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22 November 2007

Mr Peter Clark
International Accounting Standards Board
30 Cannon Street
London
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Discussion Paper: Preliminary Views on Insurance Contracts

Dear Mr Clark,

We are pleased to comment on the Discussion Paper: *Preliminary Views on Insurance Contracts* (referred to as 'the DP'). Our responses to the questions raised in the DP are set out in the Appendix to this letter.

We congratulate the IASB and its staff for the work accomplished and the efforts put into the DP, as well as for addressing the complex issue of accounting for insurance contracts. We generally agree with the DP's main proposal that insurance liabilities should be measured at a current value, on the basis of the "three building blocks". However, in looking at the detailed approach outlined in the DP, we want to express the following comments and concerns.

Use of market-based data

We agree with an overall principle that all assumptions used should be market consistent, but only to the extent that references to market data are effectively available and relevant to include in the measurement of an insurance liability. If this not the case, the final Standard on insurance contracts should clearly state that an insurer will use 'portfolio-specific' data if available, and otherwise its own entity-specific data, to the extent that market participants would have included this type of data into the measurement of an insurance liability. Due to the current stage of development of insurance markets, in many circumstances we consider that it is unlikely that market data will be available, for instance to determine the administration costs associated with insurance contracts or the risk and service margins, as it is unlikely that several insurers provide exactly the same quality and level of service for the same insurance coverage. In those cases, we believe that using entity-specific data would provide the most relevant and reliable information to the users of the financial statements, unless such data appears to be abnormal (i.e. there is a distorting factor that causes the entity-specific data to fall outside a normal range for similar insurers).

Risk margins and service margins

We believe that the DP fails to provide a clear view of what are the risk and service margins. We acknowledge the late October publication by the IASB staff on "Frequently asked questions: service margins", but we continue to believe that further research is needed in the area.

In addition, the DP fails to discuss properly the nature of insurance contracts and whether analogies should be made with service contracts. This is an important point as it is a determining factor in deciding on the treatment of the element of profit margin associated with an insurance contract that is not purely associated with the risks and uncertainties attached to the set of cash flows arising under that contract. We believe that, when a policyholder enters into an insurance contract, this creates a performance obligation for the insurer. As premiums are paid in advance, it is appropriate to recognise a liability including the profit element associated with the performance of the obligation.

We believe that distinguishing separately a risk margin from a service margin is inapplicable in practice, unless some methodologies are stated indicating how the risk margin should be measured. This is because, first, as we indicated above, there is no clear view of what the risk margin and the service margin are supposed to represent. Secondly, there is generally no market information on such data taken separately. Thirdly, insurers do not necessarily make explicit valuations of such margins separately as they are often interdependent. We acknowledge that insurers do make estimates of a "risk margin", but it is unclear whether their measurement includes certain elements that the DP would have rather considered as belonging to the measurement of the service margin. As a result, we conclude that trying to distinguish a risk margin from a service margin is not the best approach for insurance contracts. We consider that it would be better if the final Standard would simply specify the types of elements to be considered in valuing insurance liabilities. In particular, we believe that, after the first and second building blocks (i.e. expected cash flows and discount rate) have been determined, the third building block should include:

(a) an assessment of the risks and uncertainties associated with the insurance contracts portfolio's set of cash flows (amounts, timing and model used to estimate the cash flows), considering the portfolio's characteristics;

(b) an element of profit margin other than the above, for the service of bearing the remaining portfolio's insurance risk; and

(c) where services other than the bearing of risks are provided in an insurance contract, an element of profit margin for the other services to be delivered.

Day-one gains and losses

Once insurance liabilities have been determined using the "three building blocks" (and taking into account our comments), a proper estimate of the performance obligations associated with the insurance contracts will have been performed. Accordingly, we agree that it is appropriate to recognise in profit or loss any difference that arises at inception of insurance contracts between the measurement obtained (less relevant acquisition costs) and the premiums received. We acknowledge that this approach is quite new and is different from the treatment of service contracts under current IFRS. However, we believe that it provides the best information to the users of the financial statements on the ability of an insurer to price contracts higher or lower than what would normally be required for such contracts, and consequently, on the overall performance of the insurer.

However, where a difference exists between the premiums received and the measurement of the related insurance liability (less relevant acquisition costs), it will be important to assess whether the evidence provided to support the recognition of a gain or a loss is robust. In that respect, as practices generally have not been those recommended by the DP, it would be

useful that auditors and actuaries identify the type of guidance that could assist in making that assessment.

Labelling of the measurement attribute for insurance liabilities

We disagree with labelling the measurement attribute for insurance liabilities as a "current exit value". We do not believe that that term appropriately portrays what the goal of the measurement should be, or that there should be a reference to a transfer value. Insurers cannot transfer their insurance liabilities to third parties freely and would generally not wish to do so. The only case where a transfer really takes place is when a business combination or a transfer of a portfolio of insurance contracts occurs, which are not frequent events of insurers. Even in the case of reinsurance, the insurance liability subject to reinsurance itself is not transferred.

The usual way of settling an insurance liability is for an insurer to continue to fulfil its commitments until the obligation is extinguished. Accordingly, we believe that users of financial statements are more interested in the best "current estimate" of the cash outflows (on a discounted basis) an insurer will incur under an insurance contract in order to satisfy its obligation, after proper consideration of the risks and uncertainties attached to the contract as well as a remuneration for the remaining performance obligation (i.e. the three building blocks approach). We encourage the IASB to reconsider an appropriate labelling to reflect that objective. Other terms that might be used to describe the measurement basis include "current ultimate settlement value", "current extinguishment value" or "current performance value"...

Unit of account

We consider it important that the final Standard on insurance contracts specifies clearly that the unit of account for estimating both expected future cash flows and the risk margin is the portfolio of insurance contracts. This point is important for determining the types of cash flows to be included in the determination of the first building block.

