DAI-ICHI LIFE

The Dai-ichi Mutual Life Insurance Company
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31 October 2003

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

Re: Comments on the ED5 Insurance Contracts

Dear Sir David,

This letter provides you with our comments on the ED5 Insurance Contracts. We respect the efforts of the International Accounting Standards Board to develop global accounting standards, and appreciate this opportunity to comment on the Exposure Draft.

The Dai-ichi Mutual Life Insurance Company was founded in 1902 and is the oldest mutual life insurer in Japan. Its total asset was approximately ¥28 trillion (.150 billion) at the end of fiscal year 2002.

Phase I of the Insurance Project is supposed to be a tentative standard developed to be put in place by 2005 when the EU will adopt the IFRSs. However, since the ED5 includes the direction of the final Phase II standard, we would like to take this opportunity to express our views on both Phase I and Phase II.

Yours sincerely,

Kazuma Ishii
Director

# I. General Remarks

The essence of insurance business is to render the service of insurance protection by assuming the risk from a large number of individual policyholders incapable of accepting the risk, and thereby organising group of insurance contracts to diversify the risk quantitatively and over time.

Insurance contracts meet the definition of financial instruments in that insurance contracts stipulate an exchange of cash flows. However, policyholders purchase insurance contracts as a means of hedging the risks which they cannot hedge individually, even if the insurance contract would be economically disadvantageous to the policyholder in terms of pure cash flows. In other words, the purpose for policyholders to purchase insurance contracts is not to expect gains from insurance benefits, but to receive the service of insurance protection provided by insurers even if the policyholders bear the price of the service provided. This difference in risk tolerance between sellers (insurers) and buyers (policyholders) is the servicing feature inherent in insurance contracts, whereas this feature is less common in generic financial instruments with little difference in their value for sellers and buyers.

To develop a useful insurance accounting standard that faithfully represents insurance business activities, the Insurance IFRS should employ an accounting model in which revenue from insurance business is recognised in each period as it is realised depending on the provision of insurance services.

Unfortunately, these characteristics of insurance business have not been fully considered in the IASB's deliberation. Illiquid insurance contracts without an active secondary market have been treated in the same way as other generic financial instruments. This results in the wrong idea forming the basis of the IASB's deliberation that insurance contracts can be evaluated simply by the present value of future cash flows based on current estimates. We are seriously concerned about this situation where an inappropriate accounting standard, which does not faithfully portray the underlying business activity, is being developed.

The remainder of this paper specifies the issues and presents our proposals.

## II. Specific Remarks

### 1. Fair Value

*The problems of fair valuation*

We are opposed to fair value accounting for insurance contracts. In general, the IASB's deliberation seems to be based on the given assumption that fair value is the best measurement basis under any circumstances. The definition of fair value by the IASB is "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." However, in the case of insurance contracts, since there is not an active secondary market and not even similar items with observable market price, the very existence of fair value that meets the IASB's definition above is doubtful. Even if the risk-adjusted expected present value of future cash flows arising from insurance contracts is referred to as "fair value", the "fair value" would involve the following fundamental flaws:

- Fair valuation for insurance contracts regards insurance contracts as trading instruments and insurance business as an activity of short-term profit taking by trading insurance contracts. Needless to say, since this presumption is far from the reality of insurance business, fair value accounting for insurance contracts is not relevant. In addition, the volatility in profit or loss arising from fair value measurements for insurance contracts, which does not reflect the substance of insurance business activities, would undermine the understandability as well as relevance of financial statements.
- Fair valuation for insurance contracts lacks reliability (objectivity and verifiability) due to the absence of an active secondary market, and would impair the comparability of financial statements among entities.
- Fair valuation for insurance contracts, which hold a servicing feature, is inappropriate, because it implies recognition of revenue, arising from future premiums not yet received from policyholders, for the future services of insurance protection not yet provided to policyholders. This problem indicates that the very measurement basis of fair value is inappropriate for insurance contracts with a servicing feature; this problem cannot be solved fundamentally by the artificial restriction proposed by the Board to avoid profit recognition at inception, which sets a lower limit in the measurement of fair value for insurance contracts. Forced valuation of non-marketable items at market value is reminiscent of the recent accounting scandals that occurred in the US.
- Fair valuation for insurance contracts is doubtful in its feasibility. No country has implemented the IASB's fair value accounting for insurance contracts. No practical study has been performed.

