APPENDIX A

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?

We do not believe that the recognition and derecognition criteria should be the same as that required for financial instruments as set out in IAS 39. The recognition of insurance contracts is more complex than the analysis in the Discussion paper would suggest and is a significant issue for the insurance industry. For example, a motor insurance contract could be agreed and paid for prior to cover starting or, in contrast, a reinsurance contract could be signed after the coverage period has commenced. In these contracts recognition has traditionally occurred at the date risk cover commences. Insurance contracts can only be classified as such if there is significant insurance risk. In our view the most appropriate recognition criterion to consider is the point at which risk cover commences.

Furthermore, derecognition of insurance assets also requires specific consideration in the light of the potential complexities involved.

We would stress that we believe that recognition and derecognition criteria should be applied to an insurance contract as a whole and no attempt should be made to separately recognise any underlying rights and obligations.

Before the recognition and derecognition criteria for insurance contracts are determined we believe more detailed analysis and discussion of current practices should be undertaken by the IASB and other interested parties.

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?

As set out in the Elaborated Principles, we support the basic concept that the three building blocks described above should underpin the measurement of insurance liabilities, i.e. we support a prospective current assumptions based model that reflects all expected cash flows associated with a contract.

We do, however, have concerns as to the detailed interpretation of each of these building blocks. These concerns surround some of the principles of application expressed in the Discussion paper as well as how parties will interpret these building blocks upon detailed implementation of the standard.

A fundamental part of any reporting model is the basis upon which profit is recognised. We understand that there is an expectation in the Discussion paper that any profit recognised at inception using the approach outlined in the Discussion paper will not be significant. We do not share this view. There is a significant initial profit margin which is demonstrated for life business by market consistent embedded value ("EV") numbers produced by some of our members. We also believe that the initial profit margin for short term business is not insignificant. It is important that the standard recognises the size of these profits and adequately addresses how these profits should be earned. Given our position on this initial profit margin we have set out our proposals for its presentation and measurement below.

With regard to the individual building blocks, and the initial profit margin, we have the following comments:

Cash flows

The Discussion paper describes this approach as 'current exit value'. As explained elsewhere we support an economic approach to contract valuation which we believe represents the most appropriate form of exit value for insurance contracts, essentially a transfer value in a run-off scenario. We believe that certain features of the measurement model outlined by the IASB, notably in terms of cash flows to be included, mean that the proposed model is not an economic exit value. This would be true of certain future premiums that would not meet the guaranteed insurability criteria, an issue that is discussed further in question 5. Furthermore, we are concerned that all expected future payments to policyholders under participating contracts would not be included in cash flows. This point is discussed further in question 16 below.

In general terms we believe that these issues can be addressed by stipulating that once an insurance contract has met the recognition criteria, all the cash flows attaching to that contract are relevant to its measurement and no further consideration is required as to whether the separate rights and obligations created by that contract meet the recognition criteria established in the IFRS framework.

We generally support the proposal that the estimate of future cash flows should be on a market consistent basis although we believe that it is important that "market consistent" is defined. Our view is that market consistent assumptions should not be confused with market average assumptions but should instead be based on the specific portfolio of insurance contracts held. Different types of assumptions should be considered on the basis of their nature. Accordingly, economic assumptions based on financial indices, such as interest rates, should follow readily observed market data. For other assumptions the attempt to create a "market" leads to an approach that is too theoretical that will result in information that is neither understandable nor relevant to users. Accordingly, we believe that certain non-financial assumptions, notably expenses, should be based on entity specific data when valuing insurance contracts.

Discount rate

We agree that the future cash flows should be adjusted for the time value of money and agree with the IASB's view that the discount rate should be consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability.

Risk margin

We support the concept of a margin to allow for risk and uncertainty. The important issue to consider is how this margin should be determined. We believe that the risk margin should represent the cost of risk and could be defined as a risk margin in addition to the expected

present value of future liability cash flows required to manage the portfolio. In our view the cost of capital basis represents the most appropriate means of determining the margin and this should reflect the excess return over risk free rates that any company (either the originating company or a transferee) would require to manage the insurance obligations over the lifetime of the portfolio. We do not believe that the risk margin should include any compensation other than this compensation for risk. We believe that this approach is consistent with the model proposed under the Solvency II regulatory basis where the best estimate of liabilities is supplemented with a risk, or market value, margin based on a cost of capital model.

As indicated in our response to question 3 below, we agree that the Board should not provide detailed guidance on how the risk margin should be calculated. This should be developed by the industry as experience and thinking in this area develops. In the light of the point made above, it is important that any guidance provided does not conflict with the risk margin calculated under Solvency II, as we believe an entity should have a single view of such a risk margin. As set out above, in our view the risk margin should be calculated using the cost of capital approach.

Service margin

The Discussion paper introduces the concept of a service margin. The exact nature of this margin is unclear and our discussions have already established several interpretations of its meaning. For example we are unclear as to which services should be considered. The Discussion paper focuses on investment management services but implies that the service margin should relate to other services as well. It is unclear how the service of providing insurance risk cover is dealt with between the service margin and the risk margin. We believe that the best estimate of the premiums received and the costs incurred in connection with providing all these services will already be included in the best estimate liability and the risk and uncertainty associated with those cash flows included in the risk margin. At inception of a contract any additional expected profit arising from providing these services would be an indistinguishable part of the initial profit margin we have described below. We feel that the inclusion of the service margin adds an unnecessary complexity into the calculation and it should be excluded from the final standard.

Initial profit margin

We believe the insurance liability measurement should consist of the best estimate of future cash flows and a risk margin represented by the cost of capital. Together these two components comprise the full economic value of the liability. The residual difference between the premium (after deduction of relevant acquisition costs) and this insurance liability represents an element of the profit expected to be generated by the contract over its lifetime. We believe that this amount is available capital for regulatory solvency purposes since it goes beyond the economic value of the liabilities and will not be paid to policyholders. We refer to it in this paper as the “initial profit margin”. We believe that this initial profit margin is more significant than that envisaged by the IASB in the Discussion paper. The size of the initial profit margin is demonstrable in market transactions and in published market consistent embedded value figures. It is therefore important that the presentation and recognition of this initial profit margin is carefully considered in the development of the final standard.

We have considered three conceptually viable options on how this initial profit margin can be presented for accounting purposes. These options were; presentation within liabilities or presentation as part of equity, either immediately as part of profit (i.e. gains upon inception) or as a component of other comprehensive income with recycling to the income statement over the contract term. After careful consideration of their respective merits and consistent with our Elaborated Principles, our current view is that the accounting presentation should reflect the provision of risk coverage, i.e. recognised in line with release from risk. In this

context, since the initial profit margin is akin to deferred income, our proposal for accounting purposes is that it is presented separately in the liability section of the balance sheet.

The resulting profit recognition pattern is consistent with the concepts of performance of obligations and provision of services currently being debated by the IASB as part of the revenue recognition project. Such treatment will provide clarity for the users of accounts and, in particular, will ensure that the regulatory position is clear. In this regard we fundamentally believe that the initial profit margin represents available capital for regulatory solvency purposes and we would not support the presentation of the initial profit margin as a liability if this were to jeopardise this position.

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?

