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EFRAG
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Our ref : AdK
Date : Amsterdam, 28 November 2007
Re : Comment on Discussion Paper Preliminary Views on Insurance Contracts

Dear members of the EFRAG Technical Expert Group,

In September 2007, the European Financial Reporting Advisory Group (EFRAG) released its draft comment letter to the discussion paper (DP) that outlines the International Accounting Standards Board (the Board) preliminary views on insurance contracts. The Dutch Accounting Standards Board (DASB) appreciates the opportunity to comment to EFRAG's draft comment letter. The DASB also directly issued a comment letter to the discussion paper of the Board; this comment letter is attached as an appendix.

We agree with EFRAG's conclusion that the DP is a major contribution to developments in insurance contracts and that the DP should facilitate a debate and explore alternatives.

We especially welcome EFRAG's suggestion to address significant frictions with other IASB projects by an accelerated coherent resolution of any cross-cutting issues to other projects like Conceptual Framework, Revenue Recognition, Liabilities, etc., provided that such an approach would ultimately lead to a standard that gives the appropriate priority to users' needs and is sufficiently tested for its practical applicability.

The DASB has issued its comments to the DP, which has been annexed to this letter.

Some key points of difference between the draft EFRAG comment and the DASB position have been summarised in chapter 1 of this letter. In chapter 2 we answer the questions for respondents as set out in the draft EFRAG comment letter.

1 Key points of difference with EFFRAG's view

We identified the following key points of difference between the draft EFRAG comment and the DASB position al set out in our comment letter to the discussion paper of the Board.

Nature of insurance contracts
In the draft comment letter of EFRAG it is concluded that there is nothing inherently different on insurance contracts that would justify any difference in accounting compared to other contracts. However, we believe the three elements determining the nature of an insurance contract (service, financial and standing at risk) and the subsequent consequences for accounting should be addressed in a more conceptual way in order to decide whether insurance contracts can be analysed into components that can be compared to other contracts or whether insurance contracts as a whole should be considered a separate class of contracts.

We would like to add that, in our view, the timely completion of the insurance project, i.e. by not waiting for the finalisation of the revenue recognition project and changes in the Framework, may require some pragmatic choices. One of these choices may be the designation of insurance contracts as a separate category. This would create flexibility to assign specific recognition and measurement rules where those of other types of contracts appear (still) to be inadequate.

Practical issues on day 1 profit

EFRAG concluded that - if the IASB ultimately decides that the appropriate measurement basis for insurance liabilities is something other than transaction price - alternative (c) is the correct only alternative.

Conceptually, we can see the logic of EFRAG's point of view, although we note that there is a significant level of hesitation in the industry with the recognition of profit at inception.
However, if the final standard would require measurement of a separate service margin, it may also be very well possible that the eventual implementation of a standard ends in a concept of a rebuttable presumption that the margin implied by the actual premium is consistent with the margin that market participants require (option (b) of Question 4).

Entity specific cash flows and data

EFRAG is not persuaded that entity-specific cash flows should be ignored when determining the unbiased estimate of future cash flows and that market data are superior to entity-specific data.

Like EFRAG we believe that entity-specific assumptions may very well result in useful information on the measurement of insurance contracts. Specifically for most operational assumptions, we believe that entity specific assumptions are superior to "constructed" market-based assumptions where such markets are factually non-existent.

However, we believe that the fundamental choices on the measurement attribute should be made based on what users regard as most useful information.

2 Questions for respondents

In this section we provide our response to EFRAG's questions for respondents.

One of the issues that EFRAG has been discussing is whether it is appropriate to include some sort of margin in a litigation provision. EFRAG has not made its mind up on this issue, but has nevertheless also been discussing whether, if the answer to the above question is 'no', whether there are any differences between litigation provisions and insurance claims liabilities that justify a different accounting treatment. We would welcome your views on this issue.

We regard 'standing at risk' from an insurance contract and from a dispute as different; the former is a deliberate choice and is part of a company's pricing. Although both require a margin for uncertainty that can not be derived from observable market information, we believe that the practical solutions emerging for insurance cannot apply for litigation-type provisions.

