



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

31 October 2003

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

Dear Sir David:

Re: IAA Comments regarding Exposure Draft Insurance Contracts (ED 5)

In response to your request for comments to ED 5, I am pleased to transmit on behalf of the International Actuarial Association (IAA) a draft of our comments and recommendations.

We agree with and encourage both the general objectives and the intent underlying this proposal. Indeed, we have already provided a significant amount of advice and assistance over the course of the projects that have led to this ED and would be pleased if our mutually beneficial collaborations continue. We offer the attached comments in the hope of further enhancing the final standard. We hope that our comments prove to be of value.

These draft comments have been prepared by a committee of the IAA, the members of which are listed in the Appendix to this submission by name and association. In accordance with our internal due process procedures for official statements by the IAA, we have circulated these comments for a formal vote to our member associations, who are also listed in the Appendix. They have three months to approve a public statement to be made on behalf of the IAA. When these procedures have been completed, we will confirm whether the draft has been approved in its entirety or modified in any way.

Yours sincerely,

W. James MacGinnitie
President

Attachment: Draft comments

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

International Actuarial Association Comments on the IASB's Exposure Draft 5 *Insurance Contracts*

(these are draft as they have not completed the required IAA due process as of October 31, 2003)

THE INTERNATIONAL ACTUARIAL ASSOCIATION

The International Actuarial Association (the "IAA") represents the international actuarial profession. Our fifty Full Member actuarial associations represent more than 95% of all actuaries practicing around the world. The IAA promotes high standards of actuarial professionalism around the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within, or likely to have an impact upon, the areas of expertise of actuaries.

We are not a trade association and do not represent the interests of either clients or employers. As actuaries, we have developed significant experience and expertise in the assessment of the value of contingent cash flows. Using this experience, actuaries will as a profession continue to provide assistance to those involved in the enhancement of financial reporting standards that will command respect from users of financial statements.

The IAA appreciates this and other opportunities to provide input to and assistance in the development of the IASB's financial reporting standards. The IAA would be pleased to provide any assistance you deem appropriate based on our expertise in the furtherance of this objective. We commend the continuing efforts of the IASB in its very worthwhile effort to develop globally accepted international financial reporting standards.

THE IAA'S DUE PROCESS

This is a draft version of the IAA's comments regarding the IASB's Exposure Draft 5 *Insurance Contracts* (ED 5) that has been prepared by the Insurance Accounting Committee of the IAA, the members of whom are listed by name and association in the Appendix to this brief. The Full Member associations of the IAA are also listed in the Appendix. The final IAA statement in response to ED 5 will be transmitted to the IASB as soon as this draft statement has completed the IAA's due process review process.

ORGANIZATION OF THIS IAA SUBMISSION

The IAA's draft submission of its comments and recommendations regarding ED 5 has been organized in three parts:

1. "General Comments and Main Issues" – a summary of what the IAA feels are the most important areas covered by this draft submission.
2. "ED 5 – Specific Responses to IASB Questions" – detailed responses to the twelve questions specifically included in ED 5.
3. Three separate papers entitled "Fair Values", "Demand Deposit Floor", and "Investment Spread" – expanded discussions of three important issues that are briefly discussed elsewhere within the IAA submission.

GENERAL COMMENTS AND MAIN ISSUES

Overall, the IAA believes that ED 5 represents an important advance in the development of international financial reporting standards. We very much believe that the objectives of ED 5 are desirable in the context of the environment in which they are proposed to be implemented. In general, with a few significant exceptions, we also support the principles included in ED 5. However, while recognizing the advances in ED 5, we note several shortcomings in this exposure draft. Some of these shortcomings relate to instances where ED 5 has reverted to a rules-based approach, particularly in the Implementation Guidance. The IAA believes that the preferred approach would be a principle-based standard overall and that these rules-based aspects of ED 5 should be addressed prior to its adoption.

We provide extensive commentary on ED 5 in response to the specific questions posed by the IASB in the following portion of this draft submission. However, from the perspective of the IAA and the actuarial profession, we believe that the immediately following issues are the eleven most important areas on which we would like to focus your attention. A more detailed discussion of these and other issues is included either in our response to the individual questions raised in ED 5 that follow or in the more detailed papers that are attached in response to the invitation to discuss issues others than those about which specific questions were asked in ED 5.

1. Importance of principles

The IAA believes that financial reporting standards will be more effective the closer they are to a principle-based system. We recognize that it is quite difficult to construct an IFRS strictly on a principle-based model, particularly for insurance contracts where rule-based approaches have historically been used in almost all existing national standards. However, rules that may have seemed appropriate in historically-based financial reporting can too often become unwarranted constraints to an otherwise internally consistent and logically constructed principle-based system.

Let us cite two rules-based ideas and two items of implementation guidance that logic and our modeling suggest may cause problems in developing a robust principle-based financial reporting system for insurers.

- The IAA believes that the correct approach to measure fair value liabilities is that cited in paragraph BC 117 (d), i.e., based on the expected (probability weighted) surrender patterns and associated cash flows and not that cited in paragraph BC 117 (e), i.e., with a demand deposit floor.
- A principal field of expertise of actuaries is that of estimating probability weighted cash flows. We observe that in the market place, products are priced and blocks of business reinsured or sold using probability weighted cash flows. To impose a cash surrender value floor, however logical for banking deposits, is to force the fair value policy provisions to deviate from observed market transactions for long term insurance contracts – which we believe is contrary to the concept of fair value itself (and indeed any

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

prospective measurement basis). In essence, the requirement to incorporate a cash value floor “forces” the probability of surrender to unity at each duration – only to reverse the assumption when the policy is not surrendered and then re-impose the assumption in the following duration.

- We believe the proposed definition of insurance is sufficiently robust to enable preparers (possibly with actuarial guidance) to determine “what is insurance”. For example, on the surface, it might appear that a pure endowment contract is not an insurance policy. This might be so for short term pure endowment contracts issued to young annuitants that do not involve significant risk transfer. However, a whole of life annuity, which is clearly an insurance contract, is nothing more than a series of pure endowments payable each year until death. By applying the proposed definition, many of the individual pure endowment contracts can be seen to involve significant risk transfer and should qualify as “insurance”. Some believe the Implementation Guidance contains rules for categorizing specific product forms that deviate from the principles outlined in the proposed definition. We recommend reviewing the Implementation Guidance to ensure that it is consistent with the definition in all cases. For that purpose, it is important that all examples in the Implementation Guidance use terminology consistent with the words in the definition.
- As another example, the IG concludes that any contract containing a guaranteed annuity feature is an insurance policy. The IAA has discussed with IASB staff ways that could be used to construct guaranteed annuity features that involve no significant risk transfer. Again, we recommend that it is preferable to delete the reference in the IG and to rely on the principle enunciated in the definition of an insurance contract.

In summary, the IAA believes that “rules” and “rulings” can cause unintended consequences – or worse, may open up the possibility for preparers to “game” the system.

2. **Consistency of measurement of assets and liabilities**

Actuaries strongly believe that consistency of measurement of assets and liabilities is necessary for insurance financial statements to be relevant. The IAA has submitted several studies to the IASB illustrating the effects of inconsistent measurement of debt instrument assets and fixed benefit liabilities.

This issue should not automatically be assessed in terms of “whatever basis is chosen for assets should determine the basis for liability measurement.” Since the purpose of insurance is to provide benefits or reimbursement relating to a loss event, recognition and measurement issues should first be addressed considering the obligation with its associated liabilities.

The IAA is very concerned that the Exposure Draft’s limited scope, and lack of coordination with other IASB projects as outlined in BC 9(c) may result in an inconsistent valuation of assets and liabilities. The consequence could be financial statements that are much less relevant than the IASB had intended.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

The potential mismatch of asset and liability measurement is acknowledged in paragraph BC 110. In rejecting several alternatives that attempt to solve this mismatch issue, the IASB concludes that the conceptual and practical difficulties in implementing these solutions outweigh the effects of the mismatch on an insurer's reported equity. The IAA disagrees with this conclusion and has attempted to demonstrate through research presented to the IASB that materially misleading earnings can result from inconsistent asset / liability measurement bases.

The IAA also thinks it understands the forces that led to the "mezzanine" category of asset measurement "available for sale" ("AFS"). Nevertheless, our research and research by one of our member organizations have indicated the use of AFS measurement (which does not allow consistent measurement of assets and liabilities) results in potentially serious misstatements of both equity and earnings both when interest rates trend rather than fluctuate under some existing national standards and when relatively small fluctuations in interest rates occur under another existing national standard. As was pointed out in research supplied to the IASB, the resulting "financial noise" can overwhelm the "business reality".

Therefore, the IAA believes the effects of the mismatch far outweigh the difficulties of establishing a suitable alternative.

In the introduction to IAS 39 (paragraph 14), one of the reasons given for the use of amortized cost measurement for some financial instruments is to maintain the consistency of measurement with associated liabilities. The fact that the IASB has chosen not to reopen the measurement of bank originated loans (on the basis of an investigation by the old IASC some 13 years ago that is cited in BC 113) is evidence that some issues are better not opened until a move to full fair value accounting for all financial services institutions (particularly financial intermediaries) is adopted. The IAA believes that similar rationale to that which led the IASB to continue the bank originated loan measurement category (allowing continued use of amortized cost measurement for assets that do not include equity characteristics) should also be allowed under the proposed insurance contract IFRS.