We are of the view that the Board should not provide detailed guidance on how the risk margin or cash flows should be calculated or determined either in the standard or in any supporting appendices. We believe that further guidance, beyond that included in appendices E and F, will be required to allow insurers to prepare financial statements in accordance with the IASB's measurement proposals. However, we are of the opinion that such guidance is best developed by the industry, both initially and, as greater experience is gained, subsequently. Thus, for example, we believe that the cost of capital is the most appropriate way to calculate the risk margin but we do not believe that the standard should prescribe such an approach as actuarial techniques and methodologies will develop over time.

As discussed in question 2 we have some concerns over how parties will interpret the building blocks upon detailed implementation of the standard. We believe that it is important that the standard makes clear that different methodologies and techniques are available to underpin the principles. For example "probability-weighted" should not be interpreted as requiring full stochastic modelling but rather the use of a technique to estimate cash flows which is mindful of the likelihood of possible outcomes, such as the use of mortality tables in existing models. Furthermore, it is common in non-life insurance to first estimate the outstanding claims in aggregate and then to determine the run-off pattern based on historical payment patterns. We would advocate that this practice be maintained rather than to produce an aggregate estimate of individual future cash flows to estimate the ultimate losses.

In addition to the general comments above and those provided in question 2 on each of the three building blocks, we have set out below a number of specific points around particular aspects of the guidance as provided:

It is apparent from our discussions that certain cash flows referred to as either requiring inclusion or exclusion in the best estimate liability model in paragraphs E24 and E25 respectively are the subject of debate. We believe that the standard need only state the principle that future cash flows should be determined on a best estimate basis and no further prescription is needed. Whilst examples could be provided, specific local practices or other contract features could mean that a single view is not relevant to all entities. For example, in certain jurisdictions, taxes, referred to as excluded in E25(e), will include those paid on behalf of policyholders and thus should be included in the best estimate of the future cash flows. We believe that this issue can be overcome by including suggestive rather than prescriptive language within the final standard.

It will be important to reconsider the illustrative cash flow listings once there is greater clarity over participating contract accounting to ensure that all relevant cash flows are included (or excluded where relevant).

Question 4

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

(a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.

(b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?

(c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.

(d) Other (please specify).

We do not support options (a), (b) or (c) above.

We do not support the calibration of the risk margin directly to premiums. We believe that the risk margin should be calculated independently on the basis set out in question 2 above. As explained there, the difference between the premium (after deduction of relevant acquisition costs) and the sum of the best estimate of liabilities and the risk margin is not insignificant and careful consideration is required in determining the appropriate presentation of this residual difference (which we have described as the initial profit margin).

As indicated above, we do not believe there is any need to separately define a service margin.

We believe that the initial profit margin should be presented in the liability section of the balance sheet and recognised as income in line with release from risk. Accordingly, this amount will be shown separately in the balance sheet from the insurance liability.

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?

We believe that insurance liabilities should be measured on the basis of the three building blocks set out in the standard, namely the discounted value of the best estimate of expected future cash flows with an allowance for risk and uncertainty. We have set out in our answers to earlier questions our views on the basis of determination of these building blocks.

We consider this to represent an economic method of valuation reflecting the expected outcome of the contract and this could be seen to constitute a transfer value in a run off situation and hence the most appropriate form of exit value for an insurance contract. However, we do not consider the label of this model to be particularly significant.

Chapter 4

Question 6

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

(a) incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?

(b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?

(c) not recognise them? Why or why not?

All expected future cash flows arising from beneficial policyholder behaviour should be incorporated in the measurement of an insurance liability. Economic transfer values applied in market transactions show that such premiums are included in the exit value paid and hence their inclusion is consistent with the 'current exit value' model being proposed by the IASB. Such an approach is also consistent with the economic valuation basis supported in this response letter.

We would highlight that we see the inclusion of expected future premiums and associated cash flows as an element of the measurement of the insurance contract rather than the recognition of an underlying right inherent in that contract. As highlighted in our answer to question 1 we do not believe it is appropriate to split the contract into its underlying rights and obligations for the purpose of recognition.

We believe that the purpose of the standard is to value insurance contracts in their entirety and that all anticipated cash flows associated with that contract, whether positive or negative, are relevant in determining that valuation. Policyholders' behaviour is one of the important factors underpinning the amount, timing and uncertainty of those future cash flows. Policyholders make decisions based on personal circumstances, including their own need for insurance and to maintain protection without further underwriting, which often results in behaviour that is counter to the general economic environment. We believe a valuation of insurance liabilities which reflects policyholder behaviour is more relevant and reliable to the users of financial statements.

We therefore support option (b). As we have set out in our response to question 7 it is important that full allowance should be made such beneficial policyholder behaviour. Option

(a) would not be relevant as it suggests that we are valuing something other than the insurance contract, i.e. a customer relationship asset, and we do not believe this to be the case.

Question 7

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

(a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.

(b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?

(c) All cash flows that arise from those terms of existing contracts that have commercial substance (i.e. have a discernible effect on the economics of the contract by modifying significantly the risk, amount or timing of the cash flows).

(d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.

(e) No cash flows that result from beneficial policyholder behaviour.

(f) Other (please specify).

We support option (b) above.

We believe that once an insurance contract is recognised then the inclusion or exclusion of cash flows associated with that contract are measurement issues and should not be influenced by considerations related to recognition of individual rights and obligations of that contract. If the approach to valuation of the contract is built around the recognition of such individual rights and obligations then it is highly likely that, given the requirement to expense acquisition costs, accounting losses may be recognised in the early years on a contract.

Based on this observation, we consider that a valuation based on (b) above is appropriate for the measurement of insurance liabilities in order to reflect the economic value of an entity's insurance contracts in the balance sheet. In getting to best estimate cash flows expected lapse behaviour would be taken into consideration thus allowing all expected future premiums to be brought into the calculation. All the other options proposed may result in exclusion of some cash flows that would be reflected in an economic exit value for the contract.

Such future premiums are considered an integral part of any contract by the insurance market and hence we believe would be included in an economic exit value. This is evidenced in two ways. Firstly, in our experience, an acquirer of a portfolio of contracts will pay for all expected future premiums under a contract. Secondly the commission paid to an agent or broker upon inception of the contract will be priced on the expectation that these future premiums will be received. Given the IASB believes that acquisition costs should be initially

expensed, limiting the expectation of premiums to be received will result in an accounting mismatch. This gives rise to the potential for losses to be recognised at the start of the contract, even if the contract as whole is expected to be profitable. Accounts prepared on this basis cannot represent relevant information to the user.

The value of insurance liabilities should therefore include cash flows arising from beneficial policyholder behaviour for all existing contracts with existing policyholders at the financial reporting date. The proposal to distinguish between existing and new contracts based on a policyholder's need to continue to pay premiums in order to ensure guaranteed insurability will fail to take into account future premiums expected to be received in respect of a variety of existing contracts. We have evaluated the proposals as individual companies and have identified issues with several contract types prevalent across the industry although the significance of the issue varies by market based on the particular contract terms. Examples of contracts identified as problematic in some territories include deferred annuity contracts, unit linked policies, universal life contracts, whole life products with shorter guaranteed cover periods, participating pensions savings contracts and pension policies where policyholders are permitted to cease to pay premiums for a period without loss of insurance cover. For these contracts we would consider that guaranteed insurability is provided through entering into the contract, not through payment of future premiums. Furthermore, the application of guaranteed insurability criteria to fee income (as referred to in Appendix E para 25 (a)(ii)) is also likely to lead to the exclusion of expected future cash inflows, for example in certain single premium contracts.