We would particularly welcome your views on this issue. Do you believe that settlement value and transfer value will be the same, or at least very similar, and if so why? Or, to put it another way, why might it be relevant to include in a settlement value the amount that a market participant would require to bear the risk inherent in the liability?

In fully transparent markets, efficiency advantages do not sustain and inefficient market participants are forced to adapt. Consequently, in such markets "where lean enterprises collide", differences between transfer value and settlement value will not remain for long. In absence of those markets, settlement value may be a reasonable proxy for transfer value. Applying this reasoning to risk margins, we feel that, in absence of direct market prices, a model that has reference to the way market values risk is superior to any other model.

This is a very tentative EFRAG position because it is still discussing this aspect of the proposals, so we would particularly welcome views on it. In commenting it is probably worth bearing in mind the following additional points.

- We have made several references in this draft letter to the importance of adopting accounting practices that reflect fully the economics of insurance activity. In that respect there is nothing unique about insurance activity; accounting needs to reflect the economic substance. However, there are lots of types of economic activity that involve expenditure being incurred on day one in the expectation that it will be recovered in subsequent periods, and generally we do not take the view that recognising a day one loss on such activity is inconsistent with reflecting the economic substance of those activities.

- When one transfers a portfolio of insurance contracts it is almost inevitable that one transfers not only the rights and obligations themselves but also various customer intangibles. As a

result, the transfer value of the portfolio includes things we would not normally wish to recognise in the financial statements, so is the argument in (b) above still a fair one?

- In order to be able to argue persuasively for option (b), one probably needs to be able to argue persuasively that there is an economically substantive difference between renewal options and cancellation options. There is no doubt that there are differences in terms of effort etc but are there any economically substantive differences?
- Some EFRAG members believe that the answer might lie in refining option (a)'s notion of guaranteed insurability. Do you agree, and if you do what refinements do you suggest? For example, it is not just guaranteed insurability that causes policyholders not to stop making payments. What are those other reasons and how if at all should they be reflected in the accounting?

As described in the key points of difference, we believe the three elements determining the nature of an insurance contract (service, financial and standing at risk) and the subsequent consequences for accounting should be addressed in a conceptual way; we are not convinced yet that there is nothing inherently different on insurance compared to other contracts. Regardless of a conclusion on the nature of insurance contracts, we agree with EFRAG that insurance accounting should fully reflect the economic substance of insurance activities, although we would like to mention that what is regarded as the economic substance of cash flows from insurance activities may depend on what is decided on the nature of insurance contracts.

Option a (guaranteed insurability) would not fully reflect economic substance and may therefore lead to an accounting mismatch. We would therefore sympathise with option b (all cash flows from existing contracts). However, we agree on EFRAG's observations on the magnitude of potential consequences of option b for accounting, especially with regard to short term insurance contracts. At this moment, we do not see a clear-cut solution for this issue.

We do not exactly understand the difference between option b and c, because the commercial substance principle is also part of option b.

The DP's proposal that the benefits of diversification (and negative correlation) between portfolios should not be taken into account seems to be simple to implement, consistent with the IASB's proposal that a transfer value approach should be applied with the unit of account being the portfolio, and in line with Solvency II. But is it right? EFRAG would particularly welcome your views on this issue because it has been argued that whenever there is a diversification benefit it should be recognised, even if it results from diversification between portfolios. It is also suggested for example that insurers take such diversification into account in their modelling.

We would suggest field testing to identify which diversification benefits are included in technical product pricing. If priced-in diversification benefits are not allowed to be part of measurement, an accounting mismatch would occur.

We would like to mention that the Solvency II allows for diversification benefits.

We shall be pleased to give you any further explanation that you may require.