The IAA recommends that the IASB reconsider the proposed IFRS to allow or even require consistent measurement of assets and liabilities to be an important principle. In our response to the Exposure Draft's specific questions we note several families of alternatives for amending the Exposure Draft. We would be happy to work with the IASB to flesh out these alternatives or identify others that allow for consistent measurement.

3. Minimum deposit floor rule

In the Basis for Conclusions to ED 5, the Board expresses its intent to modify IAS 39 to make clear that the fair value of a financial liability with a demand feature is not less than the amount payable on demand ("APD").

The view that the fair value of a financial liability is not less than the APD is not one that the insurance industry or the actuarial profession would reach, based on common pricing

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

practices, observed wholesale market transactions or based on the existing fair value guidance in IAS 39. Since most insurance and investment contracts are not sold by insurers primarily for their demand deposit features; the APD constraint on the liability measurement would place too much emphasis on one feature of contracts that contain many features. Further, the APD constraint is not consistent with guidance for financial assets; for example, the fair value of mortgages is not limited by the amount that would be realized if they were repaid immediately.

The imposition of a requirement that the value of a contract cannot be less than the APD places a significant constraint on the measurement process that limits the ability to calibrate the measurement results to known market transactions, distancing it from fair value concepts. Comparing the notional fair value of a contract to APD is not valid.

We recommend that the Board reconsider its view on fair value and that the Board not impose the constraint of a minimum liability of the APD on the valuation of long term insurance contracts that are not sold primarily for their demand deposit features. We recommend instead that the final guidance in IAS 39 should emphasize that fair value methods should consider actuarial estimates, such as probability weighted expected value, of all of the cash flows in a contract and should, wherever practical, be calibrated to market transactions involving similar contracts.

See the attached paper entitled "Demand Deposit Floor" for a further discussion of this issue.

4. **Fair value issues**

ED 5's Basis for Conclusions presents the Board's tentative conclusion with respect to phase II, as well as some considerations on proper measurement methods under IAS 39 for investment contracts that are classified as trading. We believe that the direction of the Board regarding fair value measures includes guidance that is too prescriptive and would have the effect of making it difficult, if not impossible, to calibrate fair value models to market observations. As such, the prescriptive guidance deviates from the principles articulated in IAS 39. The areas of concern include:

- the constraint that the fair value of a financial liability is no less than the amount payable on demand,
- possible constraints on inclusion of renewal premiums on certain long duration contracts, and
- a prohibition against consideration of investment performance in the valuation of liabilities.

We are providing comments on each of these points elsewhere, but it is important to recognize that they all relate to fair value techniques and that they should be considered not only individually as topics of importance but collectively as aspects of the larger issue of the objective of a fair value method. As stated in IAS 39,

The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

We recommend that, rather than providing prescriptive guidance on fair value methods that may have the result of limiting a company's ability to meet the objective of a fair value method, the Board should reaffirm the principles articulated in IAS 39 and encourage preparers to develop measurement techniques that meet the objective.

See the attached papers entitled "Fair Values" and "Investment Spread" for further discussion of these issues.

5. **Renewals**

The IAA believes that the issue of continuation or renewal options and cancellation options should be addressed prior to finalizing the amendments to IAS 39. There are many financial instruments that contain such options and their treatment under IAS 39 remains unclear.

We support the reference in the definition of amortized cost to the recognition of "the contractual stream of future cash flows". We also support the concept in paragraph BC 117 (d) to use "all associated cash flows". The IAA believes that the treatment of such options should be independent of the underlying measurement basis, i.e., the same definition should apply irrespective of whether the contracts are measured on an amortized cost basis or on a fair value basis. The difference in the cash flows that are considered under amortized cost and fair value measurement methods could lead to material discontinuities, particularly if the IASB moves towards a full fair value system to replace the optional amortized cost / fair value systems that it currently allows.

In addition, the IAA believes that it is appropriate that the recognition of renewal and cancellation options for insurance contracts under phase II should be the same as applies for investment contracts under IAS 39 to avoid accounting arbitrage between insurance and investment contracts and to ensure that the addition of a small quantum of insurance risk should not significantly change the accounting measurement of a contract.

6. **Embedded derivatives**

We disagree with the conclusion in paragraphs 5 and 6 of the draft IFRS to require companies to give fair value treatment to *all* embedded derivatives in insurance contracts *during phase I*. We believe that the requirement for separate measurement of *all* embedded derivatives may require major changes in valuation systems and may impose costs that exceed the resulting benefits. The embedded derivatives found in insurance contracts are not similar to standard financial derivatives, and typically can not be valued by common option pricing techniques, but rather require complex and burdensome valuation techniques. In addition, *during phase I*, the differential valuation of the host contract under current accounting policies (which may already capture the value of some embedded derivatives, options and guarantees) is likely to present many conceptual difficulties and to require extensive systems changes that will be reversed in phase II.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Most importantly, the *separation* of embedded derivatives is not warranted as many options and guarantees in contracts that are not embedded derivatives may reflect more significant risks and uncertainties with respect to future cash flows. These options and guarantees are not “caught” by the requirement to give fair value treatment to embedded derivatives.

As the Board appears to be moving towards fair value measurement of insurance contracts in phase II, and given that there will be extensive disclosures regarding options and guarantees and robust liability adequacy testing in phase I, we believe the requirement to separate and give fair value treatment to embedded derivative should be dropped in the final phase I standard. In addition we request that the Board review and clarify its understanding of what are embedded derivatives, as many of the examples given in ED 5 and the Basis for Conclusions do not seem to meet the definition of derivatives. Examples include renewal rights and surrender options, as well as the equity component in unit-linked contracts.

7. **Reinsurance**

Paragraph 19 of the proposed IFRS results in inconsistent treatment of insurance liabilities and ceded reinsurance assets. This is the case for example, where reinsurance assets would have to be discounted under IAS 36, even if insurance liabilities are not discounted under local GAAP. The IAA believes that using IAS 36 for reinsurance purchased for phase I is both unnecessary and potentially misleading. The impact of paragraph 19 would cause many companies to report significantly lower discounted reinsurance assets while reporting their reinsured insurance liabilities at a higher undiscounted amount. This would also create a loss for new reinsurance contracts and would be inconsistent with the intent of phase I. Therefore, the IAA recommends (1) the elimination of paragraph 19 and (2) that the requirements for a loss recognition (or liability adequacy) test be permitted to be applied to the combination of insurance liabilities less the corresponding reinsurance assets. However, if the IASB decides that a complete elimination of paragraph 19 is not acceptable, we would be pleased to explore other alternatives to resolve the issues that we have identified.

8. **Unbundling**

Paragraph 7 of the draft IFRS effectively introduces a decision tree to determine whether unbundling is required. The IAA proposes that the unbundling requirement should be redrafted as a principle-based requirement rather than the rules-based requirement drafted in paragraph 7. Such a principle should strive to meet the Board objective outlined in BC 34 which requires “unbundling only when it is easiest to perform and the effect is likely to be greatest.” We have included specific recommendations in response to question 6 to clarify the unbundling requirements in paragraph 7 as we understand them.

9. **Performance reporting**

We believe that it is quite important to consider related issues when reviewing a proposed IFRS. In considering ED 5 (and its subsequent phase II), one issue that cannot be overlooked is how such a proposal affects a company's performance reporting. In this case, the

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

effectiveness of either of the proposed first two phases of the IASB's insurance contract project will be assessed by how it will affect a company's income statement.

We believe that it will be crucial to consider a company's performance reporting in the context of its major operations. In the case of an insurer, similar to other financial services institutions (including financial intermediaries), performance reporting should enable a user to determine the effectiveness of the company's business operations. For example, for a life insurer, separating its operations from its financing function is conceptually difficult to implement. Yet, proposals that might combine financing and operations before full fair value accounting is in place might in effect introduce inconsistent asset and liability measurement "through the back door".

The IAA would be pleased to work with the IASB in both designing the principles on which an effective performance report should be based for a financial services institutions (including financial intermediaries) and determining whether the insurance IFRS at the time has been or can be designed with these principles in mind.

10. Performance linkage features

A major open issue of the IASB Steering Committee and the DSOP was the treatment of performance-linkage features in insurance and investment contracts. We believe that this is a significant accounting issue that should be considered in a principle-based manner, not only in insurance accounting but also in other areas. In many segments of the insurance business, performance-linkage is an integral aspect of the insurance process. In fact, from insurers' viewpoint, many insurance or investment contracts are performance-linked. In essence, insurers can in some cases transfer certain of the risks that they have underwritten either back to policyholders through performance-linked benefits or through ceding the business to a reinsurer, which in turn can be a form of performance-linkage, as can any insurance taken from policyholders' view point as well.

This legal connection between expected cash flows and the rights and obligations under the linking contract is present in principle in the case of minority interests in entities, income tax, and those insurance contracts qualified in some countries to cover employers' pension obligations. In all these cases, IFRS already requires a consistent recognition and measurement approach to expected performance-linked cash flows, along with the underlying cash flows. Since examples for performance-linkage are already considered in IAS 12, 22, and 19.104. We would expect a consistent treatment with respect to the participating features found in many insurance contracts.

