October 31, 2003

Comments on "Insurance Contracts" in IFRS Exposure Draft

Sumitomo Life Insurance Company

Sumitomo Life Insurance Company (Sumitomo Life) would like to express its respect for the efforts made by the International Accounting Standards Board (IASB) to prepare international accounting standards, as well as its appreciation for being given the opportunity to comment on the exposure draft concerned.

The comments put forth here are those of Sumitomo Life. Sumitomo Life is one of the largest life insurance companies in Japan. Sumitomo Life belongs to The Life Insurance Association of Japan (LIAJ) and supports the opinion of LIAJ.

I. Executive Summary

Our fundamental views and opinions on each question are as follows:

- Insurance IFRS should properly indicate the overall financial standing of an insurer. Therefore, the scope of Insurance IFRS should not be limited to insurance contracts alone. Accounting standards should reflect the unique characteristic of the insurance business.

This proposal comes as a reaction to the current Board's view that insurance contracts should be treated as being the same as other financial products. This does not take into consideration the primary characteristic of the insurance business. A unique characteristic of the insurance business is that it receives premium for providing policyholders with a security, by assuming individual risks through the reduction and diversification of the risks for a large number of contracts by underwriting them.

- Some matters in the Exposure Draft should be discussed anew during Phase II because the Exposure Draft contains some matters that already anticipate the direction of Phase II, which we have been led to believe has not been decided yet. (ex. Definition of an insurance contract, Unbundling, 'Fair value' assessment of insurance liabilities, and Disclosure of 'Fair Value' of insurance liabilities.)

The Exposure Draft states, "insurance measurement methods are based on fair value". These descriptions are not appropriate. Because they result in misleading that they have already obtained public agreement, although no consensus is obtained regarding the methods of recognition and measurement for insurance liability.
For example, there is a description that "In the Board's view, fair value is the only relevant measurement basis for derivatives, because it is the only method that provides sufficient

transparency in the financial statements." Concerning fair value assessment of insurance liabilities, It should be noted that the problems exist such as that since there is no brisk secondary market for insurance contracts, the assessments would not have sufficient objectivity and verifiability, that since long-term insurance liabilities would be assessed based on suppositions made at a single point in time, the assessments would be greatly influenced by conditions such as fluctuations in interest rates and therefore lacking in the possibility of being understood and conformity with objectives and so on. These problems have not been solved yet.

Requiring the disclosure of fair value in Phase I is not also appropriate, because Phase I's IFRS included no rules of recognition and measurement and did not stipulate anything regarding the fair value of insurance liabilities. Fair value disclosure should be discussed anew after the recognition and measurement standards have been determined in Phase II.

And more, it is not appropriate to provide Sunset Clause in Phase I, assuming that the Phase II review will be completed after a fixed period of time. We concerned that Sunset Clause will make the lack of enough deliberations to establish more useful accounting standard in Phase II.

- In the application of IAS39, we think that there is a need for appropriate measures. For example, in order to escape from the mismatch between assets and liabilities, we suggest the establishment of a new category for assets to counterbalance insurance liabilities or the relaxation of conditions concerning bonds to be held to maturity.

- To establish a more useful accounting standard, we would like to ask you to establish a system that will reflect useful outside opinions appropriately in the deliberations. We would like to see the written comments that the insurance industries of respective countries have prepared taken into account and more consultation with the Insurance Advisory Committee.

This is because the opinions of the insurance experts have not been reflected in the deliberations. It is essential that insurance experts participate adequately in the preparation of insurance accounting standards as the insurance industry is to a great degree a public service and has unique qualities.

II. Replies to the Questions Presented

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?
(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?

<Comment>
The contents of the proposal are not appropriate.
Phase I is supposed to consider the existing accounting systems in respective countries as its basis, so that there would not be a need to make major changes that would require a reversal of contents when Phase II is completed. Phase I respects the existing practices (accounting as practiced for the insurance business) in respective countries.
When the proposal for measurements of the exposure draft concerned is applied above and beyond the application of the standards of respective countries, it is necessary to ensure that the legitimacy of insurance accounting as a whole is not diminished. This should be the standard that stipulates the scope.
The holding of assets to counterbalance insurance liabilities, which is a measure to avoid mismatches of assets and liabilities, should not be prohibited.

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?

<Comment>
The contents of the proposal are not appropriate.
The definition of an insurance contract should not be made in Phase I.
Having IFRS determine the definition of insurance is itself a departure from the intent of Phase I, which is based on the principle of maintaining the existing accounting systems of respective countries.
In Phase I, everything that is an insurance contract under existing practices should be the subject of Insurance IFRS.

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?

(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?

(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?

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

<Comment>
The contents of the proposal are not appropriate.
An insurance contract (host contract) and its embedded derivative usually cannot be separated or are difficult to separate. If they were to be separated forcibly, it is possible that the separation of embedded derivatives would cause major changes to existing accounting standards; be accompanied by major system changes; and incur tremendous labor and cost. In addition, there will also be points, such as the definition of a derivative and the scope of separation, that will remain and require further deliberation until Phase II; therefore, there is the possibility that changes will be made in Phase II. It is because of the two points noted here that the separation of embedded derivatives contradicts the

intent of Phase I.

