November 20, 2007

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

Dear Sir David:

The Group of North American Insurance Enterprises ("GNAIE") appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB") Discussion Paper, *Accounting for Insurance Contracts* ("DP"). GNAIE consists of the Chief Financial Officers of 16 leading insurance companies including life insurers, property and casualty ("non-life") insurers, and reinsurers. GNAIE members include companies that are among the largest global providers of life and non-life insurance and reinsurance products.

We applaud the IASB's efforts to develop a consistent set of international accounting standards for insurance contracts. Given the critical role insurers play in the global economy, we believe it is important that a high quality set of internationally recognized standards for the accounting and reporting of insurance contracts (both life and non-life) be adopted.

We support the development of principles-based accounting standards that are accompanied by an appropriate level of implementation guidance. We believe the globalization of capital markets will be aided by the development of internationally recognized accounting and reporting standards that promote consistency and comparability in insurance accounting and reporting across international boundaries. We appreciate the IASB's collaborative process that led to the development of the DP and remain committed to assisting the IASB as it works toward the goal of a final standard.

We believe that the most appropriate measurement model for insurance contracts is one that recognizes profit over the coverage period as the insurer is released from risk and risk protection services are provided (i.e., no gain at issue). The premium agreed upon with the policyholder is the only market transaction in the lifetime of an insurance contract for both life and non-life insurance contracts. For life insurance contracts, we believe risk margins should be calibrated to premiums received to produce no gain at issue. In contrast, for non-life insurance contracts, we support the use of an unearned premium reserve ("UPR") for pre-claims liabilities, no explicit risk or service margin for claims liabilities, and no discounting, unless the cash flows and payment patterns can be reliably determined on an

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individual claim basis. This would result in non-life insurance contracts being held at full settlement value. The notion of full settlement value used throughout the remainder of our response assumes settlement with policyholders "in the normal course" pursuant to the terms of the underlying contracts **and not** a hypothetical settlement with a market participant at the reporting date.

For life insurance contracts, we agree with the basic concepts of the three building blocks (i.e., using estimates of expected future cash flows, discounting those cash flows, and including a margin). In contrast to the DP, however, we believe the expected cash flows used in measuring life insurance contracts should be an unbiased best estimate of **all** expected future cash flows, without any artificial restrictions. Moreover, the discount rate used in the valuation of life insurance contracts should reflect the return an insurer expects to earn on invested assets. We believe our proposed measurement approach would provide users with the most relevant, reliable, decision-useful information to evaluate company performance.

While we believe the efforts of the IASB and its Staff in developing the DP will be helpful in furthering the debate around the development of an internationally accepted measurement model for insurance contracts, as articulated in our responses to the specific questions set forth in the DP, we have a number of significant concerns with the IASB's tentative conclusions in the DP. More specifically:

- We do not support the measurement objective of "Current Exit Value" (CEV) for insurance contracts. We do not believe that CEV is a relevant measurement objective since insurance contracts generally cannot be transferred without obtaining necessary approvals. Accordingly, we question the ability of CEV to aid financial statement users in better understanding an entity's future cash flows when the model is based on hypothetical transfers that may not occur. We believe that a settlement with policyholder-based measurement is significantly more indicative of the future cash flows of an insurer. In addition to our concern with the relevance of CEV, we have serious concerns about the reliability of the inputs to the individual components of the three building blocks of CEV. What we find most problematic is the general subordination of the value of entity-specific inputs (e.g., a reporting entity's own cash flow estimates) to that which is market-based; or in the absence of market-based information, entity-specific information that is modified to incorporate the views of a hypothetical market participant. In our view, because the required inputs into the three building blocks are largely non-observable and not market-based, because there are no regularly observable transfer markets, the resulting measurements labeled "current exit value" fail to attain the same level of relevance as measurements that rely on entity-specific inputs which are more verifiable and represent the reporting entity's actual expectations about net cash flows and thus should be the most relevant information to financial statement users. GNAIE believes that entity specific settlement value of insurance contracts provides more relevant information to users of financial statements than CEV because settlement value represents the cash flows expected to emerge from a group of insurance contracts which we believe is more insightful to financial statement users than a hypothetical transfer value based on a hypothetical market with hypothetical market participants.

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- We believe the DP proposal to use a single model for life and non-life insurance contracts is flawed. Life and non-life insurance contracts are fundamentally different and require measurement models that reflect their unique economic characteristics.
- The DP permits the recognition of significant gains at inception for insurance contracts, before insurers are exposed to any risk, before any services are provided, and while the full amount of premium is fully refundable. Fundamentally, and as defined in IFRS 4, the business of insurance involves providing risk protection ***services*** by accepting future, unknown risks. Accordingly, we believe it is inappropriate to recognize revenue or profit before an insurer has been exposed to risk or has provided risk protection services.
- The DP requires introduction of explicit risk and service margins and discounting for non-life insurance contracts. We are opposed to the discounting of non-life reserves except in situations where the payment pattern and ultimate cost are fixed and determinable on an individual claim basis. We believe that present valuing uncertain cash flows only increases the subjectivity and variability of these estimates and does not result in information that is more decision-useful to investors. Moreover, given the lack of market-observable data to periodically validate the reasonableness of risk and service margins, we question the decision-usefulness of the resulting measurements.
- We believe that "market consistent" cash flows, as required by the DP, are problematic as there are no observable "transfer" markets with which to calibrate such measurements; thus, they may be potentially misleading and open to potential manipulation. Accordingly, because there are no regularly observable transfer markets, we believe entity-specific assumptions should be used as the preferred input in any insurance contract measurement standard as they are comparatively more objective, reliable, verifiable, and more importantly provide a better estimate of the amounts the company expects to pay for servicing and settlement.
- The DP places artificial limitations on allowable cash flows included in measuring insurance contract liabilities, including the allowance for future premiums and the ability to recognize all expected payments to participating policyholders. While we have already expressed our lack of support for CEV, we feel it is important to point out that in not incorporating all expected cash flows the proposed model becomes inconsistent with its stated objective as placing limitations on expected cash flows is inconsistent with the economics that would result from a transfer between market participants, in situations where they occur.
- Life insurance liabilities, as generally interpreted under the DP, would be inappropriately discounted at current risk-free interest rates that ignore best estimates of portfolio or asset-linked returns an insurer expects to earn, and that would be used to evaluate a transfer between market participants, in situations where they occur.
- The DP inappropriately requires tacit unbundling and consideration of own credit risk in measuring insurance liabilities.
- The DP contains insufficient discussion of financial statement presentation making it difficult to determine how the proposed measurement model would be reported in financial statements. This ignores the significant importance of financial reporting in determining the value of insurers' equity and more importantly the negative impact that could arise if a new

measurement and reporting model is introduced that makes it more difficult to understand and forecast insurer's future performance and cash flows than is possible with the existing model.

- In addition, as the entire model is new and untested, we strongly recommend extensive field-testing and cost-benefit analyses be performed before a final standard is issued.

We acknowledge the significant efforts involved in developing the proposed measurement model set forth in the DP, however, for non-life insurance contracts we believe the IASB should give greater consideration to elements of existing U.S. GAAP where many financial statement users and preparers have voiced serious concerns with the measurement model proposed in the DP and have reiterated the belief that the existing measurement and reporting model used world-wide is "not broken". We believe giving greater consideration to existing elements of U.S. GAAP would be appropriate for a number of reasons, the most important of which are that U.S. GAAP is the most comprehensive and widely recognized set of standards in the world today, is most representative of the way the insurance business is managed and therefore, allows for continuation of key, well-understood performance metrics such as claims, expense, and combined ratios, and is used by analysts in U.S. and abroad as basis of evaluating companies.

In contrast, the DP ignores the accumulated wisdom of current insurance accounting standards and proposes to replace those standards with an experimental approach based on untested and unverifiable theoretical constructs. Accordingly, we urge the IASB to reconsider key elements of its approach for the measurement of life insurance contracts and to reconsider the basic foundation of the proposed measurement approach for non-life insurance contracts.

**Single Measurement Model for Life and Non-life Insurance Contracts**

A fundamental flaw in the DP is that it supports one measurement model for both life and non-life contracts. This is inappropriate in that it ignores the significant, fundamental differences that exist between life and non-life insurance contracts, as summarized below:

- For life contracts, the insured event is generally certain to occur unless the policy lapses whereas for non-life contracts, the insured event may or may not occur.

- For life insurance contracts, the amount of future payment obligation is generally specified, or readily determinable from the contract. For example, whole-life insurance contracts pay an insured upon death (an event certain to occur) and the amount payable at death is specified in the contract. For non-life contracts, the amount of future payment obligation is not specified or readily determinable under the contract (other than in terms of contractual limits). Moreover, in a typical non-life contract, losses, if any, can vary from negligible amounts in excess of deductibles to the contractual limits of the policy.

- For life insurance contracts, the timing of future payments are typically reliably estimable from the contract (e.g., an immediate annuity contract with defined future payments), mortality tables (for annuities with mortality risk), or from a company's own experience (e.g., lapse studies). For non-life contracts, the timing of future payments cannot be reasonably estimated

from the contract or by reference to other internal or external data. Stated differently, the uncertainties in a non-life context include not only whether or not a loss may occur during the coverage period (often one year), but also the amount of potential loss, and the fact that losses can be reported several years after the stated coverage period ends and paid years subsequent to the date the loss is reported to the insurer.

Other areas of differentiation include the settlement period between the reporting and payment of claims, which is typically longer for non-life contracts than for life contracts. For example, the period required to determine whether a person has actually died is typically much shorter than the claim settlement period for non-life contracts that often depends on future events. Moreover, while interest is an essential component of pricing and profitability for life products; for non-life contracts, underwriting results are the most critical component of pricing and profitability; and interest, while important, is a secondary consideration.