Estimates of future cash flows: policyholders' behaviour and participation

Consideration of policyholders' behaviour is a reality of insurance activities. We support an overall objective for the final Standard on insurance contracts that is to provide relevant information to the users of the financial statements, enabling them to predict the cash flows relating to insurance contracts that will flow to and from the reporting entity. In order to meet this objective, we consider that it is appropriate for insurance liabilities both to reflect a current measurement and to include all relevant cash flows associated with existing contracts. This means that:

(a) we believe that the determination of the expected cash flows should consider beneficial policyholder behaviour, to the extent that it does not result in a negative amount (i.e. a net insurance asset rather than a liability). However, we disagree with the reasoning that presents the need for taking into account the beneficial policy behaviour as arising from the recognition of part of a customer relationship. It is simply a reality that projecting cash flows over the expected life of a portfolio of existing contracts provides more relevant information on the cash flows that will flow to and from the reporting entity. We support the principle of restricting the extent to which expected cash flows are considered and note that further work is required in this area. The limit that we would suggest on the consideration of future cash inflows associated with an insurance contract due to beneficial policyholder behaviour is the extent to which such inflows are integral to the fulfilment of the obligations under the contract, taking into account that part of the

obligation that might arise from an automatic prorogation of the contract at the choice of the policyholder, to the extent that the components of the contract are not modified significantly; and

(b) the expected cash flows associated with participating insurance and investment contracts shall include at least an unbiased estimate of the policyholder dividends payable to satisfy the legal or constructive obligation that exists at the reporting date. An alternative view would be to include in the expected cash flows all the additional cash flows that are expected to be paid to policyholders. In that respect, while we acknowledge the interaction of the issue with the discussions on the IASB's project on Liabilities and Equity, we do believe that it is worthwhile debating again whether economic compulsion shall be an element to consider in determining the expected cash flows. In particular, we note that the questions of whether to take account of expected cash inflows that customers cannot be compelled to pay (beneficial policyholder behaviour) and expected cash outflows for which the insurer may have some discretion over timing and/or amount (policyholder dividends) are, in a sense, two sides of the same coin and should not be considered in isolation from each other when drafting a Standard.

Unbundling of insurance contracts with a deposit component

We would wish to see all insurance contracts that fall within the scope of a Standard dealing with such contracts to be dealt with in the same way, i.e. by measuring them according to the three building blocks (subject to our comments) as well as the consideration of policyholders' behaviour. However, we recognise that insurance contracts may be written along side, or bundled with, other forms of business. For example, a car dealer might sell cars complete with insurance cover for the first year's use. Clearly such transactions should be treated separately in accordance with the relevant Standards. To make the answer to this type of fact clear, the issue needs to be addressed in the Standard through guidance. We believe that this is best dealt with within the scope section of the Standard, by addressing what is meant by an insurance contract where such a contract is bundled with other services. If this is done appropriately, any such scope definition should also adequately deal with the situation in which an insurance contract is bundled with other financial services, such as investment services.

Consistency of the requirements for insurance contracts with other Standards

We acknowledge the difficulty of progressing on the insurance contracts project due the interaction with other IASB projects such as those on the Conceptual Framework, Revenue Recognition, Liabilities and Equity, Financial Statement Presentation and Fair Value Measurements. Also, some of the proposals are quite innovative and raise questions on the consistency with the accounting currently applicable in other areas (e.g. for service contracts, financial instruments, lease contracts, etc.). We nonetheless support pursuing the efforts undertaken so as to produce proposals for insurance contracts – in the not too distant future – that result in sound and relevant financial information for those contracts, enabling the users of the financial statements to better predict the future cash flows that will flow to, or from, the reporting entity. If a treatment is considered to best meet the objective that we indicate, but would create an inconsistency with other parts of the IFRS literature, we do not consider that this treatment should be rejected outright. Once again, as long as the scope of the Standard on insurance contracts is clear and the definitions do not provide room for accounting arbitrages, it might be appropriate to elect the best treatment applicable to insurance contracts and to limit it to such contracts. If such a treatment appears to conflict with other areas of the IFRS literature, then the treatments applicable to those other areas could be reassessed subsequently.

If you have any questions concerning our comments, please contact Ken Wild in London on +44 (0) 207 007 0907.

Yours sincerely

Ken Wild

Global IFRS Leader

Appendix – Responses to Questions for respondents

1. CHAPTER 2 – RECOGNITION AND DERECOGNITION

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?

Yes, we agree that the main principles for the recognition and derecognition of financial instruments in IAS 39 should apply to insurance contracts. However, we would prefer to have recognition and derecognition principles and guidance included separately in a Standard on insurance contracts. We also note that guidance will be particularly needed on areas such as the timing for recognition, i.e. when the insurer becomes party to the insurance contract and is exposed to an insurance risk in the financial statements. The guidance would need to deal with cases such as when the insurer is making an offer to a policyholder, when the policyholder accepts an offer from the insurer, and when premiums are received in advance before the start of the insurance coverage period.

2. CHAPTER 3 – MEASUREMENT – CORE ISSUES

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?

We agree that insurance liabilities should be measured using the following building blocks:

(a) explicit, unbiased, probability-weighted and current estimates of the expected cash flows,

(b) current 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 required for bearing risk (a risk margin) and for providing other services, if any (a service margin).

In our response to Question 6, we present our views on whether the expected cash flows shall reflect the contractual cash flows or not. We note that the cash outflows included in the expected cash flows are unlikely to comprise only 'contractual' cash flows. Hence, caption (a) will need redrafting.

We agree with an overall principle that all assumptions used should be market consistent, but only to the extent that references to market data are effectively available and relevant to include in the measurement of an insurance liability. If this not the case, the final Standard on insurance contracts should clearly state that an insurer will use 'portfolio-specific' data if available, and otherwise its own entity-specific data, to the extent that market participants would have included this type of data into the measurement of an insurance liability. Due to the current stage of development of insurance markets, in many circumstances; we consider that it is unlikely that market data will be available, for instance to determine the administration costs associated with insurance contracts, as it is unlikely that several insurers provide exactly the same quality and level of service for the same insurance coverage. In

those cases, we believe that determining administration costs using entity-specific data would provide the most relevant and reliable information to the users of the financial statements, unless such costs are abnormal (i.e. there is a distorting factor that causes the entity-specific data to fall outside a normal range for similar insurers). This overall view results from the following analyses.

Expected cash flows

In determining the expected cash flows associated with an insurance contract (in practice for a portfolio of insurance contracts – see our comments on the unit of account in Question 11), we identify three different types of variables for which estimates will need to be made:

(a) **variables exogenous to the contracts**, such as interest rates, inflation, foreign exchange rates. Those data are usually available in deep and liquid markets. Also, as those data are normally obtainable from efficient markets, they are equally applicable to everyone. Therefore, it is normal to use them in measuring an insurance liability.

Those data are referred to in the DP as "*current market variables*" or "*direct inputs without adjustments*" (see DP, paragraph 38). We believe that any final Standard on insurance contracts should identify them separately and distinguish them from the second type of data as stated in (b) below, as they are of a different nature.