Yours sincerely,

Hans de Munnik
Chairman Dutch Accounting Standards Board

APPENDIX I COMMENT LETTER OF DASB TO IASB REGARDING DISCUSSION PAPER PRELIMINARY VIEWS ON INSURANCE CONTRACTS

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International Accounting Standards Board
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Our ref : AdK
Direct dial : Tel.: (+31) 20 301 0391 / Fax: (+31) 20 301 0279
Date : Amsterdam, 28 November 2007
Re : Comment on Discussion Paper Preliminary Views on Insurance Contracts

Dear Mr Clark,

The Dutch Accounting Standards Board (DASB) appreciates the opportunity to comment to the discussion paper (DP) that outlines the International Accounting Standards Board (the Board) preliminary views on insurance contracts. We have summarised our reactions to the specific questions in appendix I to this letter.

Our general observation is that the direction in which the discussion paper points, has the potential to significantly improve financial reporting for insurance contracts. At the other hand, the discussion paper clearly reveals some significant frictions between the present IFRS Framework and other Standards, and what is broadly regarded useful information on insurance contracts. The discussed changes are significant for financial reporting on insurance contracts and perhaps even for financial reporting in general, when comparing them to present practices. Unavoidably, choices need to be made to either finalise the ongoing projects with respect to the Framework and topics like liabilities and revenue recognition or to make specific choices regarding insurance contracts. With respect to these choices, we would strongly recommend to let users' needs and preparers' containment of compliance costs prevail above the exact match to the present framework. In this respect, EFRAG recommends in its draft comment letter to give priority to the main issues that arise from the DP as soon as possible. We very much support this recommendation. As regards users needs, we hesitate as to whether these are sufficiently reflected in the DP and we would welcome them to be specifically addressed in the discussion. As regards the position of the preparer, we recommend to carefully consider frictions in delivery of the required measurements in a sufficiently robust system of control over financial reporting

and the time frame in which such frictions could be solved in the future. Clear-cut field testing may be appropriate in order to verify feasibility and proper timing.

In this letter, we offer some general comments to the direction of the Board's insurance project.

1 Identification of the nature of insurance contracts

Before entering into the discussion on measurement and revenue recognition, it is important to decide on the nature of an insurance contract. In general, elements of a financial instrument, a service contract and acceptance of insurance risk can be identified within an insurance contract. Acceptance of insurance risk may have similarities with a service contract or may be regarded a third class of contracts for which measurement and revenue recognition is specific.

A "bundle" of service, investment feature and insurance risk acceptance may or may not be regarded a third class of contract and in assessing measurement attribute and revenue recognition the financial instrument features or the service features may be considered dominant. If financial instrument features are considered dominant, revenue is recognised consistent with IAS 39 as this standard may develop in the near future. If service features are considered dominant, revenue recognition is based upon critical events, although the Board is considering alternatives.

As long as the revenue recognition project has not been finalised it makes an important difference whether an insurance contract is treated predominantly as a financial instrument, as a service contract or as a third class of contracts consisting of a "bundle" of service, investment feature and insurance risk. Furthermore, it is important to assess whether an insurance contract can / must be unbundled and the separate elements can be measured in accordance with the respective applicable standards.

The timely completion of the insurance project, i.e. by not waiting for the finalisation of the revenue recognition project and changes in the Framework, may require some pragmatic choices. One of these choices may be the designation of insurance contracts as a separate category. This would create flexibility to assign specific recognition and measurement rules where those of other types of contracts appear (still) to be inadequate.

2 Measurement models

The DP mentions current exit value as the preferred measurement attribute although a large minority within the Board favours current entry value. The DP also mentions the value in settlement with the policy holder, which is the (largely entity-specific) value at which the enterprise runs off its liabilities.

In our opinion, the question about the preferred measurement model cannot be answered without addressing the issues raised on identity in the previous paragraph. But the choice of the model

largely determines the information about the development in liabilities and in results during the reporting period. In response to your request on the exchange of ideas on how to present performance in an insurer's financial statements we have included three possible models depending on the measurement attributes selected (see Appendix 2 to this letter).