We recommend that a definition of performance-linkage be included in the phase I insurance standard and that the Board clarifies that any legal or constructive obligation of participation in performance (either in the insurer's overall performance or in the performance of specific assets or specified sources like mortality profits) constitutes a liability, even if it is described as discretionary, provided there is sufficient precedence to establish a constructive obligation as defined in IAS 37.10. We further recommend a principle-based approach be developed in phase II of the IASB's insurance contracts project to provide for the many types of

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

performance-linkage in use throughout the world. We would be pleased to assist the IASB in this effort.

11. Timeline

The IAA has significant concerns over the timeline proposed in various sections of ED5, namely regarding:

- The fair value disclosure of insurance assets and insurance liabilities although such disclosure will not be required for dates before 31 December 2006.
- The removal of the exemption from paragraphs 5 and 6 of IAS8 for accounting period beginning after 1 January 2007.

While the IAA understands the symbolic commitments to phase II that the removal of the exemption represents, we are concerned that the Board has not spent any significant time on considering phase II since it adopted the date for termination of the exemption. The effective implication of the above two combined requirements would seem to mean for most entities that fair value disclosure is required as at 31 December 2006 but then phase II (if it is suitably developed) – or worse a modified phase I - will be required as at 31 March 2007, possibly with comparatives as at 31 March 2006. We understand this actually implies fair value disclosure would be required at year-end 2005.

We are concerned, however, that it is unlikely that the Board will materially expand its discussion on phase II prior to the completion of its other projects that affect 2005 year-end reporting, which is likely to be in the first quarter 2004. In addition, as would be expected given our support for robust principle-based standards, we recommend that the Board consider fair value concepts more widely before it concludes its discussion on phase II, since fair value principles will also affect other projects such as financial instruments and business combinations.

The IAA also believes that at least two years lead time should be provided to allow the orderly implementation of any suitable guidance on both phase II and fair value to auditable standards. Such guidance should be subject to full due process and consultation as noted by the Board in BC 6. The combination of the above factors may mean that it is unlikely that insurance entities will be able to meet the above timetable unless the Board is able to resolve, or sufficiently narrow, its phase II and fair value issues prior to 31 March 2004. If the resolution of the fair value conceptual issues is delayed beyond this date, then the Board should reconsider the date of implementation of the above requirements prior to finalizing the phase I standard.

Along with other responders to ED 5, the IAA appreciates the opportunity to express our views in the IASB's due process procedures. Once again, we offer our assistance to, and collaboration in, the IASB's future deliberations on its insurance and related projects.

ED 5 – SPECIFIC RESPONSES TO IASB QUESTIONS

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?

IAA Response: It has been a longstanding principle of the IAA that relevant financial statements require assets to be measured on a basis that is consistent with the measurement of liabilities. Consistency of measurement is achieved in many national accounting systems through several different, and varied, mechanisms. The IAA believes the Exposure Draft's limited scope and lack of coordination with other IASB projects will result in inconsistent measurement of assets and liabilities and thus less relevant financial statements. The IAA suggests several families of possible alternatives for expanding the Exposure Draft to improve the consistency of asset and liability measurement, and thus the relevance of insurers' financial statements. Some of these alternatives may impact assets or liabilities not addressed by the Exposure Draft.

The Exposure Draft allows insurance contracts to be valued using an insurer's current accounting policy, with most insurer assets valued according to IAS 39. Most, but not all, current accounting for insurance contracts is conceptually similar to the amortized cost basis of accounting for assets. However, IAS 39 restricts the use of amortized cost in asset valuation to such an extent that a significant proportion of many insurers' financial instruments will be valued in the balance sheet at market value.

The potential mismatch of asset and liability measurement is acknowledged in paragraph BC 110. In rejecting several alternatives that attempt to solve this mismatch issue, the IASB concludes that the conceptual and practical difficulties in

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

implementing these solutions outweigh the effects of the mismatch on an insurer's reported equity. The IAA disagrees with this conclusion because we believe that there is the potential to produce materially misleading earnings from these mismatches, as demonstrated in the several research papers we have prepared for IASB Board and staff consideration. The IAA believes the effects of the mismatch far outweigh the difficulties of establishing a suitable alternative. The results of the Joint Research Project that the IAA undertook with the ACLI clearly shows that the volatility of earnings and equity that emerges purely as a result of inconsistent asset and liability measurement can generate financial statements for an insurer from which even a knowledgeable reader cannot discern the underlying business reality. Other research conducted by one of our member associations shows that the effect of inconsistent measurement may affect earnings more than equity. The IAA believes that measuring assets on a basis that is consistent with that used to measure an insurer's liabilities will produce financial statements that are more relevant. In this respect, we note that one of the reasons given in the introduction to IAS 39 (paragraph 14) for the use of amortized cost measurement for some financial instruments is to maintain the consistency of measurement with associated liabilities.

Four alternative families of methods to deal with the inconsistent measurement issue are presented here for consideration in order of preference.

1. **New Asset Category - Create a new category of assets within IAS 39 similar to bank originated loans that would be continued to be measured using amortized cost methods for some assets held by insurers. This category would be measured in the same way as assets classified as held-to-maturity, but would be limited to fixed income (or cost of living or wage index linked) assets whose expected cash flows do not contain any equity element. The IAA notes that the IASB has shown great sensitivity for the need to avoid a "double conversion" of insurance liabilities during phase I. The IAA notes that conversion of asset measurement bases from amortized cost to available for sale on the way to a full fair value system in a few years involves just such a "double conversion" problem, in addition to introducing a temporary asset / liability measure inconsistency problem. The creation of such a new asset category similar to bank originated loans would allow the IASB both to avoid criticism that it treats banks and insurers differently and to bring both banks and insurers to a full fair value financial reporting basis simultaneously at a future date of the IASB's choosing.**
2. **Relaxation of HTM category – The requirements for using the HTM category of assets could be relaxed such that a non-insignificant percentage of the HTM portfolio could be sold in non-disaster scenarios without impacting an entity's future ability to classify assets as HTM. The criteria for using the HTM category could be based on how well the expected cash flows of the HTM assets reasonably reproduce the expected cash flows of the liabilities they support. This "effectiveness" test could be based on duration measures or**

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

cash flow testing type of analysis. Sales of HTM assets would not “taint” the HTM portfolio to the extent they can be shown to be in response to changes in expected liability cash flows.

3. **Hedge Accounting Treatment** – Allow hedge accounting treatment for both cash instrument and derivative financial instruments backing well defined groups of insurance contract liabilities, provided that the hedging relationship is clearly defined, measurable, and actually effective to changes in economic circumstances. This proposed treatment would allow the hedge asset to be valued in a manner that is consistent with how the hedged instrument (insurance liability) is valued. We note that, while such a solution could solve many insurance contract measurement problems, time for developing robust hedging methodologies suitable for a large variety of existing national accounting policies is very short considering that such solutions will likely involve a “double conversion” effort when many first time users will be strained to implement the basic IFRS.
4. **Shadow Adjustments** – For amortized cost type liabilities that are backed by assets classified as Available for Sale (AFS) or Available for Trading (AFT), allow an off-setting explicit adjustment in equity equal to the unrealized gains or losses from AFS or AFT assets multiplied by a measure of how well the expected cash flows of the AFS or AFT assets reasonably reproduce the expected cash flows of the liabilities they support. For liability measurement bases that are closer to fair value in concept that are backed by HTM or AFS assets, allow a similar offsetting adjustment in earnings. While such adjustments might allow the informed reader to discern the underlying business reality, the IAA believes that creating a “fudge” primarily to fix the AFS “rule” that itself is not principle-based is undesirable. This would involve significant additional “double conversion” work and different “shadow accounting systems” might be needed for the many existing national accounting policies that are allowed in phase I.

In the explanation of its decision not to relax the criteria for classifying financial assets as held-to-maturity, the IASB cites an example implying that an insurer could, after examining its circumstances carefully, classify specific assets representing 80 per cent of the fixed-maturity assets backing a book of insurance contracts as held-to-maturity. An insurer may well be able to conclude that it would not be compelled to sell more than 20 per cent of its assets (except in the “disaster” scenario) but it would be highly unlikely to be able to determine which specific elements of its current assets would make up the 80 per cent that is to be retained. This is one of the primary reasons why most insurers who report under US GAAP (which has broadly similar rules for accounting for financial assets as IAS 39) classify far less than 50% of their fixed income assets as held-to-maturity. Further, the IAA sees no principle that is violated by trading assets measured at amortized cost that are chosen to match the cash flow characteristics of liabilities that are measured using bases conceptually similar to AC.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

In paragraph BC 111, the Board noted that the mismatch between assets and liabilities has existed for some years under US GAAP. The implication is that since there has been no significant outcry from preparers or users of US GAAP financial statements regarding the effects of this mismatch, then there should be no concern about adopting the same approach. It is important to note, however, that in US GAAP the unrealized gains and losses associated with holding available for sale assets at market value in the balance sheet are shown separately from other changes in equity. This allows users to include or exclude these amounts as they see fit. Since the Exposure Draft has limited its scope and is not coordinated with any other IASB project, there is no guarantee that the unrealized gains and losses will be shown separately in financial statements prepared under IASB rules. In this respect, the IAA notes that the IASB's early considerations of a Performance Reporting standard may lead to the elimination of these unrealized amounts in financial intermediaries' financial statements. This leads the IAA to stress that the IASB take steps to ensure that the financial instrument project, the insurance contract accounting project and the performance reporting project be tightly coordinated.