(b) **variables endogenous to the contracts**, which are described in the DP as "*portfolio-specific*" (see DP, paragraph 57), which are not usually available on the market but on which any participant sharing information about the contracts would normally agree. Examples: estimated mortality-related cash flows are portfolio-specific and may differ from one insurer to another for an otherwise identical contract simply because the insured population characteristics differ from one insurer to another.

We believe that those data should be identified as such as they can neither be considered to be "market" data nor strictly speaking "entity-specific" data[1], as the DP acknowledges it in paragraph 57. We agree that those data shall be used.

(c) **variables endogenous to an entity** which, as mentioned in the DP, will mainly relate to costs assumed by an insurer in order to satisfy the obligations of an insurance contract. In this category, the DP mainly refers to servicing costs and considers that the measurement of the liability should be based on "*the servicing costs that market participants would incur*" (DP, paragraph 60), which may differ from the entity's own servicing costs "*because of synergies with other recognised or unrecognised assets or liabilities*" (DP paragraph 60). However, "*The servicing costs would need to reflect the characteristics of the contracts being measured, including the level of service being provided to policyholders and the approach to claims management*" (DP, paragraph 61). We understand that the servicing costs referred to in the DP mainly consist of the claims handling/administration costs and costs associated with the provision of other services, such as investment management services.

One estimate would be the servicing costs that would be incurred if such tasks were outsourced (with the consequence that the profit margin of the service provider would be included into the measurement of the cash outflows).

Another estimate could be the servicing costs incurred by other insurers (having the same approach to claims management and level of service as the reporting entity). As the DP

[1] Note that, in practice, such data cannot be fully free from entity-specific tainting elements because factors such as fraud risks and an insurer's contracts acceptance policy (which may differ from one insurer to another) affect the determination of the variables endogenous to an insurance contracts portfolio and are difficult to eliminate.

acknowledges in paragraph 62[2], such information is usually not available externally. So, we consider that in virtually all circumstances an insurer will revert to using its own data, which is appropriate in the specific situation described. We also note that "*identifying whether an insurer is significantly more or less efficient than other market participants*" would present practical problems with any differences difficult to quantify and support with relevant and reliable evidence.

Moreover, we note that, if the information on costs incurred by other insurers (having the same approach to claims management and level of service as the reporting entity) were available, this information would nonetheless reflect the other insurers' synergies with their other recognised or unrecognised assets or liabilities. We question the reasoning why, in such a case, it is better to reflect other insurers' synergies rather than those of the reporting entity. The DP does not discuss this point.

Even if cost information were available from the market, it may be troublesome to reflect a counterintuitive pattern of performance if the insurance liability is measured based on costs of other insurers and not those of the reporting entity. Everything else being equal, gains would be generated at inception where an insurer is performing more poorly than other insurers having similar contracts and would reverse ultimately as losses over the life of the contract – and vice-versa for an efficient insurer. Would this information effectively allow the users of the financial statements to better predict the cash flows to be generated by the reporting entity? This outcome and the reasons for the superiority of this type of information are not sufficiently described and discussed in the DP. We would agree that, in an ideal world, if there were market data available for each cost component of a valuation as well as a proper disclosure of the split between each component, this may provide valuable information to external users. However, as active markets do not exist, it is not today's situation for many contracts involving performance obligations, particularly those from insurers. We acknowledge that this issue is just an illustration of more fundamental discussions which warrant further debates on the purpose of the financial statements, the definition of performance and the manner in which it should be reported (refer to IASB's discussions under the Conceptual framework project).

Coming back to our point on whether the valuation of the expected cash flows should reflect the costs incurred by other insurers (approach tentatively supported by the Board in the DP from our understanding), we believe that the DP does not discuss enough whether any profit margin of an insurance contract associated with those costs should be included either into the expected cash flows building block, elsewhere or not at all. Initially, we understood that the DP proposed that all market-based profit margin elements associated with the bearing of an insurance risk, including for claims management, were to be considered in the determination of the risk margin. However, considering the IASB staff paper released at the end October 2007 on "Frequently asked questions: service margins", we are unsure of this initial view and we understand that some element of the profit margin may be included in what the DP refers to as the service margin. Overall, we consider that clarity should be brought on those issues.

Discount rate

In determining the discount rate required to take into account the time-value of money, an insurer will usually consider risk-free market data. Therefore, a reference to market data is relevant.

[2] "*In practice, the Board expects that an insurer would use estimates of its own servicing costs, unless there is clear evidence that the insurer is significantly more or less efficient than other market participants*" (DP, paragraph 62)

Risk margin

The DP defines the risk margin in the glossary as "*An explicit and unbiased measurement of the compensation that entities demand for bearing risk*". Also, in Appendix F3(a), it is stated that "*the risk margin should be consistent with the margin that would be expected if the insurer were to transfer its contractual rights and obligations to another party*". We believe that those definitions do not make it clear what the risk margin covers exactly and we are aware that its meaning is already subject to various interpretations. This is particularly true in the light of how Question 2 is phrased and the Board's preliminary view indicated in the DP's paragraph 86(a): "*The objective of a risk margin is to convey decision-useful information to users about the uncertainty associated with future cash flows*". There is no longer any reference to the term "*compensation*". The confusion stems from the fact that it is unclear whether the risk margin shall include an element of an insurer's remuneration for having entered into an insurance contract as a whole (i.e. a service contract), other than just the pure assessment of the risks and uncertainties attached to the cash flows associated with the contract (see also the discussion on the service margin below)[3]. Also, the DP does not discuss enough the various models for the recognition of this element of remuneration as revenue. We present some views later in this section as well as in Question 4.

In practice, the models used by insurers to determine what they refer to as the risk margin generally involve the consideration of two elements that are not, and cannot be, distinguished separately. The first element is an assessment of the risks and uncertainties associated with the set of cash flows (amounts, timing and model used to estimate the cash flows) of the portfolio of insurance contracts subject to the valuation, which depends on the portfolio's characteristics. The second element is an additional remuneration element on the insurance contracts (e.g. the cost of capital model[4], which is built to include remuneration on the cost of capital that would be required to be maintained for the insurance liability). The first element could be described as being a "portfolio-specific" data,[5] whereas the second element could be described as being a market-based data as, often, it looks at a required level of compensation. The result is again that the risk margin cannot be described as being either fully "market-based" or "portfolio-specific" or "entity-specific".