We believe that any selected measurement attribute should be consistent with the users' understanding of the amount, timing and uncertainty in future cash flows. Our current view is that the true economic valuation of the liability (based on current assumptions) would be preferable as it provides transparency on the liability against policyholders.

3 Profit at inception

Conceptually, we can see the logic of a situation where profit at inception exists when the sources of this profit can be positively identified in a reliable way (option (c) of Question 4), although we note that there is a significant level of hesitation in the industry with the recognition thereof.

However, it may also be very well possible that the eventual implementation of a standard ends in a concept of a rebuttable presumption that the margin implied by the actual premium is consistent with the margin that market participants require (option (b) of Question 4).

This would imply that a profit at inception, if any, should only be recognised as income if the sources of these profits can be identified positively, unambiguously and stringently. Clear-cut field testing is needed to help identify, evaluate and decide on the practical implications.

In addition to the measurement of profit at inception, there are the issues of presentation and of revenue recognition. We would encourage the Board to develop further guidance on the presentation of (operating) performance in the profit and loss account and the use of other comprehensive income. This guidance should be consistent with decisions to be made on performance reporting and revenue recognition in general.

4 Building blocks

We welcome the building blocks approach for measuring insurance liabilities and the expected value of future cash flows being one of those building blocks, which has the potential to give the user the long-desired insight in the experienced cash flows against previous unbiased expectations.
We believe that the Board should further clarify the need for a service margin, as the components of such margin appear to be reflected already in the best estimate of cash flows and/or risk margin.
It is commonly agreed that market observables are rare for this building block. While the industry is gradually developing commonly accepted practices to measure risk margins, for service margins this is not the case; separate identification of a service margin will definitively meet

practical hurdles and would require arbitrary allocation decisions. Therefore we have significant hesitance with respect to the practical applicability of a separate service margin.

5 Practical issues in assessing future cash flows

The first building block is represented by the probability-weighted average of future cash flows. This concept is similar to the exposure draft for IAS 37 that has been issued in 2005. Although much concern has been expressed in comment letters to the application of this concept for all types of liabilities, we feel that it may very well be appropriate for insurance liabilities, being liabilities that originate from transactions and that relate to a large number of similar contracts.
Nevertheless, there are some practical issues.
First, there are the limitations in recognising future premiums (guaranteed insurability) and discretionary participation features (constructive obligations), which means that certain expected cash flows cannot be taken into account. While we understand the Board's concerns on significant frictions that may emerge within the Framework, we observe that these limitations may create new accounting mismatches that users will find difficult to understand. We would encourage the Board to let the users' understanding of amount, timing and uncertainty of future cash flows prevail above technical restrictions that relate to the definitions of assets and liabilities.
Second, in our opinion, more guidance is required to the application of the fair value hierarchy when selecting the assumptions within the models used to measure insurance liabilities. For a number of assumptions, like maintenance expenses, no faithfully representational market quotations are available and a hypothetical transaction with the enterprise's own shadow can hardly lead to useful information. Therefore, we would encourage the Board to develop guidance how to deal with the lowest level in the hierarchy and how enterprise specific data can be transformed into a reasonable proxy for liability measurement. Specifically for most operational assumptions, we believe that entity specific assumptions are superior to "constructed" market-based assumptions where such markets are factually non-existent.

6 Coherence disclosures and measurement framework

We believe that proper measurement at a mark-to-model level cannot go without proper disclosure. We encourage the Board to revisit the present IFRS 4 disclosures and assess as to whether they are complete, relevant, sufficiently concise and sufficiently prescriptive to support a measurement model that is highly dependent upon an evaluation of estimated future cash flows and a model-based risk margin. Examples of such disclosures are liability development tables where cash flow information is clearly separated from judgmental information like change in estimates, quantitative and qualitative analysis of experienced cash flows against previous periods' assumptions, explanation of the development in the risk margins against risk and capital disclosures, the models and parameters used, etc.