The IAA notes that its research suggests that the use of AFS in the USA since 1993 may have introduced a bias towards over reporting earnings and equity as interest rates were in a long term secular decline. The effect of the mismatch seems to have been to increase insurers' equity. If interest rates had been increasing rather than decreasing during this time period, a reduction in equity would likely have resulted. The Supplement to the Second Report on the ACLI/IAA Joint Research project discussed this issue in detail and showed that, if interest rates were to increase in the same manner that they decreased, otherwise healthy insurers could appear to be capital impaired. This could cause severe market dislocation as well as significant regulatory problems if regulators are placed in a position of having to explain that an insurer that appears capital impaired under IFRS is in a sound financial condition. The IAA believes that, were such regulatory intervention to occur, it could undermine confidence in the IASB itself.

BC 111 implies that volatility of equity resulting when assets are designated as available for sale can be dismissed because earnings would not have such volatility. One of our member associations research demonstrates that there would be a significant misstatement of earnings due to asset / liability measurement mismatch given even modest fluctuations in interest rates. Even if such a dramatic result had not been uncovered, the IAA finds the reasoning in BC 111 to be very puzzling given the IASB's stated preference (in BC 6) for an asset/liability approach to accounting. An asset/liability approach can be valid only when assets and liabilities are measured on consistent bases. If equity, the difference between assets and liabilities, is unreliable or irrelevant it can only be because one or both of assets or liabilities itself is not relevant or reliable.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

The IAA does not understand why the IASB has deemed consistency of asset and liability measurement as not being important during Phase I, while at the same time concluding that an asset/liability accounting approach, which necessitates consistent accounting treatment, is the preferred approach for Phase II.

- (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?

***IAA Response:* The IAA agrees that weather derivatives should be reported under IAS 39 unless they meet the proposed definition of an insurance contract. It should be noted, however, that some insurers have been proposing the use of weather derivatives as a partial hedge against weather related risks assumed in a portfolio of insurance contracts. Insurance regulators in the US have been considering whether to allow insurance accounting for weather derivatives if their use can be tested for effectiveness as a hedge against weather related insurance losses. The US proposals would have the effect of allowing insurers to account for “recoveries” from such weather derivatives similar to reinsurance recoveries, rather than as an investment gain or simply an increase in equity. This is important to US insurers where local insurance regulations do not recognise derivatives as assets.**

The proposed treatment of weather derivatives under IAS 39 appears to only allow recognition of the benefit of using weather derivatives if they would meet the IAS 39 hedge accounting requirements. It is not clear if the hedge accounting provisions in IAS 39 can be applied to weather derivatives used to hedge against highly correlated insurance losses from weather related events in the valuation of such contracts. The definitions and provisions under IAS 39 for a cash flow hedge seem to be close to what is needed to measure the benefits of weather derivatives used to offset weather related insurance losses. The IAA recommends that the economic benefits of such offsets should be recognised in reporting the financial impact of weather derivatives. If weather derivatives are to be reported under IAS 39, then hedge accounting should apply to weather derivatives used as a hedge against weather related risks in insurance liabilities and the implementation guidance should discuss how hedge accounting under IAS 39 applies, including how to assess hedge effectiveness for weather derivatives. Also, the Board should consider improvements to IAS 39, if necessary, to include appropriate principles for derivatives based on non-financial variables, such as weather derivatives.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

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?

IAA Response: The IAA agrees that, for accounting purposes, an insurance contract should be defined using a principle-based approach. We believe that two modifications to the definition of insurance are needed to provide a sufficiently robust distinction (possibly with the help of more specific actuarial guidance) between insurance contracts and investment contracts. The first modification would be to replace the word “compensation” by “pay benefits and insured costs to”. The second change, in the second line of B 21 would be to add the word “expected” before the words “present value”.

This modified definition is broad enough to avoid the reporting of potentially misleading financial results due to insurance risk that is relatively small, but significant, if (1) ignored or (2) accounted for by other IFRS (IAS 37 or IAS 39). In addition, we believe that it identifies as insurance contracts those contracts that are likely to be subject to phase II of the insurance project and which should be therefore exempted from applying other approaches in the meantime.

Notwithstanding our request to eliminate several “rules-based” items contained in the draft implementation guidance, the IAA believes that the addition of “principles-based” implementation guidance to deal with the following items will strengthen the IFRS.

Reference to a contract

The definition, scope exclusions and guidance should refer to the concept of a contract as defined in IAS 32 6 under the concept of “substance over form”, rather than establishing rules based on legal contracts provisions and interpretations.

The term contract, as defined in IAS 32 6, is assumed to also apply to insurance contracts. Under the concept of “substance over form”, the contract to be considered should be the relevant economic relationship rather than the legal contract.

If different and independent economic relationships (such as an insurance contract and a financial instrument) are artificially stapled together in one legal document,

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

they should be unbundled under the concept of “substance over form” and be measured separately. Conversely, if dependent economic relationships are artificially split and reported in different legal documents, they should be treated as a single unit.

Similarly, the IAA believes there should be no requirement to artificially split insurance contracts that contain many bundled, and interrelated, features. The IFRS for insurance should refer to the whole insurance contract in the sense of IAS 32 6 and ensure that it is treated consistent with the principles outlined above.

Referring to that principle eliminates the need for the footnote of B 22. The reason for this rule is to prevent misuse by artificially designing two contracts providing coverage for negatively correlated risks so that the aggregation of both contracts does not include any significant insurance risk. The rule is inconsistent with BC 28 (b) and we recommend omitting that footnote and relying on the concept of “substance over form” contained in IAS 32 6.

Further, retention of the footnote might have the unintended effect of seeming to permit abuse by relying on a narrow definition of “simultaneously”. Moreover, the IAA is concerned that it could take a considerable effort to identify all contracts with the same covered person or object in attempting to apply the rule contained in the footnote as written remains.

Insured interest

The current requirement regarding insured interest in Appendix B should be reduced or even eliminated. While the IAA recognizes the allure of differentiating gambling from insurance, the necessity to apply a test of insured interest may unduly complicate the application of ED 5.

Any suggestion that the requirement of the last sentence in ED 5 B 14 could be interpreted as requiring the preparer to demonstrate that, before a benefit is paid, it has to explicitly prove that the insured event had an adverse effect on the beneficiary should be eliminated. This would be onerous on any insurer.

If an insurable interest criterion is preserved, we recommend limiting any requirement on the preparer concerning insured interest to the need to prove that the coverage inherent in a product is generally assumed to protect against adverse effects. The preparer should not be required to prove the existence of insured interest at the level of each individual contract.

We question whether the reference in ED 5 BC 23 to exclude prepaid service contracts of uncertain cost, e.g., to require insured interest, is desirable. A contract between a stove fitter and a house owner to maintain household heating is an insurance contract under the current definition with an insured interest. From the

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

view point of the house owner, this is no different from an insurance contract. Therefore, we recommend reconsideration of the issue.

With respect to catastrophe bonds (ED 5 B 17 (k)), we refer to our response to question 1 (b).

The concept of “adverse effects” should be applied to economic effects on the insurer based on principles and not rules. Some events, like survival until a given date, usually cause a combination of positive non-financial effects (long life) with negative financial effects (extended living cost) for the insured. Some doubt that the net-effect of long life is adverse for the insured. The principle should be that only economic effects to the insurer are relevant to any test of “adversity”.

Definition of significant insurance risk

*We recommend that the definition of significant insurance risk be clarified by referring to a plausible set of events with significant impact, rather than to the plausibility of individual events. For that purpose at outset the expected present value of all net cash flows under each plausible event, should be compared with the **overall expectation** for the present value of net cash flows.*

We believe that it is conceptually clear from the definition that the principle underlying the definition of insurance involves the concept of the risk from random occurrences and believe that the above approach is both principle-based and robust. It would also reflect the reality that to be an insurance contract, there must be a set of plausible adverse events that would significantly change the expected present value of the insurer's net cash flows.

Then, the concepts of “plausible” and “significant” should be assessed using principle-based logic. If further guidance is necessary, the IAA is willing to consider providing guidance (as opposed to “rules”) to assist preparers and reviewers.

Some of that guidance could clarify that the concept of “significance” does not consider effects of uninsured events that can be triggered as well by the deliberate actions of the policyholder like surrendering the policy, ceasing any further net cash flow.

We note that there are examples in Appendix B and the Implementation Guidance for classifying contracts as insurance or non-insurance that do not seem to be consistent with the principle of significance. We recommend that these inconsistencies be eliminated.

Principle-based definitions

Particularly since it is the stated intention of the IASB to use the definition for phase II, we recommend consider whether there are additional principles, in addition to

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

those mentioned above so that the definition of insurance can remain constant in both phase I and phase II.

Terminology used regarding insurers and policyholders

Undefined terms, such as “issuer of a contract”, “holder of a contract”, “contract term”, and “coverage term”, are used in ED5 that should be defined for clarity or preferably replaced by insurance-specific terminology.

An insurance contract is based on such two-sided agreements. In contrast, the terminology used in the proposed IFRS, e.g., in defining reinsurance contracts in Appendix A, as well in ED 5.2, 9, B 2, B 8, B 12, B 17 etc., which refers to issuers of an insurance contract as insurers and holders of an insurance contract as policyholders, is inappropriate, and could be misleading in certain reinsurance situations. For example, in the case of a weather bond, the issuer would be in the position of the policyholder and the holder would be in the position of the insurer (ED 5 IG1.20).