We support the determination of a risk margin for a portfolio of contracts subject to further guidance on whether the risk margin should include both:

(a) the assessment of the risks and uncertainties associated with the portfolio's set of cash flows (amounts, timing and model used), considering the portfolio's characteristics; and

(b) an element of profit margin other than the above, which would be consistent with what market participants would require for bearing the portfolio's insurance risk.

The DP does not state whether (b) above is included in the risk margin or not.

We note that this valuation will have to carefully consider how the expected cash flows have been determined so as not to double-count elements of profit margin (please refer to our comments on the expected cash flows). We also question whether it is possible to distinguish those two elements separately. As we explained already, while it is likely that item (a) above can be determined using some models (such as the cost of capital model), it is unlikely that item (b) can be observed on a standalone basis on the market. In some cases, market information may be available but only for the combination of (a) and (b). In such cases, we

[3] We have noted that the IASB staff document published at the end of October 2007, includes responses to frequently asked questions on the service margin. This document provides some further clarity on the DP's proposals but our views remain the same, i.e. what the risk and service margins are really meant to cover is still confused.

[4] This method is commonly used in the calculation of Embedded Value number, and was included in the QIS3 study for the proposed Solvency II requirements applicable to EU insurers.

[5] With the caveat mentioned in footnote 1, on page 3, i.e. it is unlikely that any portfolio-specific data is fully exempt from entity-specific tainting elements in practice.

consider it appropriate to measure the risk margin based on the market-based information available for the combination. Finally, we note that it is also unclear whether (b) above would be something identifiable and measurable separately from the service margin as described in the DP (see our comments on service margins below).

We are aware that some question whether element (b) should be part of the measurement of an insurance liability at all. We believe that as long as the IASB has not progressed on its debates on the appropriate model for revenue recognition, the current general IFRS principles should continue to apply. Under an insurance contract, a premium is received upfront, the counterpart of which is that the entity has agreed to a performance obligation throughout the contract period. Under the current IFRS model (IAS 18 in particular), no profit element would be recognised as revenue until performance occurs. Therefore, we conclude that it is appropriate to include all the remuneration associated with the bearing of risk into the measurement of an insurance liability at inception.

With respect to the issue of whether the risk margin should reflect a market-based or entity-specific data, we believe that, from a theoretical point of view, an overall principle of reflecting a market consistent profit margin could provide useful information for the users of financial statements. This would enable the determination, at inception, everything else being equal, of the gain or loss incurred by an insurer because it has priced the premium of the insurance contract with a higher or lower profit margin than the market. However, this information will be relevant if, and only if:

(a) the other blocks (estimation of the cash flows and the service margin) are reliably measured;

(b) it is disclosed separately: if a day-one gain or loss arises on an insurance contract, it may come from factors other than the risk margin (refer to our discussions on expected cash flows above). If no specific disclosure is required, the information about the day-one gain or loss linked to the risk margin will not be available; and

(c) market data regarding risk margins, sanitised of elements specific to other insurers, are available.

We are doubtful that reliable market data on risk margins will be available for insurance contracts, particularly as there is a constraint that the information shall reflect information on insurance contracts issued by other insurers that show similar characteristics to those of the reporting entity and that the other insurers have the same approach to claims management and the level of service as the reporting entity. Consequently, once more, we consider that it is likely that an insurer will revert to using its own assessment of the risk margin.

We note that the DP does not address the pattern of release of the risk margin. As we indicated above, there are potentially three elements in this margin: one that corresponds to the pure assessment of the risks and uncertainties attached to the contract, a second that corresponds to the insurer's profit margin for bearing the portfolio's insurance risk and possibly a third that corresponds to the insurer's overall remuneration for having entered into such contract. While we could imagine a pattern of release of the first two elements following the release of the risks and uncertainties, the pattern of recognition of the third element is debatable. It depends on what this element is supposed to represent (e.g. the remuneration for a general service contract or extra remuneration for the risks and uncertainties attached to the contract). The answer might also be influenced by whether or not the three elements can be measured reliably separately. We do not currently have an answer on the preferable pattern of release and we would welcome further debates on this topic.

Service margin

The DP defines the service margin in the glossary as "*An explicit and unbiased measurement of the compensation that entities demand for providing services other than the bearing of risk*". Similar to our comments on the risk margin, we believe that this definition is confusing and we are aware that its meaning is also subject to various interpretations as to what it covers exactly. Some people have understood it to include both the profit margin associated with the service of having entered into an insurance contract as a whole, as well as the margin associated with the provision of other services (such as investment management). This stems from the fact that insurers do not usually distinguish within their profit margin elements that arise from the bearing of an insurance risk from other profit margin elements. We understand that this approach is the one proposed in the DP, as clarified in the "Frequently asked questions: service margins" published by the IASB staff at the end of October 2007. Others (including us) had initially understood the service margin to cover only the element of an insurance contract's profit margin associated with the provision of identifiable services other than the service associated with a "simple" insurance contract, such as investment management. So, in such a case, whether a service margin is present in an insurance contract would effectively depend on whether other services are provided by the insurer.

Many of the comments we made on the risk margin are applicable to the service margin (as envisaged by the DP), as distinguishing one from the other is difficult, if not impossible. The principles that we consider important are that:

(a) where services other than the bearing of risks are provided in an insurance contract, the measurement of an insurance liability shall include an appropriate element of margin for those services until delivered; and

(b) this data should be market consistent, considering however the caveats and consequences that we mentioned in our comments on the risk margin.

Again, we note that distinguishing a service margin (as envisaged by the DP) separately in all cases may require a rather theoretical and artificial exercise, as market information on such margin most often does not exist. Also, the service margin is often very interdependent with the other elements of an insurance contract's profit margin, as well as with the way the risk margin is determined (as the models may, in fact, include some remuneration for the "service" provided under an insurance contract). Those facts increase the difficulty of determining a service margin specifically. So, we conclude that, unless market information is available for the service margin separately from the risk margin, it would be impossible to estimate these margins separately.

In addition, should it be possible to value the service margin separately, some principles will need to be specified for its release (e.g. straight-line over the service period, in line with the release of the risk margin or some other method).

<u>Question 3</u> - 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?

We believe that, in general, the level of guidance provided in appendices E and F is appropriate.

In terms of the guidance itself, we already made some comments in Question 2. We also have the following additional comments.