*Fair value disclosure in Phase I*

We are opposed to fair value disclosure in Phase I since fair valuation for insurance contracts involves a number of significant problems as indicated above. Besides, it is beyond our understanding that the

Board requires an insurer to disclose the fair value of insurance contracts despite the fact that the Board recognises that "The Board must resolve several significant issues about fair value, both conceptual and practical, in phase II." (BC 140) The disclosure of variously defined "fair value" would confuse users rather than provide them with comparative and useful information.

*The term "fair value"*

The term "fair value" might give the impression that "fair value" is fair and non-"fair value" is not fair. The term "fair value" should not be used since it could harm fair discussion.

## 2. Consistency with the IASB Framework

The ultimate goal of standard-setting is to define useful financial statements that faithfully represent business activities, not to pursue superficial consistency with the IASB Framework.

The Board tentatively agreed in January 2003 to adopt a fair value accounting model for insurance contracts under an asset-and-liability approach. The basis for this tentative conclusion seems to be simply the consistency with the definition of assets and liabilities in the Framework. However, we do not believe that the proposed fair value model meets the qualitative characteristics of financial statements also set out in the Framework. (i.e., relevance, reliability, comparability and understandability.)

The definition of liabilities in the Framework is "a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits." However, in the case of insurance contracts involving ultra long-term uncertainties, it should be questioned first whether it would provide useful accounting information to estimate the amount of actual outflow of resources complying rigidly with the definition in the Framework and to recognise the liability only up to the uncertain estimated amount. We urge the Board to reconsider the appropriateness for insurance contracts of the existing definitions of assets and liabilities in the Framework in its Phase II deliberation.

## 3. Due Process

*Reflecting constituencies' opinions*

More dialogues with constituencies are needed to develop appropriate insurance accounting. Since insurance business is of a public and unique nature, the input of expertise from regulators and practitioners is essential. Specifically, we propose that the Board should directly discuss comment letters from industry associations and others in its meetings, consult the Insurance Advisory Committee for critical issues before making decisions and hold public round table discussions for controversial issues.

*Deliberation premised on fair value accounting*

Despite the fact that recognition and measurement for insurance contracts are Phase II issues, the IASB seems to be based on the given assumption that fair value accounting is the most appropriate for insurance contracts as follows:

- In the Board's view, fair value ... is the only method that provides sufficient transparency in the financial statements. (BC119)
- This proposal is intended ... to encourage insurers to begin work on fair value systems to avoid the need to provide a long transition period for phase II. (BC138)
- Disclosure of the fair value of insurance liabilities and insurance assets will provide relevant and reliable information for users, and this would still be the case even if phase II does not result in a fair value model. (BC139)

It is not fair that the predetermined conclusion excludes the process of discussing alternatives. We strongly recommend that the Board should change this stance.

## 4. Miscellaneous

From a preparer's perspective, we also believe that the IASB proposal involves significant problems as follows:

- Under the fair value accounting for insurance contracts, amounts in the financial statements could significantly fluctuate even if the management does not change the management policies. Financial statements in which the liabilities significantly fluctuate depending on the market condition involved is meaningless for the management objective to fulfill the ultra long-term obligations of providing insurance coverage with policyholders.
- Excessive requirements of disclosure would violate the intellectual properties of an entity. This could undermine sound competition that serves public interest.

## III. Our proposal

We have indicated as above the problems inherent in fair value accounting for insurance contracts. Consequently, we would like to propose an alternative accounting model, in which the measurement employs pricing assumptions used at inception in conjunction with loss recognition tests. We hope that the Board will consider this model since it has the following preferable properties:

- This model, in which revenue is recognised as insurance services are provided, is in line with the underlying insurance business activity. This model, in which the differences between pricing assumptions and experiences are recognised as they are realised, provides users with relevant and useful information.
- The measurement is highly reliable since pricing assumptions are specified. Due to the ultra long-term uncertainties in insurance contracts, reliable pricing assumptions provide more useful financial information than subjective estimates for the far future.
- This model, in which probable future losses indicated by cash flow testing are recognised immediately, is transparent.
- This model, a proven accounting model implemented in several jurisdictions, is feasible and incurs little implementation costs.
- This model does not recognise profits at inception in its nature. This model is relatively easy to harmonise with regulatory accounting and meets the needs of a wide range of users.

*Assets backing insurance liabilities*

To establish insurance accounting that faithfully represents insurance business activities, the treatment of assets held by insurers to back the long-term nature of insurance liabilities should also reflect the underlying business activity. In Japan, in the introduction of market value accounting for financial instruments, the category of the Debt Securities Earmarked for Policy Reserve, considering the unique characteristic of insurance business, was established and it does work. Creating the new category of assets backing insurance liabilities would be appropriate in the application of IAS 39 to insurers.