7 Differences and similarities with the EU Solvency II project

Simultaneously with the DP and the development of a standard for measurement of insurance liabilities, Solvency II is being developed within the European Union. Solvency II also addresses measurement of insurance liabilities. While we would not in general advocate the adoption of regulatory framework of a specific jurisdiction for financial reporting purposes, we note that the Solvency II measurement attribute is also current exit value. The definition of current exit value given in the introductory notes to the draft Framework Directive that has been issued this summer is very similar to the definition applied in the DP. It reads:

> The current exit value reflects the amount an insurance or reinsurance undertaking would expect to have to pay today if it transferred its contractual rights and obligations immediately to another undertaking. The use of current exit value should not be intended to imply that an (re)insurance undertaking could, would or should actually transfer those obligations.

Measurement in accordance with Solvency II implies an application of the fair value hierarchy. The concepts are in the process of being field tested and become more and more accepted in the insurance industry within Europe and various quantitative impact studies have been and will be performed to field-test the principles. We would encourage the Board to investigate as to whether these measurement principles sufficiently enhance the users' insight in insurance liabilities to eliminate the barriers for seamless application of such principles in IFRS financial statements. The advantage of such an approach is that detailed practices in measuring insurance liabilities can further develop during the time that the Board's projects on Framework, revenue recognition, liabilities and liabilities versus equity are still under construction. In addition, it would reduce the implementation costs and efforts of at least the European insurance industry.
We shall be pleased to give you any further explanation that you may require.

Yours sincerely,

Hans de Munnik
Chairman Dutch Accounting Standards Board

APPENDIX I COMMENT LETTER OF DASB TO IASB REGARDING DISCUSSION PAPER PRELIMINARY VIEWS ON INSURANCE CONTRACTS

APPENDIX I TO COMMENT LETTER TO DISCUSSION PAPER PRELIMINARY VIEWS ON INSURANCE CONTRACTS

Responses to specific questions

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?

Although the DP describes the issue of recognition and derecognition, the DP does not discuss it in detail. Before entering into the discussion on recognition and derecognition, it is important to decide on the nature of an insurance contract and whether an insurance contract must be unbundled for any separate elements.
If the insurance contract should predominantly be treated as a financial instrument or as a service contract, recognition and derecognition would be based on the respective applicable standards. If insurance contacts should predominantly be regarded as a third class of contracts, separate requirements for recognition and derecognition should be considered. Reference is made to paragraph 1 of our letter.

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 with the fact that an insurer should use the three building blocks as described in the DP. We also agree with the Board's view that the sum of the three building blocks do not necessarily result in the fair value of the insurance contract as a whole. However, we see conceptual issues and practical restrictions in determining a service margin in a faithfully representational way.

APPENDIX I COMMENT LETTER OF DASB TO IASB REGARDING DISCUSSION PAPER PRELIMINARY VIEWS ON INSURANCE CONTRACTS

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?

Cash flows (appendix E)
In our view the draft guidance does not require more or less detail on the nature of cash flows. However, the appendix should encompass more guidance on the application of the fair value hierarchy when selecting the assumptions within the models used to measure those cash flows. As set out in our letter, no faithfully representational market quotations are available for a number of assumptions and we therefore would encourage the Board to develop guidance how to deal with the lowest level in the hierarchy and under which conditions enterprise specific data can become a reasonable proxy for liability measurement.

Paragraph 42 explains why both the time value and intrinsic value of all options and guarantees are included in the best estimate of future cash flows, provided that all scenarios are properly evaluated and probabilities are properly set. However, stochastic models often include the development of economic parameters (like interest, inflation, and volatility), enterprise's decision rules and policyholders' behavior. Such models are most of the time calibrated to the market for the economic parameters. It is useful to make more explicit in appendix E that this "use of the fair value hierarchy within the model" is what the board intends.
Furthermore, we assume that both real world and risk-neutral scenarios are allowed. It is useful to require that the discounting process is consistent with the choice between real-world and risk-neutral. Real-world scenarios often need stochastic deflators in order to give market consistent results for options and guarantees.