We acknowledge the IASB's question in relation to option (b) with regard to the distinction between existing and new contracts as a valid concern. We recognise that to ensure consistency it is important that a clear distinction is made between existing contracts and new contracts. Whilst advocating strongly for option (b), we are not trying to push the boundary. For example, we would not seek to include annual renewals of motor or similar non-life policies. The CFO Forum has already sought to identify wordings to clarify which cash flows should or should not be included in the Elaborated Principles.

The Elaborated Principles recognises that the term "renewal premiums" is used to refer to both premiums used to ensure continuation of existing contracts and to put in place new contracts and has instead sought to make a distinction between recurring premiums and renewal options. Recurring premium is defined in the CFO Forum's Elaborated Principles as a repeat premium (often monthly) paid to ensure the continuation of an existing contract. This is applied as follows:

"EP35 The cash flows included in the estimate of the insurance liability should only include cash flows associated with the current insurance contract and any existing ongoing obligation to service policyholders. This should not include expected renewals that are not included within the current insurance contract."

"EP36 Recurring premiums should be included in the determination of future cash flows, with an assessment of the future persistency based on actual experience and anticipated future experience" and

"EP37 Where a contract includes options and guarantees that provide rights under which the policyholder can obtain a further contract on favourable terms (for example, renewal with restrictions on re-pricing or further underwriting) then these options or guarantees should be included in the evaluation of the insurance liability arising under the existing contract. Where no such restrictions on re-pricing or underwriting exist, there is no ongoing obligation to service policyholders."

We are keen to work with you over the forthcoming months to establish suitable criteria to distinguish between existing and new contracts. There are a number of factors which will require consideration when determining these criteria but it is the inter-relationship of all the factors and their overall impact that will be relevant. Inevitably it will be a matter of judgement based on the facts and circumstances of the underlying product. Possible examples of factors to take into account include; ability to re-underwrite, who has the ability to change the contract (i.e. insurer or policyholder), whether repricing is possible at a group or individual policyholder level, legal form and jurisdictional matters reflecting the diversity of products written. We are happy to discuss these and other potential criteria with you as the exposure draft is developed.

Question 8

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

The decision as to whether acquisition costs should be expensed when incurred can only be made in the context of the entire valuation model. If the financial reporting basis achieves a valuation of insurance contracts that reflects all future premiums under existing contracts and does not require a deposit floor then acquisition costs should be recognised as an expense when incurred. The liability valuation would include an allowance for recovery of initial acquisition costs in respect of lapsing policies.

Initial acquisition costs are not a component of a prospective economic valuation of insurance liabilities. The "current exit value" model proposed in the Discussion paper, however, is not an economic valuation of insurance contracts because:

- future premiums insurers expect to receive under existing insurance contracts are excluded where such premiums are not required to guarantee the insurability of the policyholder; and

- unbundling of financial elements of insurance contracts may result in application of a deposit floor under IAS 39 that does not reflect policyholder behaviour.

For long term contracts, insurers expect to recover their initial acquisition costs from future loadings in premiums and fees. Where the valuation basis fails to reflect the future value of the business written there will be a loss reflected in the financial reporting basis that is not a consequence of the economics of the transaction. If changes are not made to the proposals in respect of future premiums then, to avoid misrepresentation of losses due to the financial reporting basis, an alternative approach to acquisition costs will be required.

When contracts lapse, insurers may be able to recover a proportion of the initial acquisition costs from agents, brokers or other intermediaries. When considering policyholder behaviour, the estimation of future cash flows should also include the potential recovery of initial acquisition costs from third parties in respect of lapsing policies consistent with the measurement of other cash flows arising in respect of insurance contracts.

Question 9

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

For reasons expressed elsewhere in this response letter, we do not believe that, as currently defined in the Discussion paper, "current exit value" represents an economic value and hence is not the same as a fair value as defined in the business combinations standard. We therefore support the proposal in the Discussion paper to revisit the need for expanded presentation in

relation to business combinations or portfolio transfers once the differences between current exit value and fair value are considered. The accounting for both business combinations and portfolio transfers cannot be considered without further analysis in this area.

Chapter 5

Question 10

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

Asset/ liability matching is a key objective for insurers. We therefore believe it is important that there is an unencumbered option to fair value assets held to back insurance business in order to prevent accounting mismatches arising. This will relate to both financial assets and those non-financial assets identified by the IASB in relation to unit linked business.

Financial assets and the Fair Value Option

The elimination of the accounting mismatch should refer to both the measurement of assets and liabilities as well as recognition of gains and losses. We are concerned about a recognition mismatch as current proposals in the Discussion paper require that the recognition of gains and losses for insurance liabilities would be recognised in the income statement, whilst gains and losses of financial assets measured at fair value in accordance with IAS 39 are either recognised in the income statement or in Other Comprehensive Income.

In this respect it is important to consider that the Fair Value Option ("FVO") under IAS 39 can only be applied if certain conditions are fulfilled:

- Elimination or reduction of accounting mismatches;
- Asset-Liability Management on the basis of a documented risk management strategy; or
- Structured products.

We would ask the IASB to clarify:

- Is the first criterion sufficient to apply the FVO given that a clear identification of assets held to back insurance liabilities may, in our view, not be achieved?
- Would the implication be that all financial assets of the insurer could be valued using the FVO?

Transition rules are clearly necessary given that the FVO can currently only be applied upon inception of a financial asset or liability. There should be no restriction over the use of the FVO for assets backing insurance liabilities nor should there be any restriction over the continued use of the Available-for-Sale classification. We discuss this further in question 20.

Other accounting mis-matches

We are of the opinion that the potential accounting mismatches highlighted in paragraph 182 (treasury shares, owner-occupied properties or goodwill of subsidiaries) should be addressed by the Discussion paper for non-linked business as well, especially assets backing participating contracts, in the same way as those relating to unit-linked contracts as we discuss in question 17. If assets backing insurance liabilities can be defined clearly for non-linked/participating business as in the case of linked business then solutions similar to those

discussed under question 17 below could be implemented. We recognise that it will be difficult to establish criteria allowing clear identification of assets held to back insurance liabilities as opposed to assets held in corporate funds in certain circumstances. Accordingly, an area for additional investigation by the IASB is the definition of what assets should be included within the term "assets held to back insurance liabilities" and this should certainly include assets backing participating contracts. We would propose a wider definition that would incorporate assets that straddle a number of accounting standards.

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?

We support the determination of risk margins on the basis of a portfolio of insurance contracts. However, we would define a portfolio, as was set out in the Elaborated Principles, as "a group of contracts that are managed together when assessing risk". The current definition in the Discussion paper will introduce potential subjectivity when assessing what is meant by "broadly similar risks" and also misrepresents the business model employed by many insurers.