Expected cash flows

Please see our comments in Question 6 regarding how the consideration of policyholders' behaviour affects the determination of the expected cash flows. Also, please see our comments in Question 11 on the unit of account, where we indicate that, as the measurement of an insurance liability is directly linked to the characteristics of the portfolio of contracts to which they belong, it is inappropriate to determine the expected cash flows on a contract-by-contract basis.

We also find that the DP is not sufficiently explicit in terms of which costs should be included in the cash flows when measuring an insurance liability. There is a great deal of divergence in practice in terms of allocating costs to costs of achieving the contract (sales costs), service costs, administrative costs, and claims handling costs.

Discount rate

In theory, we agree that any risk assessment (including when it relates to financial variables) should be considered in the determination of the expected cash flows and the risk margin, and not in the determination of the discount rate. However, in practice, certain financial risks may better be reflected in the determination of the discount rate. Overall, we believe that any future Standard on insurance contracts should set principles and not be overly prescriptive on whether the financial risks should be considered into the discount rate's or the risk margin's building block. What counts is that they are taken into account while not being double-counted and that the methodology used to include them is not overly simplistic.

Risk margin

Appendix F3(a) states that "*the risk margin should be consistent with the margin that would be expected if the insurer were to transfer its contractual rights and obligations to another party*". The principle seems to imply that there is one single valuation for the risk margin (the one that market participants will require), whereas the DP implicitly infers in Appendix F9 that there are several ways of determining the risk margin (with no preferred model identified). The eight approaches described in the DP are likely to lead to different results and therefore it is difficult to understand how the outcome of any approach chosen by a constituent could be considered "the" risk margin as required by market participants.

One of the reasons why there are several ways of measuring the risk margin is because the valuation of the risk margin (for the valuation of the uncertainty in estimating the cash flows) is not independent of the way in which the estimation of the cash flows has been performed (first building block). The requirement for consistency between the valuation of these two building blocks is not addressed in the DP, whereas it is an essential element of the valuation in order to avoid a disconnect in the measurement.

As expressed in Question 2, setting aside the consideration of other elements for the remuneration for bearing of an insurance risk, our views on the measurement of the risk margin is that it should be representative at least of:

(a) the uncertainty around the data used (for instance portfolio-specific data);

(b) the uncertainty linked to the timing of cash flows; and

(c) the uncertainty linked to the model used for estimating the cash flows and their probabilities (for instance stochastic model versus a less sophisticated model).

<u>Question 4</u> - 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 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 indicated in Question 2, we believe that in a perfect world where market data are available for each of the components of an insurance liability, measurement of the insurance liability using market-based data provides valuable information. Consequently, we would support approach (c) above, i.e. 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. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. 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.

In performing the investigation exercise, it will be important to assess whether the evidence provided to support the recognition of a gain or a loss is of adequate quality. In that respect, as practices generally have not been those recommended by the DP, it would be useful that auditors and actuaries identify guidance that could be of help in making that assessment.

<u>Question 5</u> - 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?

While we support the DP's proposed building blocks for the measurement of an insurance liability (subject to the comments we made in Question 2), and in particular that the measurement should reflect a current value, we do not believe that the term "current exit value" appropriately portrays what the aim of the measurement should be nor that there should be a reference to a transfer value.

We refer to our comments on the DP on Fair Value Measurements (FVM) sent to the IASB on 4 May 2007. Our response to Question 9 of that DP, which asked whether we agree that

the fair value of a liability should be based on the price that would be paid to transfer the liability to a market-participant, indicated that:

> "*[…] Beyond active markets we believe that determining a transfer value will generally be difficult, and in some instances be inappropriate in the instance when the liability cannot be transferred to a party other than the counterparty.[…]*
>
> *[…] If the contract cannot be transferred then determining a current transfer value is theoretical, and determining fair value in practice would likely default to current settlement value, being the amount the reporting entity would need to pay the counterparty at the measurement date for being relieved of its obligations under the contract. Moreover, any decision on how to measure a non-financial liability to deliver goods or services is inextricably bound up with the question of revenue recognition, and must also be considered in that context. […]*"

Overall, we indicated in our response to the DP on FVM that:

> "[…] *we support the exit price definition based on a transfer for financial instruments and those non-financial items that are traded in an active market as long as clarity is provided on how to apply the market participant view. We have difficulty with the application of a transfer exit price for non-financial items that are not traded in an active market, for example a non-financial liability that will be settled through the delivery of goods or services, or property plant and equipment that is consumed where there is no intention of disposal". In these instances we believe measurement attributes other than current value may be more relevant.* […]"

Our comments on the DP on FVM remain valid. In the specific context of insurance liabilities, we note that insurers cannot transfer the insurance liabilities to third parties freely and would generally not wish to do so. The only case where a transfer really takes place is when a business combination or a transfer of a portfolio of insurance contracts occurs, which are not day-to-day events of insurers. Even in the case of reinsurance, the insurance liability subject to reinsurance itself is not transferred.

If the usual way of settling a liability were to transfer it to a third party, a measurement under the current exit model ("pure transfer value") would provide useful information about future cash flows. As the usual way of settling an insurance liability is for an insurer to fulfil its commitments until the obligation is extinguished, we believe that users of financial statements are more interested in the best "current estimate" of the cash outflows (on a discounted basis) an insurer will incur under an insurance contract in order to satisfy its obligation, after proper consideration of the risks and uncertainties attached to the contract as well as remuneration for the remaining performance obligation.

We do not believe that the term "current exit value" is appropriate as the term "exit" is too often assimilated to be similar to the term "transfer". If the term "exit" is retained, confusion will undoubtedly exist over its meaning, particularly if it is intended to mean something other than an exit via a transfer. Other terms such as "current ultimate settlement value", "current extinguishment value" or "current performance value" may be more appropriate in the circumstances of an insurance contract.

If the purpose of the reference to a transfer value is to justify the inclusion of a profit margin into the insurance liability measurement (since on initial recognition of an insurance contract a premium is received for which no service has yet been delivered), then we believe it would be preferable to clearly articulate that point. In addition, we do not believe that the inclusion of a profit margin into the measurement of an insurance liability is incompatible with what we refer to as a "current ultimate settlement" model. This is because there is a performance obligation to be fulfilled, which has the characteristics of the rendering of a service. Consequently, there is a service element provided by an insurer when entering into an insurance contract, for which remuneration ought to be included into the insurance liability measurement at inception. Whether that element gives rise to some immediate income

recognition on entering into the insurance contract or whether it should be recognised as time passes by is linked to the debates on whether or not the insurance liability should be calibrated to the premium received and, more generally, on revenue recognition. We presented our views on this issue in Questions 2 and 4.