Risk margins (appendix F)
Appendix F lists various approaches for measuring risk margins. We welcome the fact that the DP acknowledges approaches that are accepted in the insurance industry and we would encourage the Board to maintain this position and not to be restrictive on approaches for measuring risk margins other than those that would not fit into what are commonly considered as acceptable principles for valuation.

APPENDIX I COMMENT LETTER OF DASB TO IASB REGARDING DISCUSSION PAPER PRELIMINARY VIEWS ON INSURANCE CONTRACTS

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 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 set out in our letter, the question about the preferred measurement model cannot be answered without addressing the issues raised on identity of the insurance contract and users' needs. We believe that choosing the preferred measurement model is not only limited to choosing the conceptually preferable model but also involves assessment of practical issues that may be involved with the application of the model that would be conceptually preferred. Practical issues relate to the non-availability of market observable parameters in many cases and, if the final standard would require measurement of a separate service margin, the difficulties in identifying a profit margin separately from risk and service margins.
The conceptual logic of the possibility of a profit at inception would imply a choice for option (c) above, if it can be positively and reliably measured. However, due to practical implications an eventual standard may very well end in option (b) above. Clear-cut field testing is needed to help identify, evaluate and decide on the practical implications.

Question 5
This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.
(a) Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?
(b) Is 'current exit value' the best label for that measurement attribute? Why or why not?

Insurance companies generally settle their commitments to policyholders, rather than transferring these commitments to a third party. At first sight, a value in settlement with the policyholder could therefore be perceived more relevant to explain future cash flows than current exit value.

In addition, all practical difficulties (lack of observable parameters, etc.) mentioned before, apply to current exit value. For a number of assumptions, like maintenance expenses, no faithfully representational market quotations are available. We therefore believe that, specifically for such assumptions, entity specific assumptions are superior to "constructed" market-based assumptions where such markets are factually non-existent. Furthermore, in our opinion, more guidance is required to the application of the fair value hierarchy when selecting the assumptions within the models used to measure insurance liabilities.

However, as set out in our letter, each measurement attribute for insurance liabilities (current entry value, value in settlement with the policyholder or exit value) has its own consequences for information on performance, credibility of previous estimates and volatility. Therefore, we believe a principal decision on the measurement attribute should take into account an assessment of users' needs. We also refer to appendix 2 to this letter.

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

In our view, beneficial policy behaviour should be recognised by the insurer; not recognising such behaviour would lead to an accounting mismatch reflecting a loss that is not an economic loss. We therefore reject option (c).
Given the inherent relationship between beneficial policy behaviour and the insurance liabilities we prefer option (b).

APPENDIX I COMMENT LETTER OF DASB TO IASB REGARDING DISCUSSION PAPER PRELIMINARY VIEWS ON INSURANCE 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).

We welcome the fact that the DP addresses the issue of economic substance of future cash flows. As set out in our letter, we understand the Board's concerns on significant frictions that may emerge within the Framework. But we also observe that, due to the fact that certain expected cash flows cannot be taken into account, new accounting mismatches that users will find difficult to understand, may be created. We therefore believe that the focus should be on involving all expected cash flows in the measurement of the insurance contract as a whole, rather than individual rights and obligations under the contract. We encourage the Board to let the users' understanding of amount, timing and uncertainty of future cash flows prevail above technical restrictions. Such an understanding does not necessarily have to reflect criterion (b) or (c), but may very well lead to a broader scope of cash flows than included in the DP's current definition of guaranteed insurability.
In order to set proper boundaries for future cash flows that can be considered to belong to an insurance contract, it may be useful to further analyse the definition of in-force business in the European Embedded Value Principles. Alternatively, common practices for pricing of insurance contracts and assessment of distribution commissions could be further investigated.

Furthermore, we would like to mention that guaranteed insurability may be influenced by discretionary participation features that are only vested at maturity or after a certain period (e.g. terminal bonuses). It is important that these participation features (irrespective whether they

qualify as a liability) are treated consistently with the cash flows from beneficial policyholders' behaviour.