Compensation vs. benefits and insured cost

The definition of an insurance contract refers to compensation rather than to other terms more typically used in the insurance business, such as benefits, losses, claim costs, settlement costs, loss adjustment expenses, claims cost containment expenses, and defense costs. It is not clear that the term compensation includes all of such uncertain payments, triggered by the insured event. In addition, it is not always possible to distinguish between these various insurance benefits and costs, especially in the case of where benefits are provided in kind.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

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?

IAA Response: The IAA does not believe that derivatives embedded in insurance contracts should be required to be separated and fair valued in phase I. We recommend that insurance contracts should be exempt from the requirement for separation and fair value treatment of all embedded derivatives. We believe that the cost to separate every embedded derivative is not justified by the benefit obtained in phase I and, further, that fair value treatment of embedded derivatives would place undue emphasis on a few derivatives embedded in insurance contracts, while many other embedded options and guarantees that are more significant but which do not meet the definition of embedded derivative would not have similar treatment.

We believe that the requirement for separate measurement of all embedded derivatives may require major changes in many valuation systems and may impose costs that exceed the benefits to the users of financial statements, particularly in view of the objectives of ED 5. Derivatives found in insurance contracts may require complex, specialized pricing models to measure benefits that are not material. Further, in phase I, the requirement would be not only to separately value all embedded derivative, but also to value the host contract by current accounting policies that may already capture some or all of the embedded derivatives, options and guarantees, which is likely to present many conceptual difficulties and to require extensive systems changes that would be reversed in phase II.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

The IAA is concerned that, because of the existence of many options and guarantees in insurance and investment contracts, many of which are not embedded derivatives, and because options and guarantees in contracts are often interdependent, separation of some features that meet the technical definition of derivatives, but not others that may not meet the technical definition of derivatives but which may be of greater economic significance, may produce a misleading result. The current proposal would show the movement in the values of the embedded derivatives, but depending on companies' current accounting policies, it may not show the effect on liabilities of other, possibly more important options and guarantees.

We recognize that the Board is aware that other options in contracts that are not derivatives may have a material influence on cash flows and should be considered in the valuation of liabilities. We share the concern that, in some jurisdictions, current accounting policies may not adequately consider options and guarantees that are not derivatives. We believe that an effective fair value methodology will take into consideration all derivatives, options and that the need for separate fair value treatment of options and guarantees, whether derivatives or not, will be obviated by the requirements of phase II.

ED 5 would impose a liability adequacy test for insurance contracts based on an analysis of cash flows and would require disclosure of the risks and uncertainties related to cash flows. These disclosures should consider all embedded options and guarantees in the contracts, whether they are embedded derivatives or not.

In view of these considerations, we recommend that paragraphs 5 and 6 be entirely deleted, and that, for the interim period of phase I, the standard should allow use of current accounting policies with a more robust liability adequacy test with appropriate disclosures. While such an approach may not reflect the period-to-period cost of derivatives, it would capture the major risks and uncertainties in most insurance contracts that relate to embedded derivatives, to basic benefits and to embedded options and guarantees that would not fall under the proposed fair value treatment requirements.

The Board may wish to emphasize the need to consider embedded options and guarantees when testing for loss recognition by adding language to paragraph 11 such as "estimated future cash flows should include a realistic expectation of the effects on cash flows of options and guarantees in contracts", which could be inserted after the first sentence. The last sentence in paragraph 11 should then be changed to read, "For example, it does not specify which cash flows should be included, except that contract cash flows must reflect the expected effects of embedded options and guarantees, whether or how..."

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

The Board should also change the wording in the requirements for disclosure by changing paragraph 29 (e) to read

“Information about material exposures to interest rate or market risk under embedded options and guarantees in insurance contracts.”

Further, Appendix C Amendments to other IFRS should be changed as follows:

- Paragraph C1: the last sentence in the new paragraph 1(d) should be deleted
- Paragraph C2: the last sentence in the new paragraph 1(e) of IAS 39 should be deleted
- Paragraph C4: the last sentence in the new paragraph 1(e) of IAS 32 should be deleted

With these changes, the table in example 2 of the Implementation Guidance would require revision as well.

We believe that the IASB Board should clarify its understanding of derivatives. Because the draft standard addresses issues related to investment contracts in the context of embedded derivatives, we have the following additional comments. We do not agree that paragraph 6 of ED 5 presents the requirements of IAS 39 as it stands. We do not agree, as stated in BC 117, that cancellations and renewal rights are embedded derivatives. The right of a policyholder to surrender a contract for many, if not most, contracts does not meet the definitions of a derivative, as it does not have an underlying.

As the Board has expressed in BC 117 its intent to regard cancellation and renewal rights as embedded derivatives in investment contracts, we make the following observations

- It is not clear in paragraph 6 that the context is investment contracts that are measured at amortized cost
- The option to surrender or renew does not meet the definition of a derivative unless it has the attributes of a derivative as defined in IAS 39. The option to renew or to surrender in most contracts that are not unit-linked is not tied to an underlying. Hence the ability to surrender a fixed annuity (one with a value that is an accumulation of deposits at a flexible crediting rate, perhaps with a minimum guarantee rate) does not have an underlying. It may be that the value of the option to surrender is sensitive to market conditions, but absent a specified variable in the contract that creates a change in the value of the option, the option cannot be considered to be a derivative. Further, unit-linked contracts themselves are tantamount to the purchase of the investments in the linked fund, not just an interest in the movement of the value of the fund. Hence the equity feature should not be characterized as a derivative.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

- Nevertheless, there are some features of insurance and investment contracts that are embedded derivatives. The most common relate to enhanced yields on fixed contracts, depending on the performance of an index (such as are found in equity-indexed annuities), performance guarantees and minimum death benefits in unit-linked contracts.

When applying the amortized-cost method, companies must make estimates of cash flows, including consideration for cancellations and renewals. Since the value of the option to surrender is not independent of the amortized cost measure, a requirement for fair value treatment of the option could create a redundant liability.

We also note that the disclosure requirements in IAS 39 require companies to provide information about the material risks and uncertainties in cash flows. Further, as stated in BC 117(b), the Board intends to clarify the need to estimate cash flows to treat changes in estimated surrender patterns in the same way that a lender treats the estimated impairment of loans under IAS 39. There is a further requirement that investment contracts be tested for adequacy under the provision of IAS 37, as well as extensive disclosure requirements related to investment contracts, including disclosures regarding the risks and uncertainties related to cash flows and a disclosure of the fair value of the contracts. We believe that these requirements provide sufficient consideration of options and guarantees in investment contracts that are measured at amortized cost.

We encourage the Board to rethink its views on embedded options and guarantees and to make a distinction between those that are derivatives should require fair value treatment, and those that do not. We encourage the Board not to require separation of “minor” embedded derivatives that do not contain a material benefit or that are well “out of the money” in phase I. Further, IAS 39 should be clarified to state that options and guarantees that are not derivatives should be considered in estimated cash flows and when changes in cash flows create the need for re-measurement. The Board may want to add a comparison of the surrender value of contracts carried at amortized cost to the recorded value as a disclosure.

- (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?

IAA Response: Notwithstanding our view that fair value treatment for embedded derivatives in insurance contracts should not be required, we do not agree that, if fair value treatment of embedded derivatives is required, there should be an exception for those that have insurance features. Such features are common in equity-linked contracts and many are currently deeply “in the money.” Making an

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

exception for these derivatives would result in companies giving fair value treatment to some embedded derivatives that may be trivial, but not to others that, in the current environment, may be the most material to the balance sheet. We also note that a life-contingent guaranteed annuity option is not a derivative, and hence, even if derivatives with insurance features were not exempt from the requirement for fair value treatment, they would not be considered for separation.

- (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?

IAA Response: We believe the disclosure requirements are adequate and we do not propose any changes.

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

IAA Response: As noted in our response to (a), we believe that it is better to focus on those embedded derivatives, options and guarantees that are most relevant in phase I rather than narrowly focus on disclosing all derivatives at fair value. The work imposed on preparers in phase I is not trivial and the IAA feels that efforts should be directed at recognizing the items of greatest economic significance rather than concentrating on all items in the one category of embedded derivatives. The IAA is willing to attempt to provide actuarial guidance to help ensure that the most material of these items is recognized.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

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?

IAA Response: It is our opinion that given the approach adopted, the exemptions provided are necessary. In terms of timing, we do have some concerns that the period of exemption is inadequate.

As we have mentioned in our response to question 1, we anticipate that unless changes are made to ensure consistent asset and liability measurement during the phase I interim period, insurers' financial performance results may reflect inappropriate income not related to the underlying business reality. We regard fixing these problems as far more important than setting a short application period for phase I.

By including a firm date for the exemptions to expire and not making this date dependent on the implementation of phase II there is a possibility that insurers will in fact be faced with a third period between phase I and phase II where phase I rules apply with no exemptions. This would be undesirable and may be unmanageable.

The 2007 deadline for a set of quality insurance contract standards to be designed and implemented, given the complexity and the competing agendas for the IASB Board time, even now appears to be a challenging deadline, especially given the long period that has elapsed since phase II issues have been considered by the Board. Adopting a firm date does place a marker down and assists in generating the process for the change. However, if the IASB is serious in this regard, we would recommend a realistic deadline supported by a detailed plan which would be made public, to increase confidence and commitment.