The following table summarizes these differences:

| Key Attributes | Life | Non-life |
|---|---|---|
| **Period of coverage** | Long, extended duration | Short, fixed duration |
| **Probability of insured event occurring** | Generally certain; policyholder will either die or lapse | Unknown, none or many claims |
| **Amount of loss if insured event occurs** | Fixed and determinable; face value of policy | Unknown, limited by deductible and policy limit |
| **Timing of loss payments** | More predictable; supported by mortality, morbidity and lapse studies | Often unpredictable |
| **Loss settlement period** | Typically short | Typically long |
| **Data** | More empirical data | Less available predictable data |
| **Uncertainty of estimated ultimate claim payments** | Low | Generally very high |
| **Interest income impact on product** | Essential | Unrelated to underwriting results / incremental |

Given these clear and substantial differences between life and non-life insurance contracts, we believe it is appropriate to develop separate accounting models to conform to their unique economic characteristics.

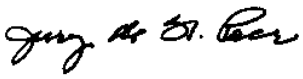
## Relationship to Other IASB Projects/Initiatives

The IASB currently has a number of key projects underway in various stages that directly or indirectly impact conclusions in the DP; namely, Conceptual Framework, Revenue Recognition, Performance Reporting, IAS 37 Contingent Liabilities, Financial Instruments, and the Liabilities and Equity projects to name a few. We believe the insurance contracts project appears to be leading the way for much of the

thinking being developed in these other projects. In general, many of the purely theoretical constructs underlying several of the proposals in the DP are both untried and untested and as such we are very concerned that the insurance industry, one of the most important to the proper functioning of the worlds financial markets, is being used as a testing ground for experimental accounting and financial reporting models that may ultimately prove impractical to implement. We believe the insurance industry is much too important to use as a test-ground for experimental accounting models. Accordingly, we believe it may be necessary to allow the above mentioned directly and indirectly related projects to more fully develop before a new accounting model for insurance contracts is developed. At a minimum, we believe the IASB's Phase II Insurance Contracts Standard should not be finalized until the proposals for these other fundamental areas of accounting are more fully debated and finalized.

We thank you for the opportunity to share our comments with you on the DP and will make ourselves available to discuss our comments in more depth to the extent the Board would find that helpful. Please direct all communications to Douglas Wm. Barnert, GNAIE Executive Director, at doug.barnert@gnaie.net.

Sincerely,



Jerry de St. Paer
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**Q1**: **Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?**

No, we do not believe the recognition and derecognition requirements for insurance contracts should be consistent with IAS 39. While insurance contracts and financial instruments possess some similarities, the fundamental differences between insurance contracts and financial instruments require different recognition and derecognition criteria to be applied to each. Therefore, simply applying the recognition and derecognition criteria in IAS 39 to insurance contracts would not lead to appropriate recognition and derecognition decisions.

In an effort to highlight the fundamental differences, we have provided examples of the accounting guidance in IAS 39 and why we believe the accounting for insurance contracts should differ from that in IAS 39. In particular we focused on paragraph 14 of IAS 39 which states that upon initial recognition, "An entity shall recognize a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument." In addition, paragraph 38, further states, "A regular way purchase or sale of financial assets shall be recognized and derecognized, as applicable, using trade date accounting or settlement date accounting."

Several key differences between insurance contracts and financial instruments include:

- Insurance contracts indemnify policyholders and contain significant non-financial risks;
- Insurance contracts are not purchased or sold on an exchange like many financial instruments (i.e., there is no "trade date or settlement date");
- Insurance contracts contain a significant "service" element not found in most financial instruments;
- Unlike most financial instruments, insurers do not typically have an unfettered ability to sell or transfer their "full" obligation to perform to another party;
- An insurance contract's "binding date" and "effective date" may sometimes align with "trade date" and "settlement date", however, the IAS 39 recognition and derecognition criteria would not provide appropriate guidance for all of the unique situations associated with life and non-life insurance contracts;

We believe that attempting to adhere to the criteria in IAS 39 would change current industry practice regarding initial recognition of insurance contracts. Currently, non-life insurers recognize an insurance premium and liability on the effective date of coverage, while life insurers typically recognize an insurance premium and liability upon receipt of the initial premium accompanying the contract. In both cases, the insurer becomes a "party" to the contract, and coverage is or can be bound, prior to the date it becomes effective. Therefore, using IAS 39 criteria would result in recognition of insurance premiums based on the contract's binding date, not its effective date, which would be a change from current practice that we believe would be inappropriate for non-life insurance contracts.

The IAS 39 model creates a problem because unconditional rights and obligations for the insurer and insured do not exist at the binding date of the contract. The rights or obligations as of the binding date are conditional given that:

- The right for the insured to obtain coverage is subject to:
  - the payment of the premium (in many countries, local law stipulates that the absence of payment within a certain period of time can provide the right for the insurer to cancel the policy); and
  - the existence or ownership of property (in a non-life contract) as of the effective date.

- The right for the insurer to collect the premium is subject to the delivery of:
  - the insurance coverage; and
  - servicing of the insurance contract.

Typically, coverage under a bound policy can be terminated prior to the inception of coverage as is the case with a life insurance contract where the insured dies prior to the policy effective date or a non-life contract where the insured property is destroyed prior to the coverage effective date. Under many existing U.S. statutes, insurance policies may also include a "policy review period", which provides the insured with the right to annul the insurance policy prior to its effective date. The point here is that the insurer's "right" to receive payment for a bound policy is not unconditional, nor is the insurer absolutely obligated to perform under the insurance contract, because an insurance contract (unlike the financial instruments contemplated in IAS 39) does not give rise to unconditional rights and/or obligations.

Moreover, we do not believe insurance contract revenue should be recognized as of the binding date since:

- written premium and unearned premium reserves ("UPR"), key analytics of financial statement users, would be recognized prior to the issuer providing risk protection services and the premium would remain fully refundable; and
- ceded reinsurance premium would be recognized concurrent with direct premium and possibly before a reinsurance liability might contractually exist.

Notwithstanding the preceding, we recognize that prior to the effective date of the policy, insureds sometimes make advance premium payments. We believe those advance premiums should be recorded as deposits.

With regard to derecognition, the practical realities of insurance are that a claims liability may never be extinguished, since on certain contracts claims may arise many years after the measurement date. Stated differently, an insurance contract may be derecognized only when all possible claims under the policy are finally settled and this may not be possible to ever assert with any certainty. For traditional life insurance contracts, the date of extinguishment is seemingly readily determinable (e.g., when the sum insured under a life policy is paid upon the death of the insured). In other situations however, such as third party liability policies, multiple claims are possible and there is no absolute certainty that further claims will not be

filed. Similarly, for long-tailed, non-life insurance contracts, claim activity can remain dormant for long periods and then unexpectedly reopen with very material claim activity. This conclusion differs from the guidance in IFRS 4 (BC 105).

Furthermore, as it relates to derecognition, we would point out that paragraphs 5 to 7 of IAS 39 concerning net settlement are not applicable in the case of most insurance contracts since they do not generally provide for net settlement.

In summary, for the reasons outlined above, we believe the guidance set forth in IAS 39 is inadequate, and would generally be inappropriate, as it relates to the recognition and derecognition requirements for insurance contracts. We believe the IASB should give further consideration to other implications and the relationship between insurance contracts and financial instruments. Insurance contracts have unique features that in many cases require different accounting treatment from financial instruments, and these differences should be appropriately reflected in an insurance contract accounting standard.

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**Q2**: **Should an insurer measure all its insurance liabilities using the following three building blocks:**

**(a) explicit, unbiased, market-consistent, probability-weighted average 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 unbiased estimate of the margin that market participants require for bearing risks (a risk margin) and for providing other services, if any (a service margin)?**

**If not, what approach do you propose, and why?**

We believe this question should be answered separately for life and non-life insurance contracts. In contrast, the DP proposes a single measurement model ("MM") for life and non-life contracts, the foundation of which is three building blocks designed to replicate current exit value ("CEV"). While the individual building blocks may be an acceptable concept for most life insurance contracts, notwithstanding the lack of market-based data to support cash flow estimates as well as risk and service margins, they are not appropriate for non-life insurance contracts. More specifically, for non-life insurance contracts, we believe the data inputs necessary to satisfy the individual building block elements do not exist in such a way as to produce reliable, verifiable, comparable, and decision-useful measurements.

We believe the most significant challenges with the three building blocks as they relate to non-life insurance contracts include: the requirement that expected future cash flows be "market-consistent" and "probability-weighted", the discounting of claims liabilities, the introduction of risk and service margins, and the possibility of recognizing Day One profit. Moreover, we believe an insurance contracts measurement model should incorporate cash flows that reflect the costs of claims and expenses to be incurred in the normal course of operation rather than either an immediate settlement or transfer situation with a hypothetical marketplace participant. In addition, while we understand the IASB's principal objective in proposing a CEV based MM for all insurance contracts (i.e., a desire to measure all financial instruments at fair value); the proposed measurement model in the DP does not ultimately achieve the objective as the resulting measurements do not represent realistic, consistent or comparable amounts that insurers could pay to transfer remaining rights and obligations under specific contracts to unrelated third-parties that are both willing and able to accept the contracts, which reinforces the observations provided to the IASB in their Conceptual Framework Roundtable on Measurement Bases that there is not one measurement model that is appropriate for all financial and non-financial assets and liabilities.