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

We concur with the current position in the DP to recognise acquisition costs as expenses as incurred. However, we would like to mention that the DP's current definition of guaranteed insurability might lead to a loss at inception regarding acquisition costs. We therefore see this issue should be addressed as a part of the issue on the scope of cash flows as set out in our response to question 7.

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

We concur with the observation of the Board that the question whether the extended presentation will need to be retained, depends on the ultimate measurement attribute.
We would like to mention that the composition of assets and liabilities regarding acquired insurance contracts, e.g. the split of a customer relationship between an intangible asset and an element of insurance liabilities, is closely connected to other issues like guaranteed insurability and discretionary participation features.

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

As a general comment we would encourage the Board to eliminate all restrictions in recognition and measurement of assets backing insurance contracts that create new 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?

In our opinion, the Board should not set narrow prescriptions for what has to be regarded as a portfolio 'of similar risk and managed together'. For this matter, the Board could allow for the principle of 'through the eyes of management' to be applied, but with proper disclosure requirements and requirement for consistent application.

We believe that risk margins should be determined at portfolio level due to the fact that, generally, portfolios are managed in that way and a portfolio could be regarded as a 'natural unit'. Determining the risk margin at portfolio level raises the issue whether diversification between portfolios should be allowed for. One of the diversification elements is the impact of scale benefits on the pricing practice of the company or group (in order to be competitive). Large insurance groups are also supposed to include their scale (including diversification) benefits in their pricing. If they cannot be reflected in the measurement of the insurance contracts, a loss at inception will be measured that is not an economic loss. It is recommended to relate the extent of giving regard to diversification benefits to common practices for pricing insurance contracts.

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 believe that the reinsurance asset should be measured according to the same measurement attribute that is used for the insurance liabilities, including the way risk margins are determined. This measurement attribute may or may not be current exit value. The question whether the reinsurance asset should be adjusted for credit risk or incurred credit losses, depends on the final choice of the measurement attribute, thereby considering consistency with other standards and practical implications.
We do not believe that a contractual right to obtain reinsurance should be recognised before any actual risk cover has commenced.

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

We would relate this issue to the question as to whether an insurance contract can be unbundled into the various components without any arbitrary decisions. If this is the case, the deposit component and the service component should be treated separately, because failing to do so, would result in similar contracts in different industries being accounted for in a different way. We would find this undesirable.
However, we assume that for a majority of insurance contracts, unbundling on a basis that is not arbitrary cannot take place.

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 view it would be appropriate to work with a rebuttable assumption that credit characteristics do not play a role in measuring insurance liabilities. Regulatory bodies would intervene when the credit characteristics of an insurer's insurance liabilities are deteriorating. If, and only if, the regulatory system would be inadequate, the credit characteristics of insurance liabilities could become a material issue.

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?

Reference is made to our response on question 10.

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?

The current view of the Board to include only legal and constructive obligations, results in limitations to recognising cash flows from discretionary participation features. As set out earlier, we would encourage the Board to let the users' understanding of amount, timing and uncertainty of future cash flows prevail above technical restrictions. Although IAS 37 and its proposed amendments give sufficient guidance for an insurer to determine whether a participating contract gives rise to a legal or constructive obligation, they also give rise to the above-mentioned technical restrictions. We refer to our answer to Question 7.
Not recognising all expected future profit participation, results in earnings volatility that does not reflect any economic reality and may even create inconsistencies between cash flows from beneficial policyholders' behaviour and expected profit participation.

APPENDIX I COMMENT LETTER OF DASB TO IASB REGARDING DISCUSSION PAPER PRELIMINARY VIEWS ON INSURANCE CONTRACTS

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).

We believe that the accounting mismatch could best be solved at the asset side of the balance sheet. We therefore suggest to permit (a), (b) and (c).
We also believe that such requirements should be facilitated in the respective standards and not be included in the standard on insurance contracts.

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

We would like to refer to the issue of unbundling. If and only if an insurance contract can be unbundled on a basis that is not arbitrary, the deposits to and withdrawals from the deposit component should not be recognised as revenue in order to avoid inconsistencies with similar contracts held by other industries.