In the latter regard, we would highlight the negative correlation between term assurance and annuity books. Insurers will manage these books together in order to take account of this negative correlation although it may be difficult to argue that they constitute "broadly similar risks". Notwithstanding the view expressed below relating to allowances between portfolios, the Board's current proposals would potentially result in an overstatement of realistic liabilities as a result of this negative correlation not being considered for these books of business.

Once the risk margin has been calculated for each portfolio we believe further allowance should be made for diversification beyond the portfolio level. The benefits of diversification between lines of business is an integral part of an insurer's business model and it is therefore fundamental that accounting reflects these benefits when valuing together a number of portfolios of insurance contract liabilities. We believe that the benefits of diversification (and negative correlation) between portfolios should be reflected in risk margins on the basis that this approach is reflective of the business model applied.

Question 12

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

We believe that the measurement of the reinsurance asset should be based on the underlying direct insurance liabilities, i.e. should be based on the same underlying assumptions with regards the best estimate of future cash flows and risk margins. As the Discussion paper says in paragraph 209 the reference transaction for determining the current exit value of the reinsurance asset is a simultaneous transfer of both the reinsurance contract and the related underlying contracts.

Our concerns set out elsewhere in this letter in relation to the current exit value would apply equally to reinsurance assets.

(b) Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?

(i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract

We agree that the a risk margin will typically increase the measurement of the reinsurance asset for the reasons set out in paragraphs 206- 209 in the Discussion paper, the principal reason being that uncertainty about the cash flows from the underlying insurance contract increases the value of the reinsurance contract to the holder. However, whilst the margin will reflect the risk margin for the corresponding part of the underlying insurance liability, it will not necessarily equal it given likely economic differences between risks assumed and ceded. The approach set out in paragraph 210 of the Discussion paper for dealing with non-proportional reinsurance could equally well apply to proportional arrangements in terms of establishing a net liability and grossing up to determine the reinsurance asset.

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

We disagree with the expected loss approach, which we consider to be inconsistent with other areas of IFRS, for example, in the valuation of receivables where expected losses are not accounted for. Furthermore it is our view that the costs of applying an expected loss model in Best Estimate Liability scenario testing would significantly outweigh the benefits of doing so as opposed to reflecting losses when incurred. The relatively small number of defaults in the reinsurance market should also be considered in this regard. We therefore support the incurred loss model.

(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 do not believe that this contractual right should be included within the current exit value of the reinsurance asset. As indicated in question 1 we believe the recognition of an insurance contract should be at the point risk cover commences. Applying this principle to the corresponding reinsurance contracts undertaken by an insurer there would be no requirement to recognise the contractual right discussed above as the reinsurer is only on risk at the point the underlying insurance contract is written. In practice there may be advanced payments on reinsurance contracts for example where cover has not yet commenced for the underlying contracts. These payments are an asset and should be treated in accordance with current practice.

Question 13

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

We do not believe that deposit or service components should be required to be unbundled from the main insurance contract. As set out in the Elaborated Principles we believe that unbundling is unnecessary as the measurement model already recognises all obligations and rights arising under the insurance contract. We have always advocated that unbundling should not be required because a contract should be recognised as a whole, rather than as component pieces, reflecting the basis on which the company manages it and recognising that different cash flows will play a greater or smaller part in the contract, depending on future demographics and economic circumstances.

IFRS 4 sets out a definition of an insurance contract that can be clearly articulated to users. This definition then drives the measurement model to be applied to the contract in its entirety. Applying different accounting models to the same contract can only serve to make accounts less transparent to users and hence result in accounts that are less relevant and reliable.

The proposals as drafted highlight how complex it can be to draw distinctions about when unbundling should be applied. The distinction is firstly between "interdependent" and "non-interdependent" components. The second distinction is between those contracts where components can be measured on a basis that is other than arbitrary and those which cannot. We have concerns over whether "arbitrary" is a principle that can be applied by users in practice. The application of terms such as interdependent and arbitrary can only add subjectivity to accounts preparation and usage. Our principal concern, however, is that we do not see the benefit to the user of such a complex and costly exercise.

The proposals require that contracts with components that can be split on a non-arbitrary basis should still be measured under the Phase II model but that disclosure should be given of the component parts. The time and costs required for insurers to analyse their underlying contracts should not be underestimated as was demonstrated by the work undertaken on product classification under Phase 1. Some entities will need to make significant and costly systems changes. We struggle to see any real benefit to users of disclosure of the component parts, given that the underlying measurement model for profit recognition purposes is the Phase II insurance standard. In addition, the component parts arrived at do not provide meaningful information for users, most notably the "insurance plug" element which could easily prove to be an asset given the application of the deposit floor under IAS 39 to the deposit element.

Accordingly, we oppose the IASB's proposals in relation to unbundling.

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?

We do not believe that credit standing of an insurance contract should be considered in the valuation of insurance liabilities, consistent with the measurement of liabilities that we are proposing as set out in our answer to question 5.

As set out in the Elaborated Principles we believe that introducing credit standing into liability valuation would result in an accounting profit in the event of a downgrade to an insurer and we consider this to be misleading. We see informational advantages to investors and analysts in presenting the liabilities as risk free so that the full extent of the liabilities is transparent.

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 would support the opportunity to reduce the inconsistencies between accounting standards, especially between insurance and investment contracts where many of the contracts

sold are unique to the insurance industry. This would also remove the need to unbundle contracts and would, in our view, provide a more appropriate means of addressing concerns about accounting arbitrage than the unbundling proposals put forward in the Discussion paper.

Given that the measurement model under the Insurance Contracts standard is still being debated it is not considered appropriate for us to make detailed comments on any amendments required to IAS 39/IAS 18 at this stage. We would seek to highlight matters arising from the continued development of the Phase II model to the IASB as they arose.

However we do consider that it would be appropriate to remove paragraph 49 of IAS 39 which requires that the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand (the "deposit floor"). Such a provision is inconsistent with an exit basis of measurement and will lead to a significant inconsistency if financial and non-financial components of insurance contracts were to be unbundled.

We would propose that investment contracts with discretionary participation features be accounted for on a consistent basis to insurance contracts under the Phase II standard (assuming that the flaws in the Phase II model identified in this response letter are appropriately addressed). It is unclear if the Discussion paper is proposing that only the treatment of the discretionary participating feature be included within the scope of the Insurance Contracts standard. It would be inappropriate for the remainder of the contract to be valued under a different measurement model as the cash flows relating to the participation feature are likely to be interdependent with the other cash flows.

Chapter 6

Question 16

(a) For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?

(b) An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247-253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?

a) We support the assertion that, for participating contracts, cash flows for each scenario should incorporate an unbiased estimate of the policyholder dividends payable to satisfy a legal or constructive obligation that exists at the reporting date. In the same way that all expected future premiums should be included in the valuation of an insurance contract in order to reflect the true economic value, as discussed above, all expected future payments to participating policyholders should be taken into account in arriving at an economic valuation. Such cash flows would be taken into account in market transactions.

The arguments supporting our views were expressed in the CFO Forum letter to the IASB in December 2006. This letter was included in the IASB observer papers for January 2007 and is included as Appendix B to this letter.