We recommend adequate time be provided from the finalization of the standards to implementation to allow insurers to adequately review their portfolios and prepare and test their systems. Insurers are required to select the asset measurement for

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

each asset from among the options provided in the Exposure Draft of IFRS 32 and 39, which we understand is largely intended to be implemented as currently drafted and not re-exposed. This will introduce a mixed asset measurement independent of the liability measurement for most countries. Research has indicated that great care will be necessary by insurers in the asset measurement selection to attempt to minimize the effect of inappropriate income not related to the underlying business distorting performance measurements.

Other implementation considerations include:

- 1) At a later date insurers will have the option of changing their asset measurement selection, but only by moving toward fair value. It would be preferable that on implementation of phase II insurers should be provided the opportunity to make a further re-election once the measurement bases of insurance assets and liabilities are finalized;**
- 2) Insurers may have to unbundle some of their products during phase I to meet IFRS 32 and 39 requirements and apply local GAAP to the balance of the insurance contract affected. Potentially, insurers may then find this was unnecessary once phase II is implemented; and**
- 3) The proposed time requirement to comply with an implementation date of 2005 and to show a one year comparative would be to have an opening balance sheet at December 31, 2003 available on the new basis. Insurers may be challenged to capture additional data prior to this year end.**

A further implication of the approach that concerns us is the potential for insurers and countries to elect to further delay adoption of IFRS because of concerns over how to avoid inappropriate measurement of performance during this Phase I period which may make the expiry of the exemptions even more problematic.

Without knowledge of how the Board will resolve the many major problems identified in this brief, the IAA is reluctant to endorse any expiry date for the expiry of the exemptions. However, if possible we recommend that the implementation date for all insurers' contracts and assets be the same point in time, likely the 2007 date.

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

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

- (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?

IAA Response: With regards to question 4 (b) (i), the IAA recommends that the proposed IFRS be modified to permit, but not require, the presentation of catastrophe or equalisation reserves as part of equity.

The IAA understands and accepts the proposed elimination of specific catastrophe and equalisation provisions from insurance liabilities. However, the IAA believes that such provisions, or portions of such provisions, may represent market value margins which can be part of the fair value of insurance liabilities. In other words, we expect fair value will include recognition of the risks associated with catastrophe exposure or the cyclical nature of certain types of losses.

However, if local GAAP does not allow recognition of such risks, except in catastrophe or equalization provisions, then the elimination of such provisions in phase I would be partially reversed in phase II. To the extent that an entity is able to reflect such risks in the entity's insurance liabilities in a manner consistent with fair value measurement objectives, the proposed IFRS should allow the entity to report on that basis. However, given the lack of sufficient fair value measurement guidance that applies to such insurance liabilities, it would be premature to recommend the use of fair value measurement.

The IAA also believes that the proposed IFRS does not prohibit the presentation of catastrophe or equalisation provisions as part of equity. Thus, such provisions could be presented as surplus "reserves" or capital risk "provisions", but not as insurance liabilities. Insurance companies who currently report such provisions should not be prohibited from continuing to present these amounts in this manner, and thus provide continuity where such amounts are allowed by taxing authorities, required by insurance regulators, or considered important by users in assessing solvency, credit standing or other purposes.

With regard to question 4 (b) (ii), the IAA agrees it is appropriate to require a test of the adequacy of liabilities if no such test exists under an insurer's existing accounting policies. However, the term "loss recognition test" can be confusing when applied to liabilities. We recommend using the term "liability adequacy test" instead.

Paragraph 12 (a) requires the carrying amount used in the liability adequacy test to be liabilities net of deferred acquisition costs and related intangible assets received in a business combination. While some accounting policies utilize the concept of deferred acquisition costs, there are several that do not, instead using other similar

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

assets such as a Zillmer asset (or contra-liability). The IAA recommends that paragraph 12(a) (i) be changed to read as follows:

“Any related insurance assets, e.g., deferred acquisition costs and Zillmer assets; and”

The IAA is concerned that the lack of guidance with regards to the cash flows to be included in the loss recognition test may allow significant items to be excluded from consideration. Therefore we recommend changing paragraph 13 of ED 5 to read as follows:

“For the test described in paragraph 12, the measurement under IAS 37 shall:

- i. take into account all significant cash flows including option, guarantees and reinsurance; and*
- ii. include future investment margins (see paragraph 16(c)) if, and only if, the amount described in paragraph 12(a) also includes those margins.”*

The liability adequacy requirement should not be interpreted as requiring fair value as the minimum liability.

The liability adequacy test should be applied to the entire contract, not to individual component parts such as individual guarantees that may be offered.

It is the IAA's interpretation that the liability adequacy tests under well-developed accounting systems (such as those required in the U.S., Canada, Japan and the European Union) would comply with ED 5's loss recognition requirement, with no additional requirements are imposed. The IASB should clarify if this interpretation is incorrect.

The IAA believes the level of aggregation at which the liability adequacy test should be performed should be no higher than the lowest level at which liabilities are reported separately in the financial statement. This is sometimes referred to as the business segment level.

ED 5 contains guidance for applying IAS 39 to investment contracts, contracts issued by insurance companies that do not contain significant insurance risk. In BC 72, the IASB acknowledges that the treatment of transaction costs incurred for investment contracts may differ from the treatment of acquisition costs for insurance contracts in Phase I. Acquisition costs are defined in many accounting systems to include both internal and external costs of acquiring new business. In such an accounting system, insurance contracts would be able to defer the recognition in income of more costs than a similar investment contract. The IASB may be inviting insurers to engage in accounting arbitrage by adding significant, but not costly insurance risk to investment contracts, thus making them insurance contracts that receive more favorable accounting treatment at the time the contract is issued or inappropriate expense allocation.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

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 recognized in profit or loss (paragraph 35 of the draft IFRS).

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

IAA Response: Paragraph 14 of ED 5 states that an insurer may change its accounting policy if, and only if, the change makes the financial statements more relevant to the decision-making needs of users and more reliable judged by the criteria in (draft) IAS 8.

The IAA agrees that insurers should only change accounting policies if the result is to make the financial statements more relevant to the decision-making needs of users.

Paragraph 15 states that, in order to justify a change in accounting policy, a change need not be sufficient to achieve full compliance with all of the criteria of (draft) IAS 8. *The IAA also finds this reasonable.*

However, paragraph 16 states that a new accounting policy than involves any of a list of “prohibited practices” may not be adopted. *The IAA has serious concerns about whether the IASB has thought through the consequences of Paragraph 16, since it believes that the “prohibited practices” all have third order effects on the relevance and reliability of the financial statements.*

It might be useful to list the relevance of various characteristics of insurance accounting policies as the IAA sees them.

- **First Order**

Actuarial provisions are determined with reference to the replicating portfolio or to the best current credible estimates of all significant contingencies at all contract durations.

- **Second Order**

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Actuarial provisions are determined at issue with reference to the best current credible estimates of all significant contingencies, with subsequent liability adequacy tests that also reflect best current credible estimates of all significant contingencies.

- **Third Order**

Actuarial provisions are determined using a discount rate that reflects estimated asset returns, spreads or fees.

To the extent that there is a “no profit at issue” constraint in the financial reporting model, the direct impact from reflecting the third order effects from asset returns, spreads, or fees may be practically overridden by the requirement to set up margins in the actuarial provisions to offset any additional “profits” from these items and to release these margins in a manner quite similar to traditional deferral and matching accounting.

Existing insurance accounting policies currently widely recognized as “high quality” for purposes of shareholder information

There are at least three new sets of accounting policies developed in the 1990s and 2000s based on the asset / liability model for insurance contract accounting that are regarded as “high quality” for purposes of shareholder information. The IAA cites the Australian, Canadian and South African insurance accounting models as examples. There are other sets of accounting policies, also recently developed, that are derivatives of these three standards. In addition, there has been a steady evolution of US GAAP which has had several new aspects of insurance accounting added periodically over three decades (including July of 2003 in respect of non-traditional long duration contracts) and the IAA notes that US GAAP (even though some disagree with certain aspects of US GAAP) is also regarded, in aggregate, as yielding “high quality” shareholder information. The IAA notes that other national accounting standards currently may also be considered as “high quality” or may develop into “high quality” standards before 31 December 2004.

All four sets of insurance accounting policies cited above are widely viewed as “high quality” insurance accounting policies in comparison to many (and possibly most) of the current insurance accounting policies continued to be deemed acceptable during phase I. All four sets of insurance standards meet the IAA's first or second order criteria. This is not to imply that many of the other national accounting standards are not “high quality” standards. The IAA recognizes that the underlying goal of many of these national accounting standards has been to have “high quality” financial reporting standards that have focused on “policyholder security”. This is explicitly recognized by the IASB in phase I by the temporary suspension of the IAS 8 criteria.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

However, all four sets of insurance standards cited above violate one or more of the “prohibited practices” in paragraph 16 that the IAA characterizes as “third order” effects.

The practical problem with paragraph 16

The effect of paragraph 16 is to deny an insurer the right to change to any of these four recognized high quality standards (or other high quality standards that meet the first two criteria) during phase I – even though its financial statements could become much more relevant to their users following such a change in accounting policy.