# IV. Response to Invitation for Comments

**Question 1 - Scope**

(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting by policyholders (paragraphs 2-4 of the draft IFRS and paragraphs BC40-BC51 of the Basis for Conclusions).

The Exposure Draft proposes that the IFRS would not apply to other assets and liabilities of an entity that issues insurance contracts. In particular, it would not apply to:

(i) assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*.

(ii) financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts (paragraphs BC115-BC117).

Is this scope appropriate? If not, what changes would you suggest, and why?

**Response**

**It is not appropriate that the draft IFRS would apply to insurance contracts. To faithfully portray the insurance business activity as a whole, the IFRS should apply to insurance business including the treatment of assets backing insurance liabilities rather than insurance contracts.**

**Apparently, the mismatch arising from the difference in measurement bases between assets and liabilities does not represent the business reality. It should be noted that this issue is caused by the fact that the IFRS applies to insurance contracts instead of insurance business.**

**In addition, existing insurance accounting practices that apply to insurance business should not be denied, because Phase I does not intend to change existing practices dramatically.**

(b) The Exposure Draft proposes that weather derivatives should be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract (paragraph C3 of Appendix C of the draft IFRS). Would this be appropriate? If not, why not?

**Response**

**No comment**

**Question 2 – Definition of insurance contract**

The draft IFRS defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary' (Appendices A and B of the draft IFRS, paragraphs BC10-BC39 of the Basis for Conclusions and IG Example 1 in the draft Implementation Guidance).

Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?

**Response**

**The definition is not appropriate. The essence of insurance business is to render the service of insurance protection by assuming the risk from a large number of individual policyholders incapable of accepting the risk, and thereby organising group of insurance contracts to diversify the risk quantitatively and over time. To develop an appropriate insurance accounting standard that would faithfully portrays the insurance business activity, we propose that insurance business should be defined as a business with these characteristics and that the Insurance IFRS should apply to insurance business rather than insurance contracts.**

**In Phase I, defining insurance contracts itself is inappropriate since it could significantly change existing national practices and contradict the Phase I objectives.**

**Question 3 – Embedded derivatives**

(a) IAS 39 *Financial Instruments: Recognition and Measurement* requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:

(i) meets the definition of an insurance contract within the scope of the draft IFRS; or

(ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

However, an insurer would still be required to separate, and measure at fair value:

(i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and

(ii) an option to surrender a financial instrument that is not an insurance contract.

(paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)

Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

**Response**

**It is not appropriate to make exempt only limited embedded derivatives from the requirements of IAS 39. Separating embedded derivatives is contrary to the Phase I objective since separation is difficult to implement without undue cost and effort and could be reversed in Phase II. All derivatives embedded in insurance contracts should be exempt from the requirements of IAS 39.**

(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). Is it appropriate to exempt these embedded derivatives from fair value measurement in phase I of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase I?

**Response**

**Same with the above response (a).**

(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs IG54-IG58 of the draft Implementation Guidance). Are these proposed disclosures adequate? If not, what changes would you suggest, and why?

**Response**

**The proposals are not appropriate. Evaluating embedded derivatives is difficult even for disclosure purposes.**

(d) Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?

**<u>Response</u>**

**Same with the above response (a).**

**Question 4 – Temporary exclusion from criteria in IAS 8**

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for:

(i) insurance contracts (including reinsurance contracts) that it issues; and

(ii) reinsurance contracts that it holds.

(paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions).

Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?

**<u>Response</u>**

**It is not appropriate to set a deadline for the exclusion. The possible risk of delay in Phase II project should not be ignored. Nobody can justify taking the risk to cause chaos in insurance accounting. We are also concerned about the worst case scenario that the Board would not discuss Phase II sufficiently and rush to standadise it just in order to meet the deadline.**

(b) Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:

(i) eliminate catastrophe and equalisation provisions.

(ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies.

(iii) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC58-BC75 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you propose, and why?

**Response**

**It is not appropriate to eliminate catastrophe and equalisation provisions.**

**Catastrophe and equalisation provisions are well established in national GAAPs which are not necessarily based on IASB Framework. Therefore, eliminating these two provisions simply due to the superficial inconsistency with the definitions of assets and liabilities in IASB Framework would impair the integrity of the overall accounting standards of national GAAPs.**

**Question 5 – Changes in accounting policies**

The draft IFRS:

(a) proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).

(b) proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss (paragraph 35 of the draft IFRS).