An unconditional obligation is created by these contracts upon inception. This obligation is to declare bonuses[1] to policyholders over the term of the contract rather than being an obligation

[1] Bonus should be interpreted to include all discretionary payments on participating policies whether called bonus, dividend or by any other term.

created by the declaration of individual bonuses. The nature of participating contracts is such that insurers have discretion over the timing and amount of future benefits, rather than the ability to avoid settling them and hence we believe this unconditional obligation to declare bonuses meets the definition of a constructive obligation.

It is extremely difficult to universally demonstrate that this obligation is based around just legal or regulatory enforceability given the differing structures of participating funds around the world. A definition based purely on legal or regulatory enforceability would, in our view, lead to classification as equity of amounts for policyholders in some jurisdictions and not in others. This will result in inconsistent and hence less relevant financial statements.

The classification as equity in some countries could be misleading, for example in those countries where a proportion of a specific fund is identified which can only be distributed to policyholders, current or future. These amounts will never be available to shareholders which is inconsistent with their inclusion in equity.

Measurement of liabilities for discretionary participation features should be on a portfolio basis. This should take into account all expected payments to current and future policyholders arising from participating contracts (or funds) held at the financial reporting date.

In terms of measurement there are a number of specific jurisdictional issues that must be addressed in the final insurance standard, given the differing contract and fund structures around the globe. We have previously referred to many of these within our Elaborated Principles and the CFO Forum letter in December 2006.

For example in certain markets, for many participating contracts the benefits under those contracts are based on accounts not prepared in accordance with IFRS, such as local GAAP accounts or regulatory accounts. To the extent that there are differences in valuation of assets and liabilities between IFRS accounts and such accounts, the portion of this difference that would be attributable to the policyholders should be included in the measurement of the insurance liability on a portfolio basis. The uncertainty over the amount and timing of future bonuses will be reflected in the measurement of the obligation through the use of probability-weighted cash-flow scenarios in common with all other expected cash flows associated with the contract.

We support the Board's preliminary view that the accounting for participating contracts should be consistent across shareholder-owned insurers and mutuals.[2]

b) The accounting for participating contracts is a significant matter for insurers and many of the underlying issues are unique to the insurance industry. We believe all cash flows relating to the contract should be included in the measurement of that contract as stated above. The proposed amendments to IAS 37 as included in the Discussion paper would, in our view, provide sufficient guidance to enable all expected bonus payments under participating contracts to be reflected in the contract valuation. Our concern is, however, that as the definition of a constructive obligation is still being discussed by the IASB, this may not be the case if this proposed definition is narrowed in final revisions to IAS 37.We would oppose such a narrowing. The IFRS definition of a constructive obligation must allow for such obligations to be included in the value of an insurance liability. This should be made clear in IAS 37 and the revised insurance contracts standard.

[2] The Swedish mutual market has separately raised this issue with the IASB.

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 agree that the Board does need to address this issue. We support the approaches outlined in (a), (b) and (c) above to eliminate accounting mismatches arising on unit-linked contracts. As indicated in question 10 we would also support this approach being extended to non-linked business, especially participating business, to reduce accounting mismatches. We do not support option (d) on the basis that we propose an economic valuation based on the expected outcome of the contract. Adjustments to this valuation relating to assets backing the contract are not considered appropriate.

We would not, however, support the narrowing of the definition of unit linked contracts to reflect separate account definitions under US GAAP. The definition of separate accounts was developed to meet the products sold in the US market. In a global environment this will represent too narrow a definition given the different legal and regulatory environments in which global insurers operate.

We note the comments in the Discussion paper on the balance sheet presentation of unit-linked assets and liabilities. We believe that all assets backing unit-linked contracts should be included on a single line in the balance sheet. We do not believe that it is helpful to users of accounts to include unit-linked assets alongside others under balance sheet line items as they reflect fundamentally different exposures for shareholders in terms of the risk and reward of the assets.

Chapter 7

Question 18

Should an insurer present premiums as revenue or as deposits? Why or why not?

The presentation of insurance contracts within the income statement is as important an issue as the measurement of those contracts. Any performance reporting model proposed must meet the needs of users and assist their understanding of the new measurement model and the drivers of profit. Our discussions to date have revealed that this is a difficult and complex area and will need further careful consideration as the standard is developed. It will also be important to understand how the financial statement presentation and revenue recognition projects will shape performance reporting requirements in the future and whether these will

accommodate the measurement model being proposed. This analysis is best completed once the measurement model has been finalised, but should be developed before an exposure draft is issued. We want to be involved in this debate.

We believe that the Phase II standard should contain the principles for determining which contracts should present premiums (i.e. the amount received from policyholder) as revenue and which should treat them as deposits. It should not be an accounting policy choice under which different preparers can form different views on the presentation of the same underlying contract.

In a life context our initial conclusion is that, in general, this is best achieved by using a margin presentation, where the income statement is based around the three building blocks, namely;

- Changes to the best estimate of the future liabilities arising from assumption changes and differences between actual and expected cashflows;
- The unwind of the discount rate in the period;
- Changes in risk and initial profit margins.

We have yet to reach a conclusion on the approach for non-life business. We believe further analysis is needed to decide whether or not the margin approach best addresses users' needs for non-life business and whether it is consistent with how management runs this business. Therefore we believe that further analysis and discussion is required to determine:

a) What the full income statement under a margin approach would look like;
b) What information should be included in the financial statements to supplement the margin approach to ensure important information (e.g. volume) is not lost;
c) Whether such a model can be applied to non-life as well as life business.

Question 19

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

We believe that income statement presentation should be considered in its entirety and similar to our response to question 18 we believe that further analysis is required before finalising the presentation of the income statement. Having said that, we do not believe that insurers should be subject to any disclosure requirements over and above those applied to other industries given that all entities compete in the same market place for capital. Accordingly, any disclosures required on the face of the income statement should be no more than those required by IAS 1. Prior to the proposed IASB amendment, IAS 1 requires only the following items to be included on the face of the income statement:

-Revenue;
-Finance Costs;
-Share of profit and loss of associates and joint ventures under equity method;
-Tax expense;
-Amounts relating to discontinued operations;
-Profit or loss.

A requirement to provide a detailed analysis of the changes in the carrying amount of insurance liabilities would significantly exceed this level of disclosure. IAS 1 contains a requirement to provide additional line items where such presentation is relevant to an understanding of an entity's financial performance and hence it could be argued that certain additional line items would be required in order to explain the insurer's results. However, we

do not believe that such items should be made mandatory within the insurance contracts standard.

We believe that the income statement should be presented as simply as possible and consider that mandatory disclosures on the face of the income statement would defeat this objective, particularly if this leads to disclosure of amounts that are not significant in understanding the performance of a given company or do not fully reflect how management view the business. We do not believe therefore that any prescribed disclosure should automatically be given on the face of the income statement but should be capable of being included in the notes to the financial statements.

IFRS 4 currently sets out a number of disclosure principles with which insurers must comply. These principles do not require explicit disclosures but can lead to detailed analysis tailored to a company's individual circumstances. The most helpful approach to disclosure would therefore be for the IASB to maintain the current principle based disclosure requirements but to provide an illustration as to how these might be applied in a Phase II context. Such an illustration would not form part of the standard but would simply be an example of best practice and would incorporate an element of optionality for the preparer, particularly in terms of items required on the face of the income statement. A current example already exists under IFRS 4 IG 26 whereby the IASB suggests a list of items that an insurer might need to include either on the face of the income statement or in the notes to the financial statements.

