subsidiaries of the Group) for the year ended 31 December 2012:

- Total premiums written: USD 13,599m
- Total insurance reserves: USD 68,195m, of which:
  - USD 24,477m related to insurance contracts with DPF, principally in Hong Kong
  - USD 24,374m related to investment contracts with DPF, principally in France
  - USD 13,056m related to unit-linked insurance contracts, principally in Hong Kong, Brazil and UK
  - USD 3,920m related to term assurance (principally Brazil and Mexico) and other long term assurance business (principally Hong Kong)
  - USD 2,287m related to annuities business
  - USD 81m related to non-life insurance business

Key feedback

We continue to support the IASB's decision to measure insurance contracts using the building block approach, consisting of the present value of expected future cash flows, a risk adjustment and a contractual service margin. In our view this approach is consistent with the economic value of insurance liabilities. We believe that this approach reflects the drivers of profitability of insurance contracts, reflecting how we price and manage our insurance business. Further it provides a consistent and transparent measurement of the value created by the underlying insurance contracts.

We note positive progress in a number of areas since the previous exposure draft ('ED 2010/8'), and broadly support the revised proposals in respect of adjusting the contractual service margin, the presentation of revenue and expenses, and on transition. However we have fundamental concerns about the alternative measurement approach and the use of OCI proposed in this draft standard.

As a result of the complex nature of modelling insurance assets and liabilities we have not been able to perform any comprehensive field testing of the proposals on real products in the short time since the publication of the ED. Given the importance of this standard to the industry, the fundamental changes proposed, and the complexity involved in applying them, we believe that longer comment periods are required as part of the due process. Upon completion of a final standard a review draft should be published with an extended comment period – this will enable far more comprehensive field testing to be performed, and for unintended consequences to be identified.

Summary views on each of the comment areas

Unlocking of contractual service margin

- Support unlocking the margin to better reflect the economics throughout the life of the contract
- Do not understand rationale for risk adjustment changes directly going against the P&L - adjusting the contractual service margin to reflect changes in the estimates of the risk adjustment associated with future coverage would fully align the measurement of the contractual service margin at initial recognition and in subsequent periods.
- Need to clarify whether in the case of a portfolio where the contractual service margin has been eliminated and losses taken to the income statement, subsequent favourable changes in the estimates of future cash flows relating to future coverage would immediately be deferred in the

margin or taken to the income statement to the extent they reversed past losses. We would support the latter approach, as this would be consistent with the reversal of impairment losses.

- Support the proposal that interest should be accreted on the contractual service margin, which is consistent with how the other building blocks are measured. However we do not understand the rationale for the accretion to be based on a locked-in rate set at inception when all other elements of the cash flows will be discounted using current rates. We believe the interest accretion should be at current rates, consistent with the other proposals in the ED.

<u>Mirroring</u>

- We support the proposals to reflect dependence on underlying asset cash flows in setting the discount rate, and in adjusting the interest expense through the P&L for such changes, consistent with the principle of using a discount rate appropriate to the characteristics of the liability.
- However we do not support the proposed alternative measurement model for participating contracts commonly referred to as "mirroring":
  - Rules-based gating will lead to very economically similar products being accounted for very differently
  - Unintended consequences from the "required to hold" language, e.g. UK unit-linked contracts wouldn't qualify
  - Method of deconstruction is without any conceptual basis
  - 90/10 par example is a very simplistic product - does not work for our key real-world contracts
    - Our HK par contracts operate such that the policyholder and shareholder share in the deviation of actual returns from illustrated returns provided to the policyholder at point of sale
    - Our French par contracts have a switching feature into and out of unit-linked funds - no guidance on how this might be treated
  - Deconstruction proposals are essentially unbundling - however given the interdependencies of rights and obligations (e.g. death benefits) it is not going to be possible to achieve in practice with current actuarial techniques. The Board discussed general unbundling at length and rightly decided against it in all but the most clear-cut cases of separable performance obligations.
- We would support a "floating margin" type approach, and agree with UK industry views on the shareholder share of participating returns representing compensation for asset management over the life of the contract (i.e. more of a revenue model than a financial instrument model)

<u>Revenue</u>

- Support the proposals given their comparability with our other banking operations (including consistency with deposit taking from deposit components being excluded from the measure)
- However summarised margin is also a good presentation for life insurance
- And the revenue measure has limited decision-usefulness, so support the continued disclosure of traditional written measures

<u>OCI approach</u>

- Fundamentally we agree with all of the sentiments in the alternative view
- The development of a stand-alone liability standard always had the danger of only reflecting one side of the ALM model at the heart of an insurance operation, and the OCI approach proposed creates significant mismatches (vs derivatives, equities, non-vanilla debt, etc)
- The disaggregation of the result is misleading - it conceals real economic effects arising from duration mismatches (e.g. reinvestment risks that build over time) until they bite, omitting key aspects of performance from the P&L throughout the contract

- We support a current value through approach with disaggregation of the effects of market movements in the period on the face of the P&L under IAS 1 principles. Using the fair value option under IFRS 9 will solve the vast majority of mismatch issues.

Transition

- Supportive of the proposals and believe the practical expedients strike the right balance

Other key points

- Unit of account issues & operational complexity - driven by the unlocking of the CSM and by the requirements to discount at the rate locked in on inception. The former leads to a need to track cohorts, and the latter links the definition of a portfolio to the price of risk / the yield curve even for relatively small movements that may not impact pricing immediately.
- Treatment of the hybrid contracts issued in France (with a switching feature between DPF and UL funds) is not clear