We believe that little observable market-based data exists to satisfy the informational requirements of the three building blocks. Accordingly, we do not believe the DP's requirement to incorporate the expected cash flows, risk and service margins that hypothetical market participants would estimate or otherwise require would produce measurements that are of equal or greater relevance than, for example, those based on GNAIE's proposed measurement models for life and non-life insurance which place greater reliance on entity-specific cash flows. These are more easily verifiable and also represent the reporting entity's

actual expectations about net cash flows and thus should be the most relevant information to financial statement users.

Since measurements of insurance contracts derived from applying the three building blocks are hypothetical modeled values driven by key underlying model assumptions, that are in large part not subject to independent verification, the resulting measurements are not consistent, comparable, or reliable; thus, they do not produce financial information which is decision-useful. The use of fair value (or CEV, which the IASB has suggested may be equivalent) as defined in SFAS 157, *Fair Value Measurements*, is appropriate in situations where sufficient observable market-based data exists to support the relevance and reliability of the measurement. For example, a financial instrument could be valued using a financial model with a variety of data inputs that range from directly market observable to non-observable. Pursuant to SFAS 157, the nature (i.e., observable or non-observable) and significance of model inputs to the overall measurement are evaluated to determine the significance to the overall valuation of non-observable model inputs which determines whether the resulting measurement falls in the SFAS 157 fair value hierarchy (e.g., Level 2 or Level 3).

In comparing insurance contracts to financial instruments we note that for many financial instruments that fall within Level 3 of the SFAS 157 fair value hierarchy, it is generally true that a significant portion of the total value of the instrument is attributable to inputs that are either observable or market-based. In contrast, for insurance contracts little of the information that would be used to support the data requirements of the three building blocks would be observable or market-based and thus would be among the most judgmental and least reliable measurements. We believe that insurance contracts, which represent the most significant liability for an industry that is of fundamental importance to most worldwide commerce, if valued using the three building blocks would fall very near the most subjective end of the Level 3 valuation continuum and would therefore neither achieve the IASB's measurement objective represented by the term “current exit” or "fair” value nor would it provide financial statement users with relevant, reliable, comparable, and decision-useful information.

We believe it is important to clearly state that the primary objective of any measurement model should be to provide financial statement users information that possesses four critical characteristics (i.e., reliability, consistency, comparability, and decision-usefulness), so users may properly assess a reporting entity’s periodic financial performance and financial condition to support informed investment decisions. As a result, we believe greater importance should be given to measuring the periodic performance and assessing the financial condition of insurance companies as opposed to considering it a byproduct of periodic balance sheet measurements that are based on hypothetical models, as is the case in the DP.

The proposed MM also raises concerns regarding historical performance metrics. The usefulness of well-understood performance metrics for non-life insurers such as claims and expense ratios, which are used by management to incent employees and manage the business, as well as by investors, creditors, and other stakeholders to assess periodic financial performance, would be significantly impacted by the proposed MM, and would no longer be useful as a barometer of business performance. By comparison, the proposed MM

requires significant reliance on hypothetical inputs that attempt to predict the future, and on periodic changes in those inputs. The impact on historical performance metrics will be significant in rendering those metrics useful, if at all, only to the most sophisticated financial statement users.

In the remainder of our response to this question, issues for life and non-life contracts are dealt with separately.

***Life***

We believe that many of the concepts represented by the three building blocks are appropriate for measuring life insurance contracts. Specifically, life insurance contracts should be measured using estimates of expected future cash flows, discounted, and should include a risk margin. In contrast, as discussed below, there are several significant shortcomings with the details of the three building blocks as described in the DP.

**(a) explicit, unbiased, market-consistent, probability-weighted average and current estimates of the contractual cash flows,**

A cash flow approach should use the unbiased best estimate of all expected future cash flows, without limitations or restrictions.

We find the notion of "market-consistent" cash flows inappropriate. First, a "market" from which to determine these cash flows simply does not exist, as acknowledged in the DP, in that there are no observable market values for many insurance variables (e.g., mortality, morbidity, policyholder behavior, service costs, etc.). Moreover, the use of "market-consistent" cash flows would not reflect a company's true expected future performance and would therefore make performance reporting very difficult. As a result of the preceding, we believe that instead of requiring use of "market-consistent" cash flows when such a market does not exist, it is appropriate to require the use of entity-specific cash flows.
We are also concerned with the term "probability-weighted averages" and the use of "all currently available information" which when taken together appear to require quarterly, full stochastic analysis for every assumption in valuing life insurance liabilities. Completing such a task is not possible, and even if it were, it would likely not breach any reasonable cost/benefit threshold. We think it is extremely important for the IASB to understand that practical realities require insurers to limit the scenarios modeled. In addition, we believe there are many situations where non-probabilistic approaches may produce equally valid results. For example, for a term-life insurance product with no cash values, using a stochastic approach will not produce materially different results from a discrete, best-estimate approach.

As discussed later in this letter, concerns also exist with the approach in the DP to allowances for future premiums and, potentially, the ability to recognize all expected payments to participating policyholders.

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**(b) current market discount rates that adjust the estimated future cash flows for the time value of money; and**

We believe the discount rates used in the valuation of life insurance liabilities should reasonably reflect the spread that an insurer expects to earn on assets supporting the business. In contrast, basing discount rates on a government or swap curve-based rate would not produce a "fair", "exit" or other decision-useful value as it would not reflect the underlying economics associated with the contract and related book of business. This would be particularly true for fully guaranteed long-duration insurance products, common in North America, for the reasons outlined below.

Life insurance liabilities are typically long-duration liabilities that have limited liquidation risk. These characteristics are reflected in the risk profile of assets that insurers use to support insurance liabilities. In contrast, assuming long-duration insurance liabilities are supported by a risk-neutral bond portfolio would be atypical and unrepresentative of the portfolios that insurers use to support insurance liabilities, and thus may materially misrepresent the expected yield earned on the asset portfolios and similarly result in a misstatement of the value of these liabilities. We believe the current market discount rates should reflect the expected yields based on the asset portfolios typically held to support insurance liabilities and should reflect the expected investment spreads over government bonds (or sovereign debt) earned on such a portfolio based on historic data.

We believe the use of current market discount rates based on expected yields (or spreads over government bonds or sovereign debt) on a portfolio that an insurer would typically use to support insurance liabilities is a more faithful representation of the value of the contract than use of a risk neutral framework. We believe an objective framework can be established to determine representative asset portfolios and current market based discount rates for the valuation exercise. For example, for fixed rate assets, the discount rate could be based on the current market yields for either the assets held, or similar reference assets less the expected cost of defaults based on an asset's quality rating. These expected costs could be readily established based on credit default studies. The difference between the net yield and the relevant risk free yield is the best representation of the expected yield spread over risk free rates.

We believe our suggested approach would be consistent with an exit value framework. More specifically, the use of discount rates that are consistent with expected returns on both assets held and expected reinvestment strategies matches how insurance liabilities are priced, including block sale transactions. For situations where asset and liability cash flows are matched, the use of discount rates based on the assets held ensures the change in asset and liability fair values will be consistent, which will not be the case if liabilities are valued at discount rates that are inconsistent with the market yields on the assets held.

In addition to the issues noted, we would also point out that the risk neutral framework outlined in the DP leaves a number of issues unaddressed. More specifically, it does not specify how discount rates are to be set when there are no market-observable reference rates. For example, a risk free rate in developed markets typically does not extend beyond 20 to 30 year durations, and a substantial portion of the insurance cash flows to be discounted are typically beyond these durations. In addition, developing markets may have much more limited risk free reference points, either because of lack of depth of the market, or because reference rates (e.g., long duration risk free bonds) simply do not exist. Also, while paragraph 69 of the DP makes a very brief reference to inclusion of a liquidity premium in the discount rates, there is no detail on how such liquidity premiums would be determined.

**(c) an explicit unbiased estimate of the margin that market participants require for bearing risks (a risk margin) and for providing other services, if any (a service margin)?**

For life insurance liabilities, the concept of a margin representing a measure of risk and uncertainty is fundamental to the nature of insurance. We believe the margin should be established by calibrating to the only market transaction in the lifetime of an insurance contract; the premium agreed upon with the policyholder at contract inception. There are no other more relevant or more reliable values to use in estimating risk margins. Estimating margins without such calibration would result in a lack of consistency among companies, and could very well lead to earnings manipulation. Similarly, any distinction between risk margin and service margin would, in our opinion, not be meaningful or useful.

We believe the net insurance liability ("net liability") must at all times be sufficient to provide for payment of all expected future obligations with adequate provision for risk and uncertainty. Underlying this view is a belief that all assumptions should be the company's current best estimates at each measurement date. We also believe that margins should be revised whenever there is conclusive evidence that they are no longer appropriate.

We believe the margin should be released into profit over the life of the contract as the insurer is released from risk. Release from risk will generally be measured based on expected benefits and margins inherent in the profit profile of the product (generally as reflected initially in pricing models and subsequently in current cash flow projections). For claims liabilities for which no margin is anticipated in pricing, any margin should reflect the risk inherent in the estimation technique.

At initial issuance, we believe there should be no accounting gain or loss since the initial margins used for establishing the liability will be those margins that result in no gain or loss at issue. However, in the event that an insurer issued a contract on which it anticipates an ultimate loss over the term of the contract (a situation that should be rare), that loss should be recognized at issue.