CHAPTER 4 – POLICYHOLDER BEHAVIOUR, CUSTOMER RELATIONSHIPS AND ACQUISITION COSTS

***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?

The issue relating to which cash flows should be included in the measurement of an insurance liability, and whether there should be a consideration of policyholders' behaviour, is probably amongst the most difficult ones to answer.

We support alternative (b) above, to the extent that it does not result in a negative amount (i.e. it does not lead to the recognition of a negative liability or an asset). We believe that the measurement of an insurance liability should include all expected cash flows arising from an existing insurance contract and the ability for it to be continued, should a policyholder decide to do so (see our further comments in Question 7). We believe that this will provide users of the financial statements with the best current estimates of the cash flows that are expected to flow to and from the reporting entity. In that respect, we would not describe the beneficial policyholder behaviour as an element that is valued separately and acts as a "*reduction*". Rather, it is simply an element whose effects are considered in determining each of the building blocks when measuring an insurance liability.

We do not support the tentative view that an insurer's ability to derive benefits from policyholders' behaviour arises as part of a customer relationship but rather from the fact that we are dealing with a portfolio of contracts demonstrating some intrinsic behaviour (refer to our views in Question 11 with respect to the unit of account to be used for determining the first building block). The DP argues that the reason why the identified internally generated customer relationship (corresponding to expected policyholders' exercise of existing contractual options) shall be recognised is because it is closely linked with existing insurance contracts. We note that this is generally the case for any internally generated customer relationships. Therefore, we find the reasoning developed by the Board rather complex and somewhat ruled-based simply to achieve the expected accounting result. The proposed principle that is expected to apply only to insurance contracts does not appear to be properly justified, even if it is said that the internally generated customer relationship would not be recognised as an asset but as part of the related insurance liability. Ultimately, we note that IAS 38's principles regarding internally generated customer relationships are not applied. Moreover, the Board acknowledges in paragraph 147 that, in practice, the recognised insurance liability would be the same as if the expected cash flows from beneficial policyholder behaviours arose from the contract itself, rather than from the customer relationship, since the internally generated customer relationship will be recognised at a current exit value. This is another departure from IAS 38's principles.

The Board makes an analogy between a contract of n years, cancellable at anytime and a contract of one year that is renewable over n years. In substance, the analogy works only if the contract to be renewed is renewed by tacit agreement, without any modification either in the pricing, in the risk insured, etc. If so, in substance, these two contracts are a long-term agreement for which, if none of the parties takes any action, there is an expected life that can be assessed on a portfolio basis.

In an "exit value" model, and also in a "current ultimate settlement value" model, the valuation of a portfolio of insurance contracts will take into account an expected life as described above. This is not the valuation of part of a customer relationship, rather it simply reflects the way the contracts are established and their meaning in substance, i.e. as long as the customer has not exercised its option to cancel (or to surrender), the entity has an obligation to continue to provide coverage. The fact that a customer decides to continue an existing contract with terms and conditions that are not significantly modified is not equivalent to entering into a new contract.

We acknowledge that the direction proposed for insurance contracts may create significant differences compared with the way other types of contracts are accounted for today. We have not explored all the consequences of such an approach nor have we concluded that the approach would also be appropriate for other types of contracts. Nonetheless, as we support making progress on a Standard on insurance contracts using principles that provide relevant information, we believe that if our views are followed, the IASB should make it clear that the principle relating to the consideration of beneficial policyholder behaviour should not be applied by analogy to other types of contracts until the IASB has conducted further research on the relevance of its application to those other contracts.

***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 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).

Consistent with our comments in Question 6, we do not support alternative (e). Further, as we have difficulty understanding the exact meaning of each of alternatives (a) to (d) and the differences between them, we prefer indicating the principle that we believe appropriate to follow in the circumstances. We support the principle of restricting the extent to which

expected cash flows are considered and note that further work is required in this area. We suggest that the limit to the consideration of future cash inflows associated with a contract due to beneficial policyholder behaviour is the extent to which such inflows are integral to the fulfilment of the obligations under that contract, taking into account that part of the obligation that might arise from an automatic prorogation of the contract at the choice of the policyholder and to the extent that the components of the contract are not significantly modified. This notion is not very far from the "guaranteed insurability" defined in the DP.

Other remarks are:

(a) looking at the Board's illustrations in Example 7 of Appendix G, we consider that the split between the good policyholders from the bad ones is artificial, as usually no one is able to differentiate (except in rare cases) the good policyholders from the bad ones at inception. It is feasible only when experience occurs. Net economic benefits cannot be attributed to specific insurance contracts at inception. This point highlights once more that an approach on a contract-by-contract basis is not appropriate, even in the model described in the DP (see our comments on the unit of account in Question 11); and

(b) we suggest that the IASB considers how to deal with the fact that a policyholder may be able to get a refund for part of the premium (e.g. in a damage insurance contract), should the policyholder decide to cancel the insurance contract sometime during the insurance period. Should this be considered as part of the policyholder behaviour?

Consideration of the use of a deposit floor for insurance liabilities

We have considered the appropriateness of using a deposit floor for insurance liabilities in the case where the measurement resulting from the "three building blocks" (i.e. which is closer to real economic value) is lower than the surrender value/deposit floor (i.e. the measurement would reflect a surrender value where savings features are included in an insurance contract). Similarly to the views preliminarily held by the Board, we do not believe that inclusion of such a deposit floor would be appropriate. We believe that insurance contracts have characteristics such that their measurement should reflect the policyholders' behaviour on a portfolio basis. However, we acknowledge that disclosure of the surrender value/deposit floor in the notes to the financial statements may provide valuable information to the users of the financial statements.

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

If the measurement of the insurance liability includes all future cash flows expected to arise from the contract, i.e. even beyond guaranteed insurability (see our comments in Questions 6 and 7), we agree that acquisition costs should be recognised as an expense when incurred.

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

The question is difficult to answer as long as there is no better view on how insurance liabilities shall be measured. In theory, in the case of a business combination, we believe that the general requirements of IFRS 3, Business combinations, should apply. Consequently, it may be appropriate to recognise goodwill after all identifiable intangible assets have been recognised and measured. In the case of a portfolio transfer, there is a need to understand the models being used to value the insurance liabilities and those that serve as a basis for determining the amount that arose from the single transaction, so as to understand why a difference exists.