Question 20

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

We believe that all assumption changes should be reflected in the insurance liability, comprising the best estimate of future cash flows and the risk margin. These changes should be accounted for in the income statement or in Other Comprehensive Income consistent with asset valuation movements. This is a significant issue for the insurance industry on which we shall perform further work. We await the development of the Board's revenue recognition project before making any further comment on the subsequent accounting for the initial profit margin.

At present current IFRS standards require certain assets' valuation movements (owner occupied property, treasury shares, investments classified as available-for-sale) to be taken outside of the income statement. Our view is that the fundamental principle should be that accounting mismatches should not be created. Therefore, the IASB should review the standards which create the asset mismatches, and permit insurers to take the related element of insurance liability movements through Other Comprehensive Income.

Other matters

Question 21

Do you have other comments on this paper?

Definition of insurance contracts

We support not revisiting the definition of an insurance contract under the Phase II standard.

Consistency with regulatory developments

The model being discussed by the IASB is to some extent consistent at a conceptual level with that being developed for the Solvency II regulatory regime in Europe. A consistent approach both reduces the cost of implementation and also ensures that the accounting basis adopted provides a closer reflection of the economic realities of insurance business as illustrated by its capital requirements. We believe that the Board should follow the on-going developments in Solvency II as the regulators develop their final proposals to ensure no unintentional inconsistencies apply at a detailed implementation level. Furthermore, the European Commission have indicated a willingness to take accounting developments into consideration when establishing future Solvency II requirements.

Practicalities of implementation

The introduction of an insurance standard on the basis of the Discussion paper will be a fundamental change for all insurers. It is important that the standard is flexible enough to permit insurers to use suitable methodologies and approximations to ensure that an unnecessary cost burden is not placed on companies. For example for some non-life contracts the unearned premium methodology may act as a proxy of the measurement model and the use of such an approximation should not be explicitly excluded. In addition there are likely to be specific features of reinsurance contracts that will have practical implementation issues.

Transitional arrangements

We support the inclusion of extensive and well thought through transitional arrangements within the proposed standard to ensure that users of accounts are fully supported in their understanding of the new requirements. Furthermore, given the level of change expected for preparers of accounts it is essential that the practical implications are also fully considered in establishing transitional requirements. A further specific transitional matter would be an allowance for insurers to reclassify their assets backing insurance liabilities on transition.

Disclosure requirements

We believe that the IASB should conduct a full analysis of the disclosure requirements for insurance contracts on the basis of the new measurement model. IFRS 4 and IFRS 7 provide ideal starting points for this analysis although we would like to note that the level of disclosures required by those standards is partly a reflection of the inconsistent measurement models prevailing through the grandfathering of existing GAAP in IFRS 4 and hence the extent to which it will continue to be required should be carefully evaluated.

Due process

We recognise that the normal process in the development of a new accounting standard is for the next stage after consideration of responses to the Discussion paper to be the development and issue of an exposure draft for further comment. Given the level of change proposed by this standard and the fundamental nature of some of the issues commented on in this response letter we would request the IASB to regard this standard as an exception and to establish a dynamic process of consultation prior to the development of an exposure draft. Such a process should go beyond the reconvention of the Insurance Working Group and should also involve roundtables and other means of ensuring that the views of constituents are fully understood and, if appropriate, reflected. We would like to work with you to develop a mutually suitable programme over the coming months.

Field testing

We believe that the fundamental nature of the changes proposed in this standard allied to the complexities of the insurance industry make the introduction of field testing an essential requirement. It is only through such detailed testing with real life data that the theoretical nature of many of the concepts underlying the Board's proposals can be properly evaluated. It is important, however, that any field testing initiatives are carried out at the right time, notably, once the proposals have been further developed but not too late for the results to impact the final standard. The Quantitative Impact Study (QIS) programme supporting the Solvency II regulatory provides a good model in this regard as it evaluates the proposals on an iterative basis as part of an ongoing programme of testing. We believe that it may be appropriate to carry out some aspects of field testing both before and after the publication of an exposure draft. As well as timing, the scope of field testing will also be important and will need to encompass all aspects of the changes, including processes, metrics and presentation.

Appendix B Joint letter to the IASB on participating contracts (December 2006)

The European Insurance CFO Forum
Group of North American Insurance Enterprises
Nippon Life Insurance Company
Dai-ichi Life Insurance Company
Sumitomo Life Insurance Company
Meiji Yasuda Life Insurance Company

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

21 December 2006

Dear Sir David

IASB consideration of Insurance Contracts Phase II: Unconditional obligation requirements in relation to the accounting for future participating benefits

The CFO Forum, GNAIE, and the Four Japanese Life Insurers have been considering the IASB's proposal that the measurement of liabilities in relation to insurance (and investment) contracts with discretionary participation features (DPF) should only include future benefits expected to be payable under contracts when the insurer has an unconditional obligation that compels the insurer to transfer economic benefits to policyholders, current or future. Additionally, Peter Clark has asked for our views in this area and has specifically requested us to comment on:

1. whether insurers have enforceable obligations to pay bonuses under such contracts and whether the determination of enforceability would present practical problems; and
2. whether different treatment should apply to mutuals as compared with proprietary insurers.

We have considered the various contracts that exist in different jurisdictions represented by our groups and the local legal and regulatory constraints around those contracts. We have further considered the exposure draft of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the related subsequent discussions in this area (together referred to in this letter as "the IAS 37 ED") in our analysis of these issues.

We have concluded that:

- an unconditional obligation is created by these contracts once the contract is signed and issued. This obligation is to declare bonuses[3] to policyholders over the term of the contract rather than being an obligation created by the declaration of individual bonuses;
- in accordance with the nature of participating contracts, insurers' discretion is over the timing and amount of future benefits, rather than to avoid settling it, and this should be appropriately allowed for in the measurement basis;

[3] In this letter, the term "bonus" should be interpreted to include all discretionary payments on participating policies whether called bonus, dividend or by any other term.

- it would be extremely difficult to universally demonstrate that this obligation is based around legal or regulatory enforceability and such an approach could lead to inconsistent and less relevant and reliable financial statements;
- since it is very difficult to determine legal or regulatory enforceability we believe that, in practice, classification as equity of amounts for policyholders would be common in certain jurisdictions and not in others;
- in the absence of legal enforceability, the IAS 37 ED indicates that the presence of a constructive obligation will fulfil the definition of a liability and we believe that the unconditional obligation to declare bonuses meets the definition of a constructive obligation;
- the structure of participating funds varies by jurisdiction, but will, in some countries, identify a proportion of a specific fund that can only ever be distributed to policyholders, current or future. It would be misleading to account for these amounts as equity if they can never be distributed to shareholders;
- measurement should therefore be on a portfolio basis taking into account all expected payments to current and future policyholders arising from participating contracts (or funds), where applicable, held at the financial reporting date; and
- the recognition and measurement of discretionary participation features could apply for mutuals in the same way as for shareholder owned entities.