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***Non-life***

**(a) Use of explicit, unbiased, market-consistent, probability-weighted average and current estimates of the contractual cash flows,**

We believe the use of explicit, unbiased, cash flows should reflect the ultimate costs of claims and claims expenses to be incurred in the full settlement of obligations with customers in the normal course as claims arise. For avoidance of doubt, we do not interpret full settlement value in the context of either an immediate settlement or transfer. This is consistent with the basic reserving methodologies currently employed under most bases accounting for non-life insurance contacts used worldwide.

We are concerned with the introduction of the concepts "market-consistent" and "probability-weighted" as they relate to the estimate of future cash flows (including expenses). More specifically, we do not believe it is appropriate to require "market-consistent" estimates in the absence of markets and market-observable data from which estimates of contractual cash flows could be obtained, calibrated to, or otherwise used to assess the reasonableness of estimates. Similarly, we are concerned with the use of "market consistent" cash flows as they may result in measurements that are potentially misleading and open to potential manipulation. Moreover, we do not believe market consistent cash flows would be more objective, reliable, and verifiable than company-specific cash flows which represent the amounts a company actually expects to pay. Similarly, while "probability-weighted" averages may be appropriate in some situations, they should not be required in all instances, as it would not generally be cost beneficial to employ such an estimation process in all cases for every line of business. More importantly, we do not believe the resulting measurements would be consistent, comparable, reliable or decision-useful.

**(b) Use of current market discount rates that adjust the estimated future cash flows for the time value of money.**

Historically, the time value of money has not been explicitly incorporated in the measurement of non-life reserves or into performance measures used for non-life insurance contracts due to the basic inability of non-life insurers to ***reliably*** estimate cash flows and the associated risk margin for underlying liabilities by individual reporting period (e.g., quarterly); an exercise that must serve as the foundation for any discounting (i.e., time value of money) exercise. As a result, non-life insurers do not typically discount claims liabilities for financial reporting or internal management reporting purposes (except for a limited number of coverages where future cash flows are both fixed and determinable on an individual claim basis). In addition, non-life reporting entities also typically do not engage in any sophisticated asset-liability management activities similar to those employed in the life insurance industry, where

future cash flows *are* reliably estimable. It is important to note that while non-life insurers have sufficient comfort with estimating the ultimate (i.e., undiscounted) full settlement value of non-life insurance claims, they lack sufficient information (due to the existence of inherent uncertainties) to produce meaningful estimates of how those insurance liabilities will emerge over individual reporting periods.

Notwithstanding the preceding, non-life insurers invest premiums received (net of commissions and other expenses) in interest-bearing financial instruments during the life of the underlying contracts and place importance on earning investment income. Nonetheless, non-life insurance contracts (both short-duration and long-duration) are priced, managed, and evaluated for performance based principally on underwriting results (i.e., underwriting income excluding investment income), and we believe any exercise designed to specifically isolate the time value of money element from non-life insurance contracts or portfolios would be highly subjective and would not produce information that is reliable, comparable, or decision-useful. We are aware of some financial statement users who, while they stipulate to the un-reliability of non-life cash flow estimates for discrete periods (i.e., quarters), nonetheless have a desire to see discounting introduced as long as it is accompanied by robust disclosures about the expected level of uncertainty underlying the estimates. We firmly believe that robust disclosure never cures bad accounting and thus believe discounting should not be introduced if cash flow estimates lack sufficient reliability, which we believe to be the case.

**(c) Use of an explicit unbiased estimate of the margin that market participants require for bearing risks (a risk margin) and for providing other services, if any (a service margin)?**

We believe non-life contracts should be measured at inception based on the amount of contractual premium received, which is determined on an arm's-length basis, as are other contractual provisions regarding coverage, benefits, and other services to be provided. Any alternative measurement (e.g., those which would result from applying the three building blocks) is not superior to the amount of premium contractually agreed upon at inception. Moreover, we would also point out that in the past, situations where reporting entities were permitted to use mark-to-model measurements, as was the case with the Enron Corporation, often led to significant problems. Moreover, we believe that because non-life insurance contracts are executory in nature and contain significant future service components (e.g., claims-related services), any recognition of profit before services are provided would be wholly inappropriate.

For non-life contracts, we believe an insurer should record UPR at policy inception, which would be subject to a liability adequacy test. Additionally, non-life insurance liabilities should be measured at "full settlement value", and thus would not be discounted, since, as previously discussed, cash outflows cannot be reliably estimated for discrete quarterly financial reporting periods.

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With regard to risk and service margins; markets do not exist to calibrate or otherwise verify estimates of market risk and service margins. In connection therewith, business combinations, the reinsurance market, catastrophe bonds, the life settlement market, and third party administrators as possible market calibration points were considered as follows:

- Business combination accounting requires the allocation of purchase price to the fair value of assets acquired and liabilities assumed, regardless of whether active, liquid markets exist to which fair value estimates may be calibrated to or otherwise verified. For insurance contracts, the purchase price allocation exercise requires the application of considerable judgment in determining the value assigned to insurance contracts and designated as a proxy for fair value. The preceding reflects the fact that in a typical business combination, there are generally no individually negotiated fair values for underlying assets and liabilities, but rather an aggregate fair value is assigned to the controlling entity and from there individual values are estimated resulting in an allocation of the total consideration to the assets acquired and liabilities assumed. However, since insurance contracts are not traded on an active market, their fair value is typically determined in a manner that is generally not consistent or comparable between entities.

- The reinsurance market is not a useful calibration point for fair value estimates of insurance contracts because reinsurance transactions are most often private transactions (i.e., their terms are not readily accessible to other market participants) and they contain floors, ceilings, and other features that transfer less than one hundred percent of the insurance risk from the ceding to the assuming company.

- The catastrophe bond and life settlement markets are also not valid calibration points as both are very immature; in the case of catastrophe bonds, similar to reinsurance contracts, they often contain features that transfer less than one hundred percent of the underlying insurance risk from the ceding to the assuming company.

- Third party administrators would provide a potential market based proxy for the market price of servicing. The practical constraint, however, is that the vast majority of insurers service their own contracts, since this is typically what differentiates one insurer from another in the marketplace, and is often considered one of the most valuable core competencies of a non-life insurer.

Despite the lack of external third-party sources to which risk margins could be calibrated or otherwise inferred, some proponents of the three building blocks support the estimation of risk margins using a “cost of capital” methodology that relies on subjective inputs concerning confidence intervals, desired (or required)

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returns used to derive the cost of capital, and expectations about future capital needs. We believe the development of confidence levels to be a wholly subjective exercise for non-life products due to the uniqueness of each portfolio, an indeterminate pattern of claims payments, and numerous external factors affecting ultimate claims payments. Given the subjective nature of the underlying assumptions, and no practical means to calibrate assumptions to a credible market transaction, the risk margin estimate using the cost of capital methodology would be inherently unreliable and not comparable between companies. Furthermore, the impact on the financial statements would be exacerbated by the fact that risk margins for non-life insurance contracts tend to be greater and more volatile due to the level of uncertainty regarding the amount and timing of ultimate claims payments.

We believe measuring non-life insurance contracts using the three building blocks would involve a complex compilation of numerous judgments and assumptions and the resulting measurements would be no more informative, and perhaps less so, than reporting claims liabilities at undiscounted full settlement value, consistent with current practice. Additionally, we also note that application of the three building blocks would cause periodic results to fluctuate for a variety of inter-related reasons, including changes in interest rates, changes in expected payments, changes in various assumptions underlying the estimates of risk margin, etc. Most important, however, is that the periodic fluctuations in performance would be primarily attributable to management's expectations about the future, and therefore be highly judgmental, speculative, non-verifiable, and subject to manipulation. Moreover, for each speculative underlying assumption affecting the periodic determination of financial performance, financial statement users would need to make their own decision about whether or not to accept management's judgment or to use their own expectation of the future. Under these circumstances, financial statement users would need to perform extremely thorough reviews of financial statement disclosures to understand the underlying factors, and their sensitivities, driving earnings and operating performance. For many equity investors, the level of necessary review would not be feasible, even if the level of financial statement disclosures were to be significantly enhanced in an attempt to explain the myriad of assumptions underlying measurements using the three building blocks.

As a result of the preceding, we believe the measurement of non-life insurance contracts using the IASB's three building blocks cannot be considered a more suitable accounting model to that proposed by GNAIE in our Non-life Extended Principles which are summarized as follows:

> ***Pre-Claims Liability*** – determined based on premium received at inception (less acquisition costs). Amount would be subject to a liability adequacy test. Recognition of Day One profit would be prohibited; however, if the liability adequacy test revealed a reserve deficiency, a Day One loss would be recognized. Premium would be

earned as insurance protection services are provided during the policy coverage period.

***Post-Claims Liability*** – measured using best estimates of the full settlement value of ultimate expected claims payments, using either a single best estimate or probability-weighted average approach.

This methodology best achieves the objective of measuring assets and liabilities in a manner that provides financial statement users consistent, comparable, reliable, and decision-useful information to assess a reporting entity's periodic financial performance and financial condition in order to make informed investment decisions. In addition, it allows users to obtain key historical performance metrics critical to the financial review process.

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**Q3: Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?**

We believe the draft guidance contains too much actuarial-related detail. Much of this guidance should be left to actuarial standards setters rather than included in accounting guidance. In our opinion, the accounting standard should state the basic measurement principles desired and then allow actuarial guidance to be developed to implement those principles.

For example, practicality is an important consideration that requires discussion in an actuarial context. Those actuarial discussions would focus on the fact that it may not be practical to expect companies to do a complete stochastic analysis of every product, every quarter (approximations may be necessary and should be acceptable). Furthermore, there are many liabilities that are properly and accurately measured today using non-stochastic methods; we do not believe these methods should be prohibited.