CHAPTER 5 – MEASUREMENT – OTHER ISSUES

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

While we acknowledge that the current IFRS requirements may generate accounting mismatches in the financial statements of insurers, we do not support making exceptions to the general requirements of IFRS for specific industries. However, we encourage the IASB to be aware of those accounting mismatches.

***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?

Unit of account

The Board's preliminary views (DP, paragraph 202) are that:

(a) the unit of account does not affect the expected present value of future cash flows,

(b) risk margins should be determined for a portfolio of insurance contracts that are subject to broadly similar risks and managed together as a single portfolio. Risk margins should not reflect the benefits of diversification between portfolios and negative correlation between portfolios.

We believe that the portfolio of insurance contracts should be the unit of account used for estimating both the future cash flows and the risk margin, and that the final Standard on insurance contracts should state so. This is because:

(a) all the models used in order to value insurance contracts' risk margins are using principles that have been set up based on portfolio data; and

(b) projections of expected cash flows are made looking at a portfolio of contracts, and therefore consider the effect of policyholders' behaviour on such cash flows (see comments in Question 6).

The interdependency between the way the expected cash flows and the risk margin are determined is such that the unit of account should be the same for these two components.

Benefits of diversification

We support a principle that the effect of diversification should be taken into account in the measurement of insurance liabilities arising from a portfolio of insurance contracts, to the extent that market participants would consider such diversification. Consideration of diversification is a reality of an insurer's activity and it is an element that is usually included in the determination of risk margins by insurers.

We are not convinced that the final Standard on insurance contracts should prescribe how the principle we propose should be applied in practice. While we agree that this is an area where guidance will be needed, we consider that it would be appropriate that the guidance is developed by insurance valuation experts.

Question 12

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

(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.

(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.

We agree that a cedant shall measure a reinsurance asset at a current value based on the relevant share of the reinsured liability and an additional risk margin for credit risk. This seems logical in order for the reinsurance assets to mirror insurance liabilities.

We also agree that a risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contracts. Where an insurer has purchased contract level reinsurance (e.g. risk excess), the effect of that reinsurance should be modelled at the individual contract level both gross and net of reinsurance including an additional risk margin for reinsurance credit risk in order to determine the effect of reinsurance.

Where reinsurance premiums are paid in relation to a portfolio of business that is different from that for which the reinsured business is reserved (e.g. whole account reinsurance), then we believe that the reinsurance should nevertheless reflect the risk margins appropriate to the reinsured business.

We agree that items (b)(ii) and (b)(iii) are consistent with a current value model.

Where an insurer has prepaid reinsurance protection for risks that have not yet been underwritten, then we would support carrying that cost as a prepayment, provided the insurer is able to demonstrate that it would write business in the future for which the reinsurance premium would be an appropriate protection.

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

We agree that unbundling identifiable components of a service contract, when a reliable measurement of the value of the contract attributable to each of the components can be made, seems a conceptually sound principle.

We also believe that the response to the question raised cannot be made independently from the reconsideration of the various types of insurance contracts that exist and whether it is appropriate that they fall within the scope of the Standard on insurance contracts.

We would wish to see all contracts that fall within the scope of a Standard on insurance contracts to be dealt with in the same way, i.e. by measuring them according to the three building blocks (subject to our comments in Questions 2 to 7) as well as the consideration of policyholders' behaviour. However, we recognise that insurance contracts may be written along side, or bundled with, other forms of business. For example, a car dealer might sell cars complete with insurance cover for the first year's use. Clearly such transactions should be

treated separately in accordance with the relevant Standards. To make the answer to this type of fact clear, the issue needs to be addressed in the Standard through guidance. We believe that this is best dealt with within the scope section of the Standard, by addressing what is meant by an insurance contract where such a contract is bundled with other services. If this is done appropriately, any such scope definition should also adequately deal with the situation in which an insurance contract is bundled with other financial services, such as investment services.

Assuming that a contract is appropriately classified as an insurance contract falling within the scope of the Standard on insurance contracts, we note that, if there is a deposit component within the insurance contract, it may be possible to identify and value it separately. However, it is unclear why these contracts should be required to be valued differently from other insurance contracts that do not include such a feature. The value of an insurance contract including a deposit component also depends on an estimate of all the future cash flows, discounted, a risk margin and possibly a service margin, with consideration of the portfolio's characteristics to which the contract belongs.

We have also indicated in our response to Question 7 that we do not believe that contracts dealt with under the Standard on insurance contracts should be subject to a deposit floor, which represents a significant difference from IAS 39's requirements if a deposit component of insurance contracts were to be dealt with under that Standard instead. Another major difference between the DP's proposals for insurance contracts and IAS 39 is the consideration of portfolio principles in determining the measurement of liabilities.

We question what would be the added value of requiring unbundling any deposit or service component of a contract within the scope of the Standard on insurance contracts as proposed in the DP's paragraph 228. We do not believe that the application of IAS 39's requirements to a portion of an insurance contract would provide improved information as it may not portray the real economics of the contracts. The interdependency of the components within an insurance contract is such that it is generally better dealt with under the DP's measurement proposals than under IAS 39. The projections for the cash flows associated with the deposit component are often dependent on the projections for the cash flows relating to the insurance component due to the policyholder behaviour. Consistently with views expressed in Question 6, we consider that projections of all the cash flows associated with the contract as a whole, determined on a portfolio basis, would generally provide the best information to the users of the financial statements.

In any case, should the IASB proceed with the preliminary views expressed in the DP's paragraph 228, we believe that more guidance would be needed on the assessment of whether "*the components are so **interdependent** that the components can be measured only on an **arbitrary** basis.*" How far should the interdependency and arbitrary basis go?

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?

In our response to Question 16 of the DP on FVM we indicated that "*We agree that where a liability is measured at fair value, fair value must include the entity's ability to meet its obligations (i.e. an assessment of the risks and uncertainties that the cash outflows will not be paid as contractually required). It is appropriate that non-performance risk is determined by reference to the individual instrument, and not based on the entity as a whole*". We believe that this view is still appropriate for the measurement of insurance liabilities under a current value model.

In a transfer value model, we also believe that it is appropriate that a liability be measured so that the price for a transfer neither improves nor impairs the credit characteristics of the liability. However, as we expressed at Question 5, we do not believe that a transfer value model is appropriate for insurance liabilities.

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?