The IAA notes that all four of the cited insurance accounting standards use in whole, or in part, the concepts of current credible or best estimates. Many of the standards acceptable in phase I allow assumptions to be prescribed by a regulator.

A large part of making insurance financial reports more relevant to users is the use of current credible or best estimates in place of mandated assumptions that may not be either current or credible.

Similarly, many insurance accounting systems deemed acceptable under phase I allow the use of a prescribed discount rate. The prescribed discount rate is often not related to market rates or to the return on an insurer's assets. This sole fact of de-linking the asset discount rate would appear to make it more acceptable to the IASB than a return based on the assets available at the time of policy issue or at the time of the financial statement preparation date, an observation we believe to be contrary to what the IASB intended.

If the IASB accepts that it is in the interests of the users of financial statements for insurers to improve its financial reporting to any of the high quality modern insurance financial reporting policies, the IAA believes it should say so, possibly by explicitly allowing complete conversion to existing insurance accounting standards that are acknowledged as high quality. The IAA does not want to imply that the four systems of financial reporting listed above are the only systems that could be required as “high quality” systems for determining insurance liabilities. The IAA believes that the criteria listed above can be applied to assess any accounting policy to see whether a total change to that policy from an existing accounting policy can be deemed by the company's management and auditor as a change to a more relevant accounting policy.

The IAA is concerned that, in spite of the well known intentions of the IASB to develop phase II of its insurance accounting standard in an expeditious manner, the process could take considerable time to complete. In this regard, the IAA notes that the insurance accounting project commenced by the IASB in December 1997 has not yet been completed after nearly 6 years of, at times, intense study. Therefore, the IAA believes it is desirable to continue to encourage preparers in phase I to convert

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

to financial accounting regimes that incorporate the use of best estimates and margins since most of the thinking involved in such conversions will be directly applicable in phase II.

If paragraph 16 persists relatively unchanged in the adopted standard of practice, insurers might be advised to convert their accounting to one of the recognized high quality insurance standards cited above before phase II comes into effect to ensure that they are not locked into a significantly less relevant accounting standard if phase II is significantly delayed.

On the other hand, the IAA can agree with the IASB that the prohibited practices in paragraph 16 should be applied if the insurer is making only partial changes in accounting policy, as opposed to a total change to an existing accounting policy that is recognized as "high quality". The IAA can also support the elimination of the practices prohibited in paragraph 10 of the ED.

Recommendation

Therefore, the IAA believes the IASB should replace the current paragraph 16 with wording that both allows insurers to convert their financial reporting policies in total to accounting policies that are regarded as high quality and restricts the application of paragraph 16 to the prohibition of partial changes in accounting policies during phase I that might be regarded as "cherry picking" by continuing to apply the prohibited practices in paragraph 16 to partial changes in accounting policy.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Question 6 – Unbundling

The draft IFRS proposes that an insurer should unbundle (i.e. 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?

IAA Response: We agree that assets and liabilities should not be omitted from the balance sheet of an insurer. As a result, we believe that unbundling will be appropriate and feasible in those cases where the deposit component would not otherwise have been recognized. However, we note that these requirements will only apply in a limited number of cases. This may have been the intention of the Board.

Further, we note that unbundling may only be required in the period during which phase I is effective. It is important, consistent with the objectives of ED 5, to ensure that the unbundling requirements do not result in major changes that may need to be reversed in phase II.

Paragraph 7 of the draft IFRS effectively introduces a decision tree to determine whether unbundling is required. The examples in the Implementation Guidance (IG 5 and IG 6) illustrate the complexity of interpreting paragraph 7 and in particular identifying the deposit component in some contracts. We refer to suggestions below in the response to question 6 b regarding a possible redraft of paragraph 7.

Recommendation

We agree that it would not normally be appropriate to require the unbundling of surrender or maturity values. However, we would insert the word “only” in the second sentence of paragraph 8 so that unbundling is required “*only* if the insurer’s existing accounting policies mean that it does not recognizes all liabilities.”

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

IAA Response: The IAA recognizes the need to unbundle certain contracts as “Phase I permit a wide range of accounting treatments” (BC 34) for insurance contracts. Consequently it agrees with the objective in BC 34 as adopted by the Board to require “unbundling only when it is easiest to perform and the effect is likely to be greatest.”

It is, however, not clear that this objective is met by paragraphs 7 and 8 of the draft IFRS. The second sentence of paragraph 7 introduces a test to consider the

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

recognition of “rights and obligations under an insurance contract”. This is a recognition test of the liability under the contract – it is not a test of revenue recognition where the effect of unbundling could be more significant. Consequently, it may not meet the objective described above.

For example, consider a contract where the insurance and deposit components are unrelated but “stapled” together (possibly a base contract and a rider). If the rights and obligations under the combined contract are recognized and the insurance component just passes the significant insurance risk test, there will be no need to unbundle the contract and all premiums would be recognized in revenue. However, if the contract as a whole does not pass the significance test, no premium would be recognized. Here the effect of unbundling on the amount of revenue recognized is the greatest. At the same time, it may be possible to easily perform unbundling. The IAA therefore believes it would be more representationally faithful to require unbundling in this stapled case.

Recommendation

The IAA therefore proposes that the unbundling requirement should be redrafted as a principle-based requirement rather than the rules-based requirement drafted in paragraph 7. This should encompass the objective outlined in BC 34. In addition, such a requirement should adhere to the “substance over form” characteristics described in the *IASB Framework*. For example, paragraph 7 could be redrafted as follows.

“Unbundling shall be required where it would be representationally faithful to measure separately the deposit component from the insurance component. This shall only be done in circumstances when separation does not require undue cost or effort and where the measurement effect of unbundling is significant.

Unbundling shall be required only when both of the following conditions apply:

- (1) the cash flows of the insurance and deposit components do not affect each other, such as where the insurance component and deposit component are unrelated and stapled together, and
- (2) an insurer's existing accounting policies for insurance contracts do not recognize obligations to repay amounts received under the insurance contract, or rights to recover amounts paid under the insurance contracts.”

By rewording the requirement for unbundling into a principles-based approach and clearly outlining the objective of unbundling, we believe that it will be clearer when unbundling is required. It should be noted that unbundling is required under the principle of “substance over form”, if the legal contract consists of several parts that are artificially stapled together (see IAS 32.6 and our response to question 2 above).

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

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

IAA Response: Paragraph 7 and 8 are generally clear, but they are rather complex in determining when unbundling should be required. To avoid complexity, we would change the criteria as described above.

In addition, we believe that it is important that “substance over form” should be considered in both the context of unbundling and bundling. For example, if a contract has been artificially separated through the use of side letters, it is appropriate that the separate components contract should be considered together under the final standard.

Recommendation

The concept of “bundling” contracts that have been artificially separated should be addressed in the relevant sections of the insurance contract standard such as the definition of insurance contracts and the section of unbundling.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

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?

IAA Response: The IAA strongly recommends that paragraph 19 be eliminated. Paragraph 19 of the proposed IFRS would result in inconsistent treatment where reinsurance assets would have to be discounted under IAS 36, even if insurance liabilities are not discounted under local GAAP.

Paragraph 19 states that a cedant shall apply IAS 36 *Impairment of Assets* to its rights under a reinsurance contract. The specified impairment tests in IAS 36, paragraph 8 requires an assessment “at each balance sheet date whether there is any indication that an asset may be impaired” and IAS 36, paragraph 10 suggests using “other indications that an asset may be impaired.” After any indication of impairment, the amount recoverable from the reinsurance assets has to be determined. The definition of impairment (IAS 36, paragraph 7) is “when the carrying amount of the asset exceeds its recoverable amount.” And the “impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount” (IAS 36, paragraph 5).

The following IAS 36 definitions would apply:

- i. “recoverable amount is the higher of an asset’s net selling price and its value in use”,
- ii. “value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life”, and
- iii. “net selling price is the amount obtainable from the sale of an asset in an arm’s length transaction between knowledgeable, willing parties, less the costs of disposal.”

As a result of subjecting the cedant’s rights from reinsurance purchased to IAS 36, ceded reinsurance assets that are undiscounted could be impaired. Then, the application of IAS 36 would require such assets to be either stated at discounted present values or market values. Since reinsurance assets are not traded in an active market, the value in use would apply in determining the recoverable amount. Also, the applicable discount rates would be determined according to IAS 36, paragraphs 48-56. However, this IAS 36 guidance regarding discount rates to be applied could be significantly different than the discount rate requirements for fair value measurements in phase II for insurance contracts; if this is case, unnecessary and confusing changes after phase II is adopted would be needed.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

The IAS 36 requirements could thus require inconsistent treatment where insurance liabilities are not discounted for present value under local GAAP, but the reinsurance assets are discounted using IAS 36. Using the net selling price of the reinsurance assets is similar to using fair value and would only apply to the reinsurance assets while the insurance liabilities covered by the reinsurance would be valued using local GAAP.