The discussion of which cash flows should be in the estimates also needs further clarification, as does the basis on which risk margins are calculated. As stated in our response to Question No. 2, we believe cash flows should generally reflect company-specific expectations, not expectations of a hypothetical company. For example, a company with high expenses should not be able to hold a reserve based on a lower level of marked-based expense. We also believe that risk margins should be calibrated so as to produce no gain at policy inception.

In general, we believe the accounting standard should set out the basic principles upon which margins are to be calibrated and then allow an insurer's actuaries to determine the best method for calculating those margins, with appropriate disclosures. In practice, it will mainly be the Actuarial profession that must implement the guidance in the accounting standards; and as such we believe that responsibility for writing the appropriate interpretative implementation guidance should be vested there as well.

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**Q4: 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 recognize 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 this 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 recognize a profit or loss at inception.**

**(d) Other (please specify).**

We believe that alternative (a) is most suitable for both life and non-life insurance contracts.

Underlying our choice of alternative (a) is a belief that all insurance contracts are executory in nature and contain significant future service components (i.e., investment management services for life insurance contracts and claims-related services for non-life insurance contracts) and; as a result, any recognition of profit before services are provided is inappropriate.

For life insurance contracts, the net liability should be equal to the present value of all future cash flows (i.e., premiums, benefits and expenses) associated with the portfolio of insurance contracts being valued. Moreover, the only point in the life of an insurance contract where the inherent risk can be measured on an objective, market-validated basis is at issue. At this time there should be no accounting gain or loss, except in situations where the insurer issues a contract or group of contracts on which it anticipates an ultimate loss over the term of the contract(s). Accordingly, initial margins used for establishing the insurance liability will be those that result in no gain or loss at issue, except in the rare cases where a loss is anticipated.

For non-life insurance contracts, the insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. Similar to a life contract, the only point in the life of a non-life contracts where its value can be validated by a market-based arm's length transaction is at contract inception. Moreover, as no insurance protection or claims services have been provided at contract inception, it would be inappropriate to recognize profit at that time. Therefore, at contract inception, which coincides with the pre-claims phase of the insurance contract, premium received from the policyholder should be established in an unearned premium reserve.

**Q5: 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. This 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 favor and why?**

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

We do not believe CEV is a reliable and decision-useful measurement-basis for insurance liabilities. The IASB's proposed CEV-based MM is simply a complex mathematical algorithm that does not produce relevant, reliable, comparable, or decision-useful information as it relies on a number of underlying assumptions (e.g., risk and service margins, cash flows, etc.) that are not market-observable (no active markets for these contracts exist), and as such, there is no means to verify or otherwise calibrate individual insurer estimates of the market price for risk and other services included in the contract, such as those related to investment or claims fulfillment. As such, the CEV-based MM does not achieve the intended objective of creating a measurement that is equivalent to the amount an insurer would expect to transfer at the reporting date to an unrelated third-party willing (and able) to accept the remaining rights and obligations under specific insurance contracts.

For non-life insurance contracts, we do not believe CEV is superior to the measurement model based on entity specific estimates of the full settlement value of claims and claims expenses. In contrast, the MM included in the DP would require use of market-consistent cash flows (in the absence of a market), discounted cash flows (where reliable estimates of cash flow by reporting period are not available), and market based risk and service margins (again, in the absence of a market). As a result, we do not believe the proposed MM would produce measurements that would be considered relevant, reliable, comparable or decision-useful.

We believe non-life insurance pre-claims liabilities should be valued at the amount of premium received, subject to a liability adequacy test. As a result, an insurer would never recognize a profit at the inception of an insurance contract. The initial UPR should be earned over the coverage period. At the same time, claims liabilities would be established as claims are incurred. Non-life insurance claims liabilities should also be measured at "full settlement value" (i.e., they would not be discounted, since cash outflows cannot be reliably estimated for discrete financial quarterly reporting periods and any requirement to impose discounting on non-life insurance liabilities would only increase reliance on subjective estimates, and result in modeling error that would need to be corrected from period to period).

In contrast to the IASB's CEV based MM, life insurance liabilities should be measured at the present value of all future cash flows (i.e., premiums, benefits, and expenses). The initial margins used for establishing the liability would be those that result in no gain or loss at issue, except in the rare cases where a loss is anticipated.

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We do not believe CEV is an accurate description of the value resulting from an application of the three building blocks since it implies that an insurer typically has either the intent or unconstrained ability to exit the liability, which is not the case. Further, in the event the insurer did possess both the intent and ability to exit the liability, it might be at values materially different from the hypothetical value represented by CEV. Finally, as noted above, because the hypothetical modeled value computed using the three building blocks relies on a number of underlying assumptions (e.g., risk and service margins, cash flows, etc.) that are not market-observable (no active markets for these contracts exist), the basic concept of an exit value, computed using the three building blocks, is not meaningful. For these reasons, we feel the most accurate description of the measurement basis proposed in the DP is “Hypothetical Estimated Transfer Value”; however, we do not consider the label to be important.

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**Q6: In this paper, beneficial policyholder behavior 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 behavior, should an insurer:**

**(a) Incorporate them in the current exit value of a separately recognized customer relationship asset? Why or why not?**
**(b) Incorporate them, as a reduction, in the CEV of insurance liabilities? Why or why not?**
**(c) Not recognize them? Why or why not?**

We believe that for life insurance contracts, the choice between option (a) and option (b) is strictly a matter of how amounts are presented in financial statements; that is, either choice will lead to the same net balance. For the reasons described below, however, we consider option (b) the more appropriate alternative. In contrast, we believe that option (c) leads to a different net balance; but it is in substance the same as criterion (e) in Question 7.

Our response to this Question is limited to our views on how to reflect beneficial policyholder behavior (i.e., whether it should be incorporated in the current value of the liability – option (b), or shown as a separately recognized customer relationship asset – choice (a)). Our response to Question 7 addresses option (c) - whether the value of a beneficial policyholder behavior should be recognized at all.

We believe the customer relationship intangible should be offset as a reduction to the insurance liability because that is consistent with IAS 32 rules that permit related amounts to be offset. When a customer relationship asset is embedded with the insurance liability, it is so closely interrelated with the liability that any separation would be based on arbitrary rules, and separate valuation would not be relevant or reliable. Thus, the Board's preliminary view as described in paragraph 147 of the DP (i.e., that the cost of distinguishing the recognized part of the customer relationship from the insurance liability would exceed the benefits of doing so appears appropriate.

Furthermore, the reliability and relevance of quantifying the value of beneficial behavior should be questioned, especially after a class of insurance contracts is issued. More specifically, the insurer has very limited information on changes in the health or other circumstances of the insured after the time the contract is issued. Accordingly, estimates of the effects of beneficial policyholder behavior would be based on largely speculative assessments of the extent and distribution of changes among policyholders, and even more speculative assumptions about the choices of underlying policy options (e.g., to lapse the policy, to change insurance or premium amounts, to elect reduced coverage or coverage for a shorter term) that policyholders make that supposedly would be construed as beneficial to the insurer.

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**Q7: A list follows of possible criteria to determine which cash flows an insurer should recognize relating to beneficial policyholder behavior. 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 favors 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 favor this criterion, how would you distinguish existing contracts from new contracts?**

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

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

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

**(f) Other (please specify).**

We believe criterion (b) is the best choice as it appropriately considers beneficial policyholder behavior a cash flow measurement issue as opposed to a question about the recognition of an embedded asset in the contract. Criterion (a) and (d), as well as (e) (which is the same as option (c) in Question 6), are inconsistent with a market-based measurement (including CEV), because market participants would absolutely include all expected cash flows that result from beneficial policyholder behavior in valuing insurance liabilities. Such expected cash flows resulting from beneficial policyholder behavior are also key elements in determining the premium that policyholders pay for their insurance contracts. Criterion (c) (considering all cash flows that arise from terms of existing contracts that have commercial substance) could lead to results that are similar to those achieved using criterion (b); however, the use of criterion (c) might also introduce significant complexities without any improvement in reliability of the measurement.

We believe it is important to determine the expected cash flows in the context of liability measurement based upon the best estimates of what the insurer expects to pay and receive under each scenario considered. In this context, we would be concerned if cash flows resulting from expected beneficial policyholder behavior were not included in measuring insurance liabilities, as the insurer might be required to recognize initial losses on contracts that are appropriately priced, and on which the insurer expects to realize profits. Similarly, excluding cash flows arising from beneficial policyholder behavior would not reflect valid

expectations or the economic substance of the business and therefore would not produce measurements that would be valid for making business decisions.

As it relates to the reliability of estimates of cash flows arising from beneficial policyholder behavior, insurers have a wealth of historic experience and objective data upon which to base reliable expectations for the persistency of the contracts they issue. In contrast, estimates that differentiate persistency, based on whether or not an insurer's expected policy benefits and expenses for a particular contract exceed the contract's premium, would not be nearly as reliable, especially after the time the contract is issued. More specifically, the insurer generally does not have information about changes in health or other circumstances of the insured after the contract is issued. Identification of cash flows from the effects of beneficial policyholder behavior from unfavorable policyholder behavior would therefore be based on speculative assessment of the extent and distribution of such changes among policyholders, and even more speculative assumptions about the choices of underlying policy options as previously discussed, which could be considered cash flows arising from beneficial policyholder behavior.

As it relates to the basic notion of beneficial policyholder behavior, we can stipulate to the fact that policyholders do have more current information than insurers regarding changes in health and other circumstances subsequent to policy issuance. That said, however, they do not possess the ability to predict how their circumstances may change in the future nor do they typically have the ability to monetize the value of asymmetrical information. It is these facts and circumstances that distinguish options in insurance contracts from options in the capital markets, where values can be determined throughout the life of the option and can be monetized at any time through established market mechanisms.