We generally support reducing differences in accounting treatments where items presenting similar characteristics are dealt with differently under two different Standards. However, in the present circumstances, financial liabilities do not always show the same characteristics as insurance liabilities. Hence, the difference in treatment may be justified. What is of utmost importance is that the scope of the Standards on insurance contracts and on financial instruments is clear and precise enough so that there is no uncertainty over the classification of the contracts between one Standard and the other in order to limit the scope for accounting arbitrage.

CHAPTER 6 – POLICYHOLDER PARTICIPATION

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?

As a preliminary comment, we would like to obtain confirmation that contracts with participating features will continue to be treated under the Standard on insurance contracts (which seems to be our understanding of the DP's proposal), even if no insurance component exists in such contracts. We believe that this would be appropriate for two main reasons:

(a) those contracts share many common aspects with insurance contracts, in particular that they build on the principle of mutualisation of risks; and

(b) the accounting under the DP's proposals (subject to our comments) would provide a meaningful accounting outcome for those contracts.

We agree with the DP's preliminary views that the expected cash flows associated with participating contracts shall include at least an unbiased estimate of the policyholder dividends payable to satisfy the legal or constructive obligation that exists at the reporting date. An alternative view would be to include in the expected cash flows all the additional cash flows that are expected to be paid to policyholders. This latter view would be consistent with the belief that, in order to provide the best information to the users of the financial statements on the cash flows that are expected to flow out of the reporting entity, insurance liabilities shall reflect all expected cash flows associated with insurance contracts.

In that respect, we remind the IASB that, when the debates arose on the elements to be considered for the classification of a financial instrument as an equity instrument or as a liability, we expressed support for considering the existence of economic compulsion. We

acknowledge that the IASB did not reach the same conclusion on the issue. Since then, our views have not changed and we consider that economic compulsion is still an appropriate element to consider in determining the existence of a liability and for its measurement. We do believe that the debate on economic compulsion is relevant for the treatment of participating investment contracts. We acknowledge, however, the interaction of the issue with the discussions under the IASB's project on Liabilities and Equity.

If, ultimately, the IASB decides to limit the consideration of cash outflows relating to participating features to those that arise from legal or constructive obligations, we would rather see a discussion on constructive obligation applied to those contracts in the Standard on insurance contracts rather than just making a reference to IAS 37.

Further clarification would also be useful for multi-funds with both guaranteed and non-guaranteed products. Different practices are emerging on how to classify such products – one thought is to classify all the funds within the multi-funds structure as investment contracts with participating features (therefore accounted for in the same manner as insurance contracts) and another thought is to treat only the guaranteed fund as insurance contract and the remaining funds as IAS 39 products.

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).

Generally, we do not support specific exemptions to be made for asset valuation for identical assets held by entities operating in different industries. Consequently, we do not agree with any of the proposals (a) to (d) above. However, we would be in support if the IASB reconsidered the extent to which it would allow generally the measurement of certain types of assets at fair value through profit or loss in order to avoid an accounting mismatch, where the contractual terms of insurance contracts require insurers to hold specified categories of assets and pay a return directly linked to the fair value of, or return from, those specified categories of assets.

CHAPTER 7 – CHANGES IN INSURANCE LIABILITIES

Question 18 - Should an insurer present premiums as revenue or as deposits? Why?

As long as we do not have a better understanding of the measurement of insurance liabilities, as well as how the IASB's project on Financial Statements Presentation will progress, we find it difficult to respond to the question raised. Consequently, we have not considered all issues associated with the presentation of premiums as revenue or as deposits. In any case, we do

believe that the information on the amount of premiums received during the year is critical information to be provided to the users of the financial statements. This information may possibly be provided in the cash flow statement.

As preliminary views, we currently have some preference for showing the premiums received as forming part of the insurance liabilities, with only the changes in the insurance liabilities recognised in the statement that will report an insurer's performance (see further comments in Question 19 below). However, we acknowledge that this presentation would be inconsistent with the way payments received in advance for service contracts are generally accounted for under IFRS. For service contracts, the consideration received is generally recognised as revenue in the income statement as contractual performance occurs.

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

As long as we do not have a better understanding of the measurement of insurance liabilities, as well as how the IASB's project on Financial Statements Presentation will progress, we find it difficult to respond to the question raised. Consequently, we have not considered all issues associated with the presentation of income and expenses on the face of the income statement. As preliminary views, with respect to the statement that will report an insurer's performance, we understand that users of the financial statements would mainly be interested in a display that would provide information on an insurer's activity, such as the writing of new business, lapses or the conditions at which the business is retained. Consequently any changes in insurance liabilities recognised as income or expense would need to be broken down to provide meaningful information to the users on the insurer's activities.

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

In principle, we would agree with the recognition of all income and expense arising from changes in insurance liabilities in the income statement. However, we note that not all changes in the fair value of the assets that back insurance liabilities would be recognised in the income statement (such as for financial assets available-for-sale).

We believe that it is important that accounting mismatches arising across industries are eliminated to the extent they do not reflect an economic mismatch. If the various elements of the performance of insurers were presented into different statements, we believe that it would complicate the understanding of their net performance.

Consequently, we believe it is difficult to respond to the question raised without consideration of the progress being made on the IASB's project on Financial Statements Presentation.

OTHER MATTERS

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

Transition

We would recommend that the IASB grants insurers the ability to proceed to a one-off reassessment of the classification of their financial assets on adoption of the final Standard on insurance contracts. As the accounting for insurance contracts may change dramatically for insurers, they should have the ability to revisit the options available for the measurement of the assets backing their insurance liabilities.

Working with insurance supervisors

The DP's proposals for an insurance liability measurement include the estimated profit required by a market participant for bearing insurance risk and for providing other services, if the insurance liability were transferred to it. Similarly, our suggestions for the insurance liability measurement include the deferral of profit to the extent that it relates to a remaining performance obligation.

Insurance regulators are important users of financial statements prepared under IFRS. We would encourage the IASB and insurance regulators to enter into a dialogue and to seek to achieve consistency of approach in measurement of insurance liabilities where this is practicable, while recognising that some of the objectives of the insurance regulators and IFRS financial statements will be different. Regulators have regard to liabilities measured in accordance with IFRS when determining regulatory requirements and it is important that the principles underlying the IFRS measurement basis are clearly disclosed. In particular, any element of deferred profit included within the overall IFRS liability measurement for insurance contracts should be disclosed so that it is clearly identifiable and readily quantifiable and can therefore be appropriately treated for regulatory purposes.