Instead of the exemption of only some embedded derivatives from the application of IAS 39's requirements, all embedded derivatives of contracts currently treated as insurance contracts should be exempt from the application of IAS 39's requirements.

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?

<Comment>

The overall contents of the proposal are not appropriate.

It is appropriate to grant this exemption but we oppose the establishment of a deadline for it. The situation is such that Phase II has not produced any final conclusions by the Board regarding the completion of standards and the date for the commencement of application. At this current stage, the establishment of the exemption period to be until 2007 lacks any convincing basis.

If Phase II has not been completed by the deadline to end the exemption, it would cause unnecessary confusion among preparers and users.

Catastrophe and equalization provisions should not be prohibited in Phase I. Accounting standards should be studied based on a comprehensive balance of the whole. Therefore, eliminating only catastrophe and equalization provisions, a portion of the whole, would destroy the overall balance.

In applying IAS 37, it is necessary to hypothesize future cash flow. However, problems similar to those unresolved issues concerning the measurement of fair value will arise in the assessment of options held by the policyholder, such as surrender and the right of renewal. Since the loss recognition test is closely tied to the principle of recognition and measurement, existing business practices should be maintained in Phase I, as they are similarly for the principle of recognition and measurement.

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?

<Comment>
The contents of the proposal are not appropriate.
Since the definitions of conformity with objectives and credibility are ambiguous and there is the possibility of ambiguity in the judgment of their sufficiency and propriety, there is the danger of inviting changes in accounting policies that are "only for the benefit of self-interest" capriciously according to the situation. Therefore, changes in the accounting policies should not be tolerated in Phase I.
There is also the fear that insurance accounting as a whole will lack legitimacy if only the reclassification of financial assets in only one way (the reclassification of changes in fair value into categories that recognize them as profits or losses) is permitted when changing accounting policies for insurance liabilities.

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?
(b) Should unbundling be required in any other cases? If so, when and why?
(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

<Comment>
The contents of the proposal are not appropriate.
There will also be points, such as the definition of what requires unbundling and the scope of separation, that will remain and require further deliberation until Phase II; therefore, there is the possibility that changes will be made in Phase II. Consequently, unbundling contradicts the intent of Phase I.

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?

<Comment>
(None in particular)

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?

<Comment>
These proposals are not appropriate.

IAS 22 *Business Combinations* presupposes the use of the purchase method based on fair value, but there is no established method of measuring the fair value of insurance liabilities. Therefore, it is inappropriate at present to apply IAS 22 *Business Combinations* to insurance contracts.

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

<Comment>

These proposals are not appropriate.

It is inappropriate to prematurely establish any standards in phase I on the matter of "Discretionary participation features" that has not been fully discussed and for which no consensus has been built in either the former Insurance Drafting Committee or in the present IASB.

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 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?

<Comment>

It is not appropriate to require such disclosure.

All proposals in phase I should be based on the current accounting practice. Thus, the scope of disclosure should be limited to the extent that is possible within the framework of the current practice. Since no provisions are made for recognition or measurement in phase I, disclosure of the fair value should only be discussed after the standards for recognition and measurement are established in phase II.

As regards insurance liabilities, issues about the credibility of evaluating their fair values have not been resolved due to the lack of active secondary markets. We are concerned that requiring disclosure of such fair values might cause unnecessary confusion to the users of financial statements.

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.

(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?

<Comment>

These proposals are not appropriate.

Many of the proposed disclosures (disclosures of confidential proprietary information and fair value information, and disclosure requirements that are based on the measurement of fair values) would provide almost worthless information or cause misunderstanding amongst the users of financial statements. These paragraphs regarding disclosures should be deleted.

Disclosure of details on future cash flow, required by the second disclosure principle, is not appropriate. Even in applying existing disclosure requirements in other IFRSs to insurance, care should be taken to avoid disclosure items that will impose excessive burden on insurers.

Recognition and measurement models impact on the estimation of future cash flows. Disclosure of future cash flows lacks comparability and is thus misleading as no recognition and measurement models are established.

In phase I, disclosures should not be based on the current accounting practice.

Care should be taken to avoid spending unnecessary time and expense when supplementing the disclosure standard with Implementation Guidance. The guidance should only present minimum examples and leave the decision on further disclosures to preparers.

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 BC41-46 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?

<Comment>
(None in particular)

Question 13 – Other comments

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

<Comment>
In elaborating accounting standards, it seems that the IASB often gives priority to theoretical consistency to the detriment of feasibility and efficiency (cost effectiveness). Closer consultations should be made with the industry in future deliberations, through expanded use of advisory committees, etc.
Mismatches in measuring assets and liability constitute a major issue. IAS 39 should not be applied as it is to the financial assets held by the insurer, until a reasonable solution has been found. In phase I, exceptions should therefore be admitted in applying IAS 39, for assets held to back insurance liabilities, for example. Apparently, full consideration has not been given to this category. Measures to avoid mismatches of assets and liabilities (including assets held to back insurance liabilities) should be reviewed.

End.