In response to how one would distinguish existing contracts from new contracts, we believe renewal premiums (and related benefits and expenses) should be recognized in liabilities if the contract is for longer than one year, as longs as there are meaningful limitations on the insurer's right to increase future premiums or to cancel (or non-renew) contracts that it believes will be unprofitable.

Therefore, if an insurance contract is 10 years on its face, but the insurer has an unrestricted ability at each anniversary to cancel the contract or to change the premiums charged, the expected premiums following the next anniversary would not be considered in valuing the liability. In contrast, if the contract is for one year but renewable for 10 years, and the insurer does not have the right to cancel the contract during the 10 years (if the required premiums are paid), and is materially limited in changes it can make to charged premiums, then expected future renewal premiums (and related benefits and expenses) should be considered in valuing the liability (up to a time that the insurer either has the right to cancel the contract or to change future premiums without material restriction).

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**Q8: Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?**

For life insurance contracts, we believe the issue of whether or not acquisition costs should be recognized as an expense as incurred depends on the accounting measurement-basis used to value the contract's liabilities. More specifically, if the liabilities are valued based on future expected premiums (i.e., not guaranteed insurability requirement) and other operational features of the contract, then acquisition costs should be recognized as an expense when incurred. The future premiums included in the liability measurement would then include the margins anticipated to recover the acquisition costs, and thus, the liability would incorporate a reduction for an appropriate amount of acquisition costs. This liability reduction would essentially offset the acquisition cost expense when incurred. In contrast, if the acquisition cost were not recognized as an expense, profits at contract inception would be overstated.

Under different liability valuation bases this would not necessarily be true. In particular, under the approach described in the DP, because there are restrictions on incorporating certain expected future premiums into the liability valuation, the proposed MM could produce losses at the time of initial issuance. More specifically, life insurance contracts frequently have acquisition costs that exceed the initial premium received on the contracts, and thus are only recovered from margins in future premiums. Therefore, if all expected future premiums are not included in the measurement, some deferral of the acquisition costs incurred would be necessary to avoid an inappropriate, and we believe misleading, loss upon issue of insurance contracts that are expected to be profitable.

In summary, for life insurance contracts, we believe it is preferable to allow all anticipated future premiums to be incorporated into liability measurements, and to reduce those cash flows for the amount of acquisition costs rather than to hold a separate deferred acquisition cost asset that would be difficult to define and that may require amortization in a manner inconsistent with changes in the liability.

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**Q9: Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?**

We note that under IFRS 3, which requires the fair value measurement of insurance contracts within its scope, the cost of a business combination is allocated on the basis of fair values assigned to individual assets acquired and liabilities (including both life and non-life insurance contracts) and contingent liabilities assumed. These fair values are determined at the acquisition date. In contrast to IFRS 3, IFRS 4 permits the use of expanded disclosures under which the fair value of the insurance contracts may be presented as two components:

a) A liability measured according to existing accounting policies for insurance contracts (the recorded value); and
b) An intangible asset, defined as the difference between the contract's fair value and recorded value.

Use of the expanded presentation noted above is also available for insurance contracts acquired in a portfolio transfer.

In practice, a transfer of all contractual rights and obligations associated with individual insurance contracts or groups of insurance contracts between entities would include cash flows that represent a portion of the customer relationship arising from guaranteed insurability. As the IASB has not yet concluded whether CEV is the same as fair value, there may be differences that would require the retention of expanded presentation.

As it relates to insurance contracts, we would like to point out that historically, the fair value remeasurement requirement on the date of a business combination is typically accomplished through an estimation of the fair value of insurance contracts assumed using a variety of valuation practices and procedures and not by reference to specific market-observable prices for the same or similar insurance contracts. Once estimated, the fair values of all assets acquired and liabilities assumed are reconciled to the purchase price (which results from a third-party market-based transaction). While acquirers make every reasonable attempt to estimate the fair value of insurance contracts assumed, the absence of observable market-based data and standard valuation practices and procedures for insurance contracts leads to valuation practice diversities.

In addition, business combination accounting for insurance contracts would not support "Day 2" and thereafter remeasurements at fair value as the market-based transaction occurs only on the business combination date.

Accordingly, we believe it will ultimately be necessary for the IASB to synchronize the conclusions in the DP related to measurement if it concludes that CEV is equivalent to fair value with the requirements to remeasure insurance contracts at fair value in business combinations. In contrast, if the IASB ultimately determines that CEV is not equivalent to fair value or that fair value is not an achievable measurement objective as it relates to insurance contracts due to the absence of sufficient market-based data, it would need to consider

expanding the scope exception for fair valuing liabilities assumed at date of acquisition to include insurance contracts.

We believe the IASB should also consider stating explicitly that insurance contracts involved in a business combination should not be considered or otherwise treated as new for purposes of amortizing the present value of future profits (or value of business acquired). In contrast, a business combination should only trigger a re-measurement of the carrying value of insurance contracts to reflect current economic factors at the date of the combination, and, absent any modification to the terms of insurance contracts, should not trigger a re-evaluation of the nature or classification of insurance contracts (whose original terms typically remain unchanged). This is consistent with the treatment of leases in business combinations. Once a contract has been evaluated and accounted for as an insurance contract, it should continue to be accounted for as an insurance contract, and there should be no requirement to reassess risk transfer.

In the case of any *acquisition premium* related to UPR on acquired non-life contracts, the IASB should clarify that this acquisition premium should not be aggregated with the reserve discount and risk margin, but rather should be evaluated for impairment separately using a premium deficiency reserve evaluation. Moreover in the case of the discount rate, it should not be "un-locked" after the acquisition date; consistent with the practice for debt.

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**Q10: Do you have any comments on the measurement of assets held to back insurance liabilities?**

We believe life insurers should have the option to measure assets and liabilities on a consistent basis. For example, certain assets including investments in real estate, mortgage loans, and policy loans which support insurance liabilities may be measured using a different measurement basis leading to accounting mismatch. As such, certain elements of the change in insurance liabilities should be permitted to be recognized directly in equity to avoid potentially significant accounting mismatches.

The IASB has indicated on many occasions its support for CEV-based measurement approach as the one providing more relevant and reliable information. However, the Board has not provided sufficient credible research to support this position. Issues and problems encountered by preparers implementing SFAS 157, especially as it relates to Level 2 and 3 guidance, is evidence that CEV may not always be the most reliable and relevant measurement basis.

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**Q11: 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?**

(a) Yes, we believe that for life insurance contracts, risk margins should be determined for a portfolio of insurance contracts, as opposed to individual insurance contracts, in order to reflect the benefits of diversification within the portfolio. Measuring risk margins for a portfolio is consistent with insurer's pricing and risk management. The essence of insurer's business is to pool the risks resident in individual contracts. This is consistent with the fact that insurers do not price individual contracts in isolation, but rather price them with a view to including them in a portfolio.

In this regard, the definition of a portfolio should be broad enough to include the level of risk aggregation at which a company manages and prices its insurance risks, and it should reflect the benefits of diversification within that portfolio. We note that there are broadly different interpretations of what constitutes "broadly similar risks and managed together as a single portfolio." Therefore, IASB should conduct field studies and develop a working definition of a portfolio that incorporates the concepts of (a) group pricing, (b) managing risks, (c) allocation of capital and other resources by Chief Operating Decision-maker (CODM), and (d) diversification benefits.

We believe it is generally impossible to determine what a hypothetical third party transferee would determine as the compensation it requires for bearing risk, as well as the level of risk aggregation the hypothetical third party would use to price products and manage risks. From a total enterprise perspective, the level of risk aggregation for the purposes of pricing and managing insurance business is different for a well diversified multi-line insurer with both life and non-life operations from that of a purely life or non-life insurance company. Thus, a principles based definition of a portfolio should be broad enough to allow the experienced actuary the opportunity to make sound professional judgments as to the appropriate level at which to compute risk margin based on the economics of pricing and risk management.

(b) Yes, we believe that for life insurance contracts risk margins should reflect the benefits of diversification and negative correlations among portfolios to the extent they are reflected in pricing. This is inherent in the principle of calibrating margins to premiums, as discussed in the response to Question 4. GNAIE's position is supported by the following:

- A reasonable hypothetical third party would assume that insurers' portfolios are diversified and that there are correlations between the portfolios that reduce the overall risk margin/uncertainty in the timing and amount of the cash flows. Consistent

with risk margin implementation (a) of the DP, the risk margin should be calibrated to premium so produce no gain at issue.

- Diversification benefits are consistent with the "law of large numbers" as an operating principle of insurance. Insurers do not issue a single insurance contract – if insurers did, the contract would be priced much higher than if sold to a larger group of policyholders. This reflects the reality that the larger the number of risks insured, the lower the potential variability of the results. This reduction in variability due to larger number of risk exposures is reflected in the premiums charged, and should also be reflected in risk margins. As risks are spread over a larger population of policyholders, the impact of increasing risk exposures due to the expected claims and claims expense component of the premium charged, as well as the average fixed costs of the insurer, is lower.

- Other market participants would also likely enjoy the benefits of diversification. Thus, the CEV could be determined "independent of the entity that holds the asset or liability" and still reflect the effects of diversification. By restricting the unit of account to an individual portfolio, the assumption by the IASB is that a market participant would view each portfolio as a separate purchase, and not purchase a group of portfolios to participate in the benefits of diversification. This does not reflect an accurate depiction of a potential market, since most insurers and reinsurers look to diversify within and across portfolios. If a diversified company has less overall risk, the lower risk should be reflected in the risk margin.