Are these proposals appropriate? If not, what changes would you propose and why?

**Response**

**It is not appropriate to permit an insurer to change its accounting policies for insurance contracts by the criteria of relevance/reliability. We are concerned that the arbitrariness in the judgement for relevance and reliability could deteriorate the quality of financial statements. We believe that it is the most effective in Phase I to require an insurer to comply with its national GAAP so as to maintain the order of insurance accounting.**

**The proposal to permit an insurer to reclassify its financial assets is not appropriate. The proposal is applicable only for the case when an insurer adopts fair value measurement for insurance contracts. However, as indicated above, we do not believe the fair value measurement meets the relevance/reliability criteria. At least, it is not appropriate to adopt this relaxation of requirement before reaching conclusions for recognition and measurement in Phase II.**

**Question 6 – Unbundling**

The draft IFRS proposes that an insurer should unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet (paragraphs 7 and 8 of the draft IFRS, paragraphs BC30-BC37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).

(a) Is unbundling appropriate and feasible in these cases? If not, what changes would you propose and why?

**Response**

**We disagree with all unbundling. Insurance contracts are assumed as a whole. An artificial separation does not reflect the actual insurance business activity. In addition, unbundling is contrary to the Phase I objective since it is difficult to implement without undue cost and effort and could be reversed in Phase II**

(b) Should unbundling be required in any other cases? If so, when and why?

**Response**

**Unbundling should not be required under any circumstances.**

(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

**Response**

**It is not clear. Unbundling should not be required under any circumstances since the criteria could be interpreted in one's favor.**

**Question 7 – Reinsurance purchased**

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).

Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?

**Response**

**It is not appropriate to prescribe recognition and measurement requirements partially for**

**reinsurance arrangements before reaching conclusions for overall recognition and measurement in Phase II.**

**Question 8 - Insurance contracts acquired in a business combination or portfolio transfer**

IAS 22 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 *Business Combinations* proposes to continue that long-standing requirement. The Proposals in this draft IFRS would not exclude insurance liabilities and insurance Assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and

(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. Its subsequent Measurement would need to be consistent with the measurement of the Related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.

The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you suggest and why?

**<u>Response</u>**

**It is not appropriate to apply IAS 22 without modification to insurance contracts at the present stage when the definition of fair value for insurance contracts is uncertain.**

**Question 9 – Discretionary participation features**

The proposals address limited aspects of discretionary participation features

Contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this Project.

Are these proposals appropriate? If not, what changes would you suggest for
Phase I of this project and why?

**Response**

**The proposals are not appropriate. We disagree with any Phase I standards for discretionary participation features since the deliberation for these features is not sufficient.**

**Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities**

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).

Is it appropriate to require this disclosure? If so, when should it be required for
the first time? If not, what changes would you suggest and why?

**Response**

**The proposal is not appropriate. The disclosure of fair value for insurance contracts, which does not reflect the characteristics of insurance business activities, could mislead users. Besides, it is beyond our understanding that the Board requires an insurer to disclose the fair value of insurance contracts despite the fact that the Board recognises "The Board must resolve several significant issues about fair value, both conceptual and practical in, phase II." (BC 140) The disclosure of variously defined "fair value" would confuse users rather than provide them with comparative and useful information.**

**Question 11 – Other disclosures**

(a) The Exposure Draft proposes requirements for disclosures about the amounts in the insurer's financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of the draft Implementation Guidance).

Should any of these proposals be amended or deleted? Should any further disclosures be required?

Please give reasons for any changes you suggest.

To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.

**Response**

**The proposals are not appropriate. For more useful disclosure to users, we propose to delete the disclosure of the information premised on fair value measurement for insurance contracts and the information involving undue cost and effort that provides users with little value. We also propose to delete the disclosure of confidential proprietary information, which could undermine the sound competition in the industry.**

(b) The proposed disclosures are framed as high level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements.

Is this approach appropriate? If not, what changes would you suggest, and why?

**Response**

**No comment**

(c) As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS (paragraphs 34, BC134 and BC135).

Should any changes be made to this transitional relief? If so, what changes and why?

**Response**

**No comment**

**Question 12 – Financial guarantees by the transferor of a non-financial asset or liability**

The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS

39 *Financial Instruments: Recognition and Measurement* to a financial guarantee that it gives to the transferee in connection with the transfer (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or liabilities.

Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

**Response**

**No comment**

**Question 13 – Other comments**

Do you have any other comments on the draft IFRS and draft Implementation Guidance?

**Response**

**See I. General Remarks, II. Specific Remarks and III. Our Proposal.**