The obligating event

We believe the first question to consider is what the obligating event is under participating contracts – is it the point at which the bonus declaration is made or is it the point at which the DPF contract is signed? Our reading of the tentative conclusions is that the IASB has concluded that it is when the bonus is declared rather than on the inception of the contract. This would lead to very large amounts in, what we regard as, liabilities to policyholders being treated as equity even though the shareholders have no access to these funds and never will have any access to them.

In our view the obligating event is the commitment by the insurer to declare bonuses to policyholders at the stage of entering into the contract. At this point the company is committing itself to paying out the substantial majority of the available surplus based on the participation arrangements. While the contract often does not specify the exact timing or the amount of bonuses to be paid, the very clear expectation that the great majority of available surplus based on the participation arrangements will be paid to policyholders is established. This expectation is evidenced in the construction of the participating fund (if there is one), in local regulation and in the way that these contracts are marketed. Indeed, in some countries the concept of "policyholders' reasonable expectations" or similar principles are enshrined in insurance law.

Enforceable Obligation

We have carried out research into the concept that the obligation to declare bonuses in a participating contract is legally (or from a regulatory standpoint) enforceable. This is a complex issue and is likely to be extremely difficult to categorically prove given the range of jurisdictions and regulatory frameworks in place. An application of the enforceability concept would be open to significant interpretation in jurisdictions that have among them a wide range of legal and regulatory environments.

A clear indication of the existence of an enforceable obligation would be available where the policyholder can seek a legal ruling that a bonus should be paid. There is an absence of legal case history to evidence whether a contractual promise to pay discretionary benefits is enforceable or not. Legal or regulatory enforceability of performance related bonuses, if tested, would be likely to vary by jurisdiction and depend on current and anticipated future economic circumstances.

As is evidenced by the appendix to this letter, which sets out details of the nature of participating contracts in various countries covered by our groups, contract structures and regulatory requirements vary by jurisdiction. However, the substance of these contracts is common with the substantial majority of available surplus based on the participation arrangements being paid to the policyholder rather than being attributable to the shareholder.

If enforceability of expected bonus declarations at contract inception can not be demonstrated then this could be reflected in significantly different liability values and profit recognition profiles for contracts with similar economic values. For instance, in some countries the liability would only reflect realised gains whilst in others unrealised and realised gains would be included. Further the liability value of future benefits would vary by jurisdiction, notably it would be at least 20% for Japanese mutual insurers, 70% in China, 85% in France, at least 90% in Germany but zero in most of the United States, for Japanese stock companies, and for the Netherlands, Belgium and South Africa where there is no prescribed minimum. This will make financial statements of insurers considerably less comparable than they would be if all expected payments to policyholders were included.

Users of financial statements will be misled by a financial reporting presentation that includes in equity material amounts that management will either pay to policyholders or, in certain jurisdictions, are subject to restrictions on distribution to shareholders. Companies will be recognising profits in an accounting period that are not attributable to shareholders and will then need to recognise losses at a future date when benefits are allocated to individual policyholders or when a portfolio is transferred. In our view this would misrepresent the results of the business and would make financial statements considerably less relevant from an economic standpoint. Furthermore, it would materially understate what are the true liabilities in respect of contracts with a DPF element and include within shareholders' equity amounts that will never fall to shareholders.

As a related point, we believe that there are likely to be a number of consequences resulting from the exclusion of expected future payments from accounting liability values. One example relates to lapse assumptions used in modelling liabilities. If companies were to stop paying bonuses this would undoubtedly lead to a significant increase in the level of policy lapses. If the determination of the liabilities assumes that there will be no further payments unless there is a legal or regulatory obligation this should be taken into account when determining the lapse assumptions used for the modelling of the DPF contract liabilities. The resulting valuation will not be consistent with market economic conditions at the financial reporting date.

Constructive obligation

In our view it is not appropriate, with respect to discretionary participation contracts, to restrict the recognition of an unconditional obligation to legal or regulatory enforceability. We believe that the discretionary participation feature is a constructive obligation under the IAS 37 ED, which states that a liability can be recognised for an obligation that is not legally enforceable provided the criteria relating to there being little, if any, discretion to avoid settling a constructive obligation, as specified in sub-paragraphs 15(a)-(c), are achieved. We believe that these criteria are met as follows:

a) the insurer has indicated to policyholders that it will declare bonuses over the contract term. This is clear in contract and marketing literature examined;
b) policyholders purchase these contracts, which usually bear higher premiums than fixed benefit policies offering the same guaranteed benefits, in anticipation of a share in the underlying performance through future additional benefits; and
c) the additional benefits will clearly benefit the policyholder.

In our view the discretion associated with these contracts is not around the commitment to declare bonuses but is around the timing and amount of benefits that are awarded to

policyholders. Insurers' commit to pay additional future benefits depending on general or specified performance criterion. As indicated below this discretion will be built into the measurement of the liability.

Measurement of the liability value

The IAS 37 ED indicate that the valuation of liabilities can be based on the present value of expected future cash flows including the effect of risk and uncertainty and taking into account management's judgement of future outcomes and financial effects. This measurement approach is consistent with the proposals of the CFO Forum, GNAIE and the Four Life Insurers of Japan for the measurement of discretionary participation features. The IAS 37 ED measurement basis requires development to consider the specific features of insurance contracts as already considered by the IASB in developing its Phase II proposals.

The value of the DPF liability will depend on current economic conditions and other performance factors. The valuation of the liability should consider an entity's obligation to policyholders in policy wording, marketing literature or other statements that give rise to policyholder expectations of management's future actions under different economic scenarios, in addition to the legal and regulatory environment. An economic approach is consistent with the IASB's ongoing deliberations in relation to liabilities under the IAS Framework and with other tentative conclusions reached around valuation of insurance contracts.

The IAS 37 ED indicate that a valuation basis reflecting amounts that would be paid to transfer a liability to a third party can be used. It should be noted that, in transferring portfolios of DPF contracts between companies the market always takes into account undeclared bonuses. This reflects the fact that the market knows that the bulk of available surplus, whether declared or not, will ultimately be paid to policyholders rather than shareholders. If these undeclared bonuses are not included in the valuation of the liability then, were a company to transfer a block of such contracts to another company, it would have to recognise a significant loss in its financial statements reflecting the release of equity to finance the price demanded by the acquirer.

In some countries insurers' discretion gives rise to funds that have not been allocated to individual policyholders but to which shareholders have no access. Indeed in some jurisdictions shareholders have no right to any of the funds allocated to pay future discretionary bonuses until a bonus declaration is made. Where these situations apply such funds arise from the constructive obligation to pay future discretionary benefits to current and, in some cases, future, policyholders and should be included in the measurement of DPF liabilities. These liabilities may include:

- funds available to pay future policyholder bonuses but not yet allocated to individual policies; and
- unrealised gains in investments that will contribute to policyholder bonuses.

For the reasons set out above it would be misleading to the users of financial statements to present any of these funds as equity.

Mutual insurers

We believe that the proposals set out in the CFO Forum's Elaborated Principles and GNAIE and the Four Japanese Life Insurers' Life Principles that liabilities for participating contracts should include all anticipated future payments to policyholders, could apply for mutuals in the same way as for shareholder owned entities.