- Portfolio diversification refers to the concept that the aggregate risk margin for all of a company's portfolios would be less than the sum of the risk margins calculated for the individual portfolios if each portfolio were considered to be a stand-alone business. While it is appropriate to consider an individual portfolio as the unit of account, the risk margin for each individual portfolio should reflect the benefits of diversification. Risk margins should reflect diversification and imperfect correlations (i.e., correlation coefficient [r] is less than 1) between the portfolios. For example, suppose that the risk margin for portfolios A and B are $20 and $30 respectively, and the risk margin for aggregate portfolios AB is $45. The total risk margin included in the CEV liability would be $45 to reflect the fact that the measure of uncertainty on the amount and timing of cash flows across the combined cash flows is less uncertain than if the risk margins were computed assuming each portfolio were a stand-alone business. When pricing product AB, the insurer will include a risk margin of $45 as opposed to $50 to reflect the benefits of diversification.

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**Q12: (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.**

(a) No, a cedant should not measure reinsurance assets at current exit value. The measurement basis should be consistent with the measurement basis for insurance liabilities. As previously stated in the response to Question 2, we do not believe CEV is an appropriate measurement basis for all insurance liabilities.

(i) While the risk margin risk margin does increase the measurement of a reinsurance asset, in all cases, it may not equal the risk margin for the corresponding part of the underlying insurance contract depending upon the nature of the reinsurance contract. In situations where the reinsurance contract is a straightforward prorata arrangement in which there is a direct correlation between the insurance contract liabilities, and reinsurance contract assets are involved, there may be rationale supporting the equivalency of the risk margins since the cedant and reinsurer are sharing a fixed, contractually determined, portion of the same underlying values.

In contrast, in the situation of a more complex reinsurance arrangement, risk margins in a CEV based MM may not be equivalent for reinsurance assets and liabilities. For example, aggregate coverage limits placed in non-proportional reinsurance, and some proportional reinsurance, may result in lower risk margins for the reinsurance contracts with aggregate limits relative to reinsurance contracts that contain no aggregate limits. Furthermore, the differences in terms and conditions, as well as attachment points and other factors, fundamentally change the underlying value of reinsurance relative to ceded business.

In addition, reinsurance coverages may include portions of more than one underlying portfolio or unit of measure, which again causes there to be fundamental differences between the reinsurance exposure and the underlying insurance exposures. These correlation effects may change the valuation of reinsurance assets. Thus, while theoretically the sum of a portfolio of non-proportional covers that replicates the underlying insurance risk should have the same value, in application this in not the way the valuation should be performed.

(b)(ii) Yes, we believe the reduction of reinsurance assets to reflect management's best estimate of expected defaults at the balance sheet date will result in a more appropriate estimate of the value of reinsurance assets. There are typically sufficient default statistics from which to develop reliable best estimates.

(b)(iii) In general, we believe changes in the fair value of risk would be minimal between pricing and effective date of a reinsurance contract and the date a new insurance policy attaches to that reinsurance contract. For proportional reinsurance contracts, and many non-proportional contracts, the reinsurance price is based directly on the insurance price; therefore, reinsurance generally provides coverage consistent with the existing market price. For reinsurance contracts with a fixed price that does not vary with insurance premiums, fair value is unlikely to change materially between pricing and the date a new policy attaches to the reinsurance contract. This is principally due to the fact that the expected claims will not materially change until sufficient time has passed to gather additional claims experience.

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**Q13: If an insurance contract contains deposit or service components, should an insurer unbundled them? Why or why not?**

We do not believe the proposed unbundling in the DP would enhance financial accounting and reporting. In general, we do not believe deposit components within insurance contracts should be unbundled. This position was recently reinforced by comments from users related to FASB's bifurcation project. Following are more reasons why we do not support unbundling:

- Insurance contracts should not be unbundled as unbundling presumes the existence of a discrete, identifiable point where risk transfer ends and non-risk transfer begins. This is only true in an exceedingly limited number of contracts. In contrast, for the vast majority of insurance contracts, unbundling would be extremely complex and costly to apply and would require significant entity-specific judgments that would likely result in a level of practice diversity that render the unbundled information non-comparable and not decision-useful.
- Unbundling of insurance contracts into separate theoretical pieces that are not separately enforceable pursuant to the terms of the legal agreements would not provide decision-useful information to financial statement users.
- Because unbundling would require the identification and separation of unique contract components that are not, nor were they ever intended to be, separable pursuant to the terms of the legal agreements, the theoretical judgments of reasonably competent financial statement preparers will likely differ which will result in a lack of comparability between providers and purchasers of insurance and reinsurance and a lack of representational faithfulness as additional entity-specific judgments and assessments would enter extensively into the unbundling process; both of which would likely impair the relevance and understandability of the affected financial statements.

We do not support the unbundling of insurance contracts as we believe unbundling would likely have the unintended impact of impairing the relevance, representational faithfulness, comparability, understandability, and decision usefulness of financial statements.

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**Q14: (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?**

(a) For the reasons described below, we believe it is not true that the value of an insurance liability is the price for a transfer of that liability that neither improves nor impairs issuer credit characteristics. The measurement of an insurance liability should not reflect changes in credit characteristics.

The DP suggests that few people doubt that the initial measurement of debt issued for cash should reflect the credit characteristics of the debt, and there is no obvious reason to treat insurance liabilities differently. However, there are several important differences. In most jurisdictions, any transfer of insurance liabilities is subject to regulatory approval, and in some cases, policyholder approval may also be required. In virtually all situations, following such an approved transfer, the payment obligations under the transferred contracts would belong to the entity to which the contracts are transferred, and the credit standing of the entity that transferred the contracts would not be relevant.

In the Board's preliminary view (as described in paragraph 232 of the DP), a willing transferee would require a price for a transfer that compensates for an improvement in the credit characteristics of an insurance liability. The transferor may be required to pay such a price by the regulator, as the regulator seeks to protect payments to policyholders. Such a price would be consistent with the reality that obligations to policyholders generally have payment priority over other obligations of the insurer. If the transferor's credit standing is impaired and it is unable or unwilling to pay such a price, it could face sanctions from the regulator. An insurer whose credit standing is impaired could hypothesize transferring insurance liabilities to a market participant that has a similarly impaired credit standing; however, it is unlikely that regulators would allow such a transfer. In general, the transferee would be unable to realize any financial benefit as a going concern from a reduction in the credit standing of its insurance liabilities.

In many jurisdictions, the regulator could also compel payments to policyholders from other sources, such as guarantee fund mechanisms. The regulator might also impose conditions on how the transferee will settle obligations to policyholders. Market participants may have incentives to accept transfers from insurers whose credit standing is impaired for a variety of reasons, which may or may not be reflected in the price at which the obligations are transferred to them. The transferee may be motivated to reduce guarantee fund assessments, to improve working relationships with the regulator, or to minimize adverse public perception about the security of insurance contracts. The transferee may also accept the transfer to gain benefits from other assets of the transferor, such as its distribution system, that may make the transferor more inclined to write other contracts with the transferee following the transfer.

(b) Such credit characteristics should not be reflected in the insurance liability either at time of issue or subsequently. The Board notes (in paragraph 232 of the DP) that credit

characteristics of an insurance liability are unlikely to have a material effect on CEV at inception. This view appears reasonable for highly rated insurers, but less likely to be true for lower rated insurers. Potential policyholders would be less likely to buy insurance if they believe it is reasonably possible that the insurer may not satisfy its obligations in full.

Despite the preceding, we believe that even in the event credit characteristics of an insurer deteriorate after contract issuance, the credit characteristics of the insurance contract itself generally remains unchanged. We acknowledge that a different view may be justified if the contract is not subject to the industry and regulatory safeguards that are described above. However, where such safeguards apply, the question of whether the characteristics of the liability should be considered in estimating the cash flows becomes more of a semantic difference than a difference in the actual measurement. Policyholders can reasonably expect to be paid full value for the insurer's obligation with these safeguards in place, even if the insurer's credit standing has deteriorated. Thus, the insurer will not be able to reduce the amount it pays, either to the policyholder to settle the obligation or to another market participant to transfer the obligation, until and unless it ceases to be a going concern.

This view was substantiated by the International Association of Insurance Supervisors, which expressed that credit standing is not relevant in measuring insurance liabilities, and that it would be misleading to consider it. A measurement basis in which an insurer would report a gain as a result of a reduction in its credit standing or the credit standing of its liabilities would be misleading; mainly because it is difficult to imagine circumstances under which the insurer could realize any such benefit while it is a going concern.

**Q15: 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?**

Given that the IASB is in the final stages of approving a Discussion Paper on Financial Instruments accounting, we are not in a position to respond to this question. We expect that the Financial Instruments DP will put forward the entire body of accounting for these instruments with observations on the current accounting and potential future accounting. We plan to comment on that DP when it is released.

As we review that document, we will be informed by its recommendations and consider their impact on the insurance contracts accounting model. At that time, we will supplement our Insurance Contracts Discussion Paper comments with recommendations on the accounting for financial liabilities.

We recommend that this item be put on an Insurance Working Group agenda.

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**Q16: (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 cash flows used for estimating liabilities should include an unbiased estimate of future policyholder dividends. The requirement for a legal or constructive obligation is unnecessary, and it contradicts the DP's measurement goal of determining the amount that insurers could pay to transfer remaining rights and obligations under specific contracts to unrelated third parties that are both willing and able to accept the contracts. This argument is made more completely in the letter from the European CFO Forum, GNAIE and four Japanese life Insurance companies to the IASB dated December 21, 2006.