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

We encourage the Board to investigate as to whether the project on performance measurement could provide a basis for determining the presentation within the income statement.

APPENDIX I COMMENT LETTER OF DASB TO IASB REGARDING DISCUSSION PAPER PRELIMINARY VIEWS ON INSURANCE CONTRACTS

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

In our view the income statement should, in principle, cover all income and expense arising from changes in insurance liabilities. However, if any accounting mismatches remain, the final standard should include provisions to solve such mismatches.

Question 21
Do you have other comments on this paper?

Reference is made to our covering letter.

APPENDIX I COMMENT LETTER OF DASB TO IASB REGARDING DISCUSSION PAPER PRELIMINARY VIEWS ON INSURANCE CONTRACTS

APPENDIX II TO COMMENT LETTER TO DISCUSSION PAPER PRELIMINARY VIEWS ON INSURANCE CONTRACTS

Source of earnings presentations to various measurement models

In response to your request on the exchange of ideas on how to present performance in an insurer's financial statements we have included three possible models depending on the measurement attributes selected.

As observed in paragraph 1 and 2 of our letter, there is no consensus on as to whether the measurement should be a buy (entry), hold (settlement at entity specific assumptions) or sell (exit) value. This lack of consensus is due to:

- Conceptual differences; e.g. exit value is rejected because future cash flows generated by insurance companies typically come from settlement.
- Concerns about:
  - the ability to separate profit margins from risk and service margins.
  - the ability to obtain reliable transfer values for certain elements in the contract (e.g. policy administration costs).

It is important to know for which reasons participants in the insurance contract measurement discussions accept or reject certain methods; concerns about availability of information may be overcome as time evolves; conceptual differences remain, even though solutions for information issues have been found or markets for certain contracts or instruments have been created. Additionally, there may also be a need to revisit disclosures on insurance contracts when determining the measurement base.

The analysis of the measurement approaches mentioned above obviously assumes that all necessary information is available in a reasonably objective way.

Entry (buy) value

The information on movements would look at follows:

Modeled profit, risk and service margins	X
Operating variances	X
Change in operating assumptions	X
	X
Operating profit	**X**
Investment return	X
Foreign currency results	X
(Comprehensive) profit	***X***

- Modeled profit, risk and service margins include a formula-based realization of profits in excess of risk and service margins. No profit at inception is recognized.

- This table is similar to the source of earnings analysis that some insurers disclose as a supplement to their financial statements.
- Changes in operating assumption are recognized when they arise. This is different from existing measurement principles like MoS, where such changes are included in unamortized margins. This approach is consistent with the general rule in present IAS 8, where estimation changes (unless they affect asset or liability measurement) are recognized prospectively, over the lifetime of the contract, but not with IAS 18. Furthermore, it conceals the information that changes in the assumptions took place.

Hold (run-off) value

Here, the information on movements would look as follows:

Risk and service margins	X
New business profit	X
Operating performance	**X**
Operating variances	X
Change in operating assumptions	X
	X
Operating profit	**X**
Investment return	X
Foreign currency results	X
Comprehensive) profit	***X***

- New business profit is recognized at point of sale and forms part of annual performance.
- Operating variances indicate the credibility of previous entity specific operating assumptions.

Sell (exit) value

The picture of movements is as follows:

Risk and service margins	X
New business profit	X
Operating variances	X
Operating performance	**X**
Change in operating assumptions	X
Operating profit	**X**
Investment return	X
Foreign currency results	X
(Comprehensive) profit	***X***

In this model, operating variances indicate the difference between the entity specific realization and market consistent / portfolio specific assumptions. It indicates the relative efficiency of the enterprise and thus represents a performance indicator, if …… reliable market consistent / portfolio specific assumptions can be found.

The paradox that can be found in this exercise is that the application of exit value gives information on the operating performance of an enterprise on a going concern basis that remains concealed when applying a hold value. Needless to say that such information can only be provided if all portfolio-specific information is observable.