The CFO Forum, GNAIE, and the Four Japanese Life Insurers represent mutual and stockholder companies. We can see no rationale for different measurement of liabilities for participating contracts due to the nature of the organisation of the issuing entity.

Conclusion
The enforceability of the obligation to pay bonuses under participating contracts is extremely difficult to apply and demonstrate on a consistent basis. However, we believe that a constructive obligation to declare bonuses is established on signing such a contract in accordance with the definitions in the IASB's IAS 37 project.

To ensure financial statements are relevant to users, and provide consistency of measurement of economically similar contracts, an economic basis of valuation for DPF contracts is required. Such an approach should be on a portfolio basis and take into account all expected payments to policyholders including those that have not yet been allocated to individual policyholders.

We can see no rationale for mutual insurers to adopt different practices from shareholder-owned companies in the financial reporting of discretionary participation features.

Further response
If you have any queries or questions that you would like to raise, please feel free to contact us.

Yours sincerely

Dr Helmut Perlet, Chairman
The European CFO Forum

Richard J Carbone, Chairman
Group of North American Insurance Enterprises

Takao Arai, Executive Vice President,
Nippon Life Insurance Company

Kazuma Ishii, Managing Executive Officer,
Dai-ichi Life Insurance Company

Koji Hanaoka, Managing Director,
Sumitomo Life Insurance Company

Hiroaki Tonooka, Managing Executive Officer,
Meiji Yasuda Life Insurance Company

APPENDIX

The nature of contracts with discretionary participating features

As for most insurance business, the structure of DPF contracts varies widely throughout the world. Much of this has been driven by local regulation or practice. We have considered some of the major countries represented by members of our three groups.

Germany
The allocation of benefits to policyholders of participating contracts is governed by legal, contractual and supervisory rules as well as by management's discretion to distribute additional benefits. Each year the insurer is obliged by law to allocate at a minimum 90% of net investment income and an additional part of gains from insuring risk of the individual insurer (not the group accounts).The benefits to policyholders are allocated either to the technical provision or to the policyholders' bonus fund (*Rückstellung für Beitragsrückerstattung, RfB*) which are both part of the insurance liabilities to policyholders. While the technical provisions are based on guaranteed allocations of individual policyholders by contract with the insurer, the RfB belongs to the portfolio of policyholders and can only be reduced by transfer of benefits to individual policyholders. These allocations are determined by the insurer by annually setting individual profit rates for the contracts based on guaranteed interest rates, insurance results and realised capital gains. Usually management allocates, in addition to the legal minimum, additional surplus amounts which are at their discretion. The total amount of surplus allocated to policyholders is agreed each year with the local regulator.

France
Local regulations require that a minimum of 85% of investment income and realised capital gains be paid to policyholders. Even if the company can determine the timing at which unrealised capital gains are realised, ultimately however, all investment returns will be split at least 85:15 in favour of the policyholder. It should also be noted that traditionally French companies pay out more than the required minimum 85% of gains and that the difference between the 85% and the amount actually paid is material in the context of the shareholders' equity. The benefits to policyholders are allocated either to the technical provision or to the policyholders' bonus fund (PPE which must be allocated to individual policyholders within 8-year period) which are both part of the insurance liabilities to policyholders.

UK
Local regulations do not dictate the amount that should be paid to policyholders, but normally the fund structure specifies that the shareholders are entitled to one ninth of any bonus declared by the fund to policyholders. In other words any investment returns in with profits funds, be they realised or unrealised, that have not been declared as bonuses cannot accrue to shareholders since 90% of any payment out of the fund has to be paid to policyholders. Discretion may exist as to the timing at which the bonus declarations are made, and to whom, but the ultimate proportion that shareholders receive is not.

In addition, for some UK life assurance companies there are amounts that are held within participating life funds that are in excess of those required to meet expected policyholder benefits. These amounts provide capital support to the fund, in which policyholders as a class have a 90% interest. However, due to the basis of distribution from the fund being wholly tied to the declaration of policyholder benefits, shareholders have no rights of access to the remaining 10% of unallocated surplus unless attributed by a Court approved arrangement.

Note that in the UK the regulator requires that policyholders' documentation supporting the structure of these contracts and related funds includes the "Principles and Practices of Financial Management", which makes clear the basis of participation, and companies operate under the regulatory principle of "Treating Customers Fairly".

Netherlands, Belgium and South Africa
The regulator does not prescribe any minimum. Life offices have discretion as to the surplus passed on to policyholders. Nevertheless, the vast majority of investment returns on these contracts ultimately get paid to the policyholder rather than staying with the shareholder.

US[4]
In the US, almost all participating business is sold by mutual insurance companies. In addition, certain Universal Life Contracts, while often non-participating in contract form, do have discretionary elements similar to participating contracts and we believe they should be treated similarly to Participating Contracts. Participating Contract language typically requires the company to determine dividends annually and in some cases requires that the distribution of that amount be performed in an equitable manner. There is no requirement concerning a minimum amount of dividend to be paid. There is significant legal precedent that courts will not override the judgement of the Board of Directors in declaring or allocating dividends. Furthermore, it is questionable whether regulators have the authority to overturn Board decisions on this matter.

In general, dividends are paid out of current year earnings. There is no specific participating fund except for the closed block of participating policies of demutualized companies. The company decides, at the end of the year, how much surplus is required to meet its needs and any excess is paid out as a dividend. There is no concept that amounts earned today will be paid out to future policyholders.

There are two states (New York and Massachusetts) that have maximum surplus limits in their laws. In those states, companies would need to pay dividends if their surplus should exceed the maximum limit. In these cases, companies domiciled in those states would have an obligation to pay dividends lest they exceed that maximum surplus.

[4] While this letter is being submitted by the Tripartite Group, GNAIE wish to acknowledge the research performed by the American Council of Life Insurers (ACLI) in researching and developing the rationale for this document.

ACLI is the principal trade association of life insurance companies, representing 377 member companies that account for 91 percent of total assets, 90 percent of the life insurance premiums and 95 percent of annuity considerations in the United States.

GNAIE consists of Chief Financial Officers of leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations.

Together, GNAIE and ACLI companies represent a significant population of the total issuers of participating contracts in the United States.

Japan

In Japanese insurance contracts, insurers explain their policies on dividend payments, such as eligible policies, timing and methods for determining them. Because of these contractual statements, together with commercial practices such as statements in policyholders' guides, illustrations of expected payment amounts, explanation about dividend distribution criteria, and sales of par contracts with higher-premium rates than non-par contracts with the same coverage, Japanese insurers have been obliged to pay dividends, and it has created "policyholders' expectation" about dividends. The Insurance Business Law of Japan provides the underlying basis for the above statements or practices. It requires "fair and equitable" distribution of dividends, and in order to make this requirement effective, there are regulatory frameworks that ensure "fair and equitable" distribution of dividends. Those oversights are conducted by appointed actuaries and regulatory authorities. The minimum dividend payout under the law is 20% of the profit for mutuals with no limits for stock insurers. However, as a result of the above constraints, Japanese insurers have paid dividends at substantially higher level than the legal minimum (over 95% of profits for major life insurers in recent years).