This is an example of a situation where local guidance may be needed. The great variety of existing participating schemes makes it extremely difficult to write a general statement that works for all countries. However, a local standard setter might be able to more clearly decide if liabilities should include future dividends, and if so, at what level.

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**Q17: 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).**

Accounting mismatches should be eliminated to the greatest extent possible, and a definition of separate account assets or assets held for other parties should be developed that provides for these assets to be carried at fair value. This would allow for the unit-linked liabilities to be reported at the same value as the separate account assets, thus reflecting their fair value. In regard to the specific examples above:

(a) An exception should be granted for treasury shares held as separate account assets to be carried as an asset on the balance sheet when those shares directly back unit-linked liabilities. This is a reasonable exception since the insurer would presumably not have the intent or ability to cancel these shares or use them for general account purposes. The requirement to hold the shares to support unit-linked liabilities effectively prevents their use as typical treasury shares.

(b) It would generally not be appropriate to have an operating subsidiary of the company as an asset backing unit-linked liabilities. Therefore an exception should not be made to recognize internally-generated goodwill.

(c) It appears appropriate to make an exception to allow assets backing unit-linked liabilities to be reported at fair value through profit or loss, to achieve a matched offset to the fair value changes of the unit linked liabilities in the income statement.

(d) Unit-linked liabilities should be reported at fair value, and there should be no allowance for adjustments that result in a value that is not reflective of fair value.

**Q18: Should an insurer present premiums as revenue or as deposits? Why?**

Insurers should present premiums earned on contracts that meet the definition of insurance as revenues, and not as deposits. For non-life insurance contracts, premium received should be recorded as an UPR, and recognized into income as earned premium revenue over the contract period.

Management and other users of financial statements use earned premiums as a key business metric that helps them to understand and manage the business of insurance. For example, non-life insurers view earned premiums, claims and claims adjustment expenses and underwriting expenses as important benchmarks to measure the volume of insurance business, underwriting risk and return, solvency and effective use of resources. For life insurance, investment results and earned premiums are an integral consideration in pricing and financial analysis. For all insurers, premiums are analogous to a manufacturer's sales revenues, which together with the cost of goods sold, enhance users' understanding of the financial statements and management's decision-making. As an example, just as users of manufacturer's financial statements look to understand the gross margin and cost of sales percentages, users of insurer's financial statements obtain relevant information from claims ratios, expense ratios and combined ratios for strategic, tactical and operational decision-making. Therefore, it is important to emphasize that presenting earned premiums in the income statement of insurers is an important first step for evaluating the volume, growth, profitability, solvency, and the underwriting risks of both the life and non-life businesses.

Premiums for insurance contracts satisfy the definition of revenue under IAS 18, *Revenue* and SFAC 6, *Elements of Financial Statements.* Paragraph 7 of IAS 18 defines revenue as "the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants". Similarly, paragraph 79 of SFAC 6 defines revenue as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations".

Unlike bank deposits, cash received from insurance policyholders on contracts that meet the definition of insurance are not "deposits", in the sense that the amounts do not have to be refunded *if the policy is not canceled during the policy period.* After the policy period expires, the insurer has no further obligation to refund the cash premiums received. However, the cancellation of the policy or reduction in coverage will lead to a proportionate refund of premiums received by the insurer. Therefore, it is more appropriate to label such cash premium receipts from policyholders "*unearned premiums or pre-claims liabilities*" subject to the completion of the earnings process. The business reality is that the insurer, by providing coverage to the insured (a stand-ready obligation), expects to earn the cash premiums received over the coverage period as it is released from risk.

**Q19: Which items of income and expense should an insurer present separately on the face of its income statement? Why?**

Any items of income and expense that an insurer should present separately on the face of its income statement for all insurance contracts should satisfy the conceptual definitions and recognition criteria of income and expense. This should produce one combined income statement for insurers with appropriate segmental disclosures that highlight the key differences between different products.

The income statement should include income or revenue that is earned, and is realized or realizable. In addition, expenses should be recognized when they are incurred. Unrealized gains and losses and other unrealized adjustments should be recognized in the statement of comprehensive income until they are realized in an economic transaction or event.

An appropriate income statement format for insurers would include the following characteristics:

1) Although life and P&C business models may be very different, there needs to be a single format for the basic Income Statement (I/S) since some companies issue both types of insurance.
2) The following lines should be on the basic Income Statement in this order:
    a. **Revenues**
        i. Premiums
            1. Earned (for non-life)
            2. Due (for life)
        ii. Net investment income earned
            1. Securities available for sale and other
            2. Equity securities held for trading
        iii. Realized capital gains and losses
        iv. Other income (Fees for services not included in premium)
        v. Total revenue
    b. **Expenses**
        i. Benefits, claims and claims expenses (incl. change in claims liabilities)
        ii. Change in pre-claims Reserve (for non-life only)
        iii. Acquisition costs
        iv. Other expenses

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v. Dividends to policyholders (on participating contracts)

vi. Interest expense

vii. Total Expenses

**c. Net income before income taxes**

**d. Income taxes**

**e. Net income**

3) The following lines should be on the statement of comprehensive income:

**a. Net income**

**b. Other comprehensive income**

i. Changes in unrealized gain/loss on securities

ii. Cumulative effect of accounting change

iii. Changes in net gain/loss on cash flow hedging instruments

iv. Changes in foreign currency translation adjustment

v. Changes in pension liability adjustment

vi. Other unrealized gains/unrealized losses

vii. Total comprehensive income

The above presentation of the income statement puts all insurance products on a consistent basis. The pre-claims reserve for non-life contracts would presumably be UPR, so that only the portion of the premium for which coverage has been provided would be recognized in earnings.

In summary, the traditional income statement presentations shown in examples 10 (non-life) and 11 (life) of the DP are more appropriate and informative than the illustrations in example 14 on fee presentation and example 15 on margin presentation. Examples 14 on fee presentation and 15 on margin presentation do not display written and earned premiums that are critical for business managers, investors, analysts, creditors and other users of the financial statements. These financial statement line items are particularly important to assess the volume and growth in the risk exposures underwritten by an insurer in relation to underwriting expenses, benefits, and claims and claims adjustment expenses. In addition, they allow for the computation of traditional performance business metrics such as the claims ratio, and combined ratio for planning purposes and decision-making.

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**Q20: Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?**

We believe that this item is relevant only for life insurance liabilities. Material changes in insurance liabilities that are realized or realizable as evidenced by an economic event or transaction should be presented in the income statement. The following are the components of changes in insurance liabilities that should be included in the "change in reserve" line item in the income statement.

1. **Unlocking of assumptions underlying future cash flow projections** – a premium deficiency or liability inadequacy claims should be reflected in the income statement. However, where the assets supporting the liability are on an "available for sale" basis, the movement in liability values due to changes in interest rates should be shown in other comprehensive income, and not in earnings.

2. **Experience variances** – experience variances that result from differences between projected cash flows and actual cash flows should be recognized in the income statement.

3. **Unwinding of discount** – Accretion expense (i.e., unwinding of discounting) should be presented as part of the related expense (e.g., claims expense) and recognized in the income statement.

4. **Changes in risk margins or provision for adverse deviations** – The profit and risk margin that form part of the pre-claims liability should be recognized over the coverage period. The provision for adverse deviation on the post-claims liability should also be recognized in the income statement as the insurer is released from risk.

5. **Premiums -** The portion of premiums that go to increase claims liabilities.

6. **Claims incurred (reported or not reported) –** Reserves released as a result of claims payments.

As stated above, we do not believe that an insurer should recognize an accounting gain at the inception of an insurance contract because such a gain is artificial, and it is based on an insurer's subjective assumptions as to how much a hypothetical market participant will charge to assume the insurance liability. Therefore, it is not appropriate that an accounting gain at inception should be part of the income statement or the statement of comprehensive income.

**Q21: Do you have other comments on this paper?**

**Definition of Insurance**

We are assuming that the definition of insurance in IFRS 4 will not change. Should the IASB decide to revisit this definition, we will need to take any new definition into account.

**Field Testing**

The IASB should undertake field-testing as part of a carefully considered due process surrounding the continued development of the standard and its subsequent adoption. The fundamental nature of the changes proposed is such that the IASB should not be bound by conventional procedures in developing a new standard. In order to achieve a workable solution that meets the requirements of all the relevant constituents, it will be necessary to introduce a comprehensive field-testing plan alongside ongoing dialogue with preparers and users of accounts. We are happy to work with you in this regard to arrive at an effective solution.

**Solvency II**

While we appreciate the linkage between the DP proposals and the proposed Solvency II regime in the European Union, we urge the IASB to give equal weight to all parts of the world in developing a converged international accounting standard for insurance contracts.

**Other Accounting Standard Setter Projects**

As acknowledged in the DP, insurance must be coordinated with other projects, including projects on the conceptual framework, revenue recognition, liabilities and equity, financials instruments, and financial statement presentation. Insurance needs to be considered in each of these important projects. As well, the insurance accounting contracts projects should consider each of these projects.

Similarly, the IASB and FASB should consider the impact of the DP on the FASB's insurance projects related to Insurance Risk Transfer and Financial Guarantee Insurance. The FASB's tentative conclusions on financial guarantee insurance contracts differ significantly from the IASB's tentative conclusions on accounting for insurance contracts (the DP), which should be reconciled.

**Transition**

Many existing insurance systems are not able to perform different, or new, calculations or measurements without significant modifications. As well, comparative financials and comparison to previous reported results will be needed in order for users to understand these changes. Accordingly, significant time for transition to any new accounting standard will be needed.

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