In addition to inconsistencies resulting from the undiscounted valuation of insurance liabilities under local GAAP and reinsurance assets under IAS 36, the measurement of reinsurance assets using IAS 36 requires the use of a discount rate that reflects the “current market assessments of the time value of money and the risks specific to the asset” (IAS 36.48). This discount rate should also reflect “the risks that the future cash flows will differ in amount or timing from estimates” (IAS 36 50(b)). Therefore, using IAS 36 to value reinsurance assets results in lower asset values for riskier cash flows in terms of the amount or timing of recoveries for reinsured claims. However, applying local GAAP to insurance liabilities could result in liabilities that either are undiscounted or are discounted using a risk free rate or investment rate, and possibly include provisions for adverse deviation to satisfy a sufficiency requirement or to achieve a certain confidence level. Consequently, the use of IAS 36 for reinsurance assets has serious flaws that would result in inconsistent and misleading financial statements for a number of insurers.

While the fair value for insurance contracts is a measurement issue to be considered under phase II, ED 5, paragraph 19, requires reinsurance assets to be valued using IAS 36, which includes fair value measurement in the recognition of the “recoverable amount”. The IAA believes that using IAS 36 for reinsurance assets could result in misleading information. This change creates inconsistencies in the valuation of reinsurance assets compared to insurance liabilities, and therefore should be delayed until phase II addresses fair value accounting for insurance contracts.

If the complete elimination of paragraph 19 proves unacceptable, the IAA suggests that an alternative would be a limited application of paragraph 19 in certain cases. Such cases would be those of most concern to the IASB, in particular, retroactive reinsurance contracts, where the reinsurance covers insurance liabilities associated with claims that have already occurred. Reinsurance assets from such a retroactive reinsurance contract or the retroactive portion of a reinsurance contract could be required to be recorded using present value. However, this alternative would require the introduction of a definition of retroactive reinsurance coverage under phase I, where such a definition has not been developed nor exposed for comment.

Another important issue involving the separate valuation of reinsurance assets versus insurance liabilities concerns the recognition of profit and loss at inception. At the inception of the reinsurance contract, expected profits that offset to some extent the expected losses from the covered insurance liabilities can arise. Such expected profits from the reinsurance purchased should be recognized if the

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

corresponding expected losses from the insurance liabilities can be recognized. For phase I, the IAA recommends that the requirements for a loss recognition test should allow for applying reinsurance assets as an offset to insurance liabilities.

The IAA recommends that the IASB modify the proposed IFRS to defer reinsurance valuation guidance to phase II. The presentation of reinsurance purchased as an asset could be still included in phase I using local GAAP with respect to the valuation of reinsurance assets separate from the valuation insurance liabilities without any deduction for reinsurance. Where local GAAP does not provide for the separate reporting of reinsurance assets, the IAA recommends that insurers report reinsurance assets as the difference between applying local GAAP to insurance liabilities (1) without regard to reinsurance purchased (on a gross basis) and (2) with regard to reinsurance purchased (on a net basis). A loss recognition or impairment test using local GAAP should also be applied in this manner.

The IAA also recommends that consideration be given in the development of phase II regarding the valuation of reinsurance assets to appropriately reflect the contractual and economic relationships between the reinsurance assets and the associated insurance liabilities. If reinsurance assets cannot be deducted from the insurance liabilities as required under the proposed IFRS, then, due to the applicable market value margins, the fair value of the uncertain cash flows to be received by the holder of the reinsurance asset would be measured at a value less than the present value of the estimated cash flows. However, the fair value of the reinsurance asset should not ignore the contractually “linked” relationship between the reinsurance asset cash flows with the cash flows from the corresponding insurance liabilities.

The uncertainties in the insurance liabilities cash flows associated with the reinsured events are eliminated or mitigated by the cash flows from the reinsurance assets. Thus, cash flows from a ceded reinsurance contract provide risk mitigation protection via a contractual link that is a direct function of specific cash flows from the insurance liabilities. Consequently, if the fair value of reinsurance assets and the fair value of the corresponding insurance liabilities do not reflect this relationship, the fair values may not be a realistic financial representation of the impact of reinsurance. For a specific entity, the economic value in use of the reinsurance asset to that particular entity would be greater than the fair value of the reinsurance assets to another party who does not have the associated insurance liabilities.

The definition of “value in use” from IAS 36 is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. This definition does not seem to be helpful in addressing the issues discussed above. IAS 39, *Financial Instruments: Recognition and Measurement*, addresses hedge accounting and seems to be similar to what is needed to account for ceded reinsurance assets. In effect, reinsurance purchased could be looked at as providing benefits similar to a cash flow hedge for insurance liabilities.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

However, unlike hedge instruments, the cash flows from reinsurance assets are a direct function of the specific cash flows from the insurance liabilities. Also, this relationship between the cash flows from the reinsurance assets and the insurance liabilities is more than a “hedge” which generally refers to an instrument with an indirect relationship that needs to be evaluated for its effectiveness with respect to cash flows or value. In contrast, the cash flows from ceded reinsurance contracts have a direct contractual linkage to the cash flows from the insurance contracts covered by the ceded reinsurance.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

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?

IAA Response: We are in general agreement with the guidance related to insurance contracts acquired in a business combination. We agree that the proper treatment of acquired contracts is to apply a fair value measure at the date of acquisition and we believe that allowing an expanded presentation during phase I will be helpful to companies that wish to present insurance liabilities and related assets on a measurement basis consistent with insurance contracts that they have issued directly. The two-component presentation will also enhance comparability among companies, as some companies will have a greater proportion of acquired contracts than others. The Board should clarify its intent regarding whether the intangible asset should be amortized in a systematic fashion or whether it should be re-measured at subsequent reporting dates.

We recommend that the two-part presentation should be permitted in phase I for investment contracts with discretionary participation features.

While we agree with the proposed guidance, we note that it involves the measurement of insurance liabilities at their fair value. Such a fair value methodology for acquired insurance contracts will be required for many companies

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

before the Board has completed phase II. Although we do not seek guidance from the Board on fair value measures to comply with the requirements for purchase accounting, we do ask that the Board take full consideration of current practices in the industry as it discusses phase II. As expressed elsewhere in this letter, we are concerned with some aspects of the tentative conclusions for phase II as they are expressed in paragraph BC6 of the Basis for Conclusions. We believe that some of the proposed practices in the tentative conclusions would cause companies to use fair value methods that deviate from pricing practices of insurance contracts and hence would not be consistent with the definition of fair value used throughout the IFRS. We offer our assistance to the Board in phase II of the insurance project to develop a acceptable fair value methodology that is consistent with the intent of the IFRSs, acceptable to the Board, and consistent with industry practices.

We agree with that the value of customer lists and customer relationships is different from the value of existing contracts and that they should be considered apart from the intangible asset for the value of the contractual rights related to acquired contracts. Elsewhere in this letter we discuss our views on renewal premiums and our belief that the limits on the inclusion of renewal premiums as described in BC6 (d), if extended to investment contracts, could result in a misrepresentation of the value of those contracts.

IAA (draft) Comments on IASB's Exposure Draft 5 *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 this project.

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

IAA Response: ED 5 provides specific guidance for a contract feature referred to as a discretionary participation feature. However, in some cases the guidance seems to relate to participating features in general. It is at this point that certain conceptual and technical concerns arise regarding the rules provided.

Over the last year there has been a significant amount of discussion, particularly among actuaries, in respect of the recognition and measurement of participating features. As a result, we believe that there is a need to clarify the recognition and measurement of such features in broad terms to provide guidance for phase I for insurance contracts.

We are concerned with the implication of ED 5 BC108 that performance linking features other than discretionary participating features should be accounted for as embedded derivatives, subject to IAS 39.

We do not believe that a feature in the form of a specific and explicit linkage to actual cash flows of an entity is a derivative from that entity's view point. In addition, the guidance provided in BC 108 will constitute in many cases a significant change from current accounting. We understand that the Board will explore performance-linking features in more detail in the development of the phase II project. As a result, we recommend that the Board does not require that IAS 39 be applied to non-discretionary participating features for phase I.

Forms and character of participation features

The following provides our overall view on participating features, for which we prefer to use the term performance-linking features. We emphasize that "performance-linkage" is a general concept, where actual cash flows of one party determine, through a legal or constructive obligation, the cash flows of that party with regards to another party in an off-setting manner, i.e., transferring specifically incremental deviations of cash flows of the party to the counterparty.

In fact from the insurers' viewpoint, many insurance or investment contracts are performance-linked. In essence, insurers can in some cases transfer certain of the risks that they have underwritten either back to policyholders through performance-linked benefits or through ceding the business to a reinsurer, which in

turn can be a form of performance-linkage, as any insurance taken from policyholders' viewpoint as well.

This connection between expected cash flows and the rights and obligations under the linking contract is also present in principle in the case of minority interests in entities, income tax, and those insurance contracts qualified in some countries to cover employers' pension obligations. In all of these cases, IFRS already requires a consistent recognition and measurement approach between the expected performance-linked cash flows and their underlying cash flows. Since examples for performance-linkage are already considered in IAS 12, 22, and 19.104, as a general principle we would expect a consistent treatment as well in case of participating features found in insurance contracts.

Performance linking features are not elements of unit-linked contracts, since there is no contractual linkage to the cash flows of the insurer, but rather to the market value of a fund, which might or might not affect the cash flows of the insurer.

Regarding the forms of the performance linking feature, we believe that there are three classes of performance-linked features:

1. Performance-linked feature based fully on legal or constructive obligations

This performance-linking feature is based on a formula-based linking that result from a legal or constructive obligation. The linkage may relate to the insurer's overall equity, part of equity, earnings or part of earnings like the performance on a pool of assets or the performance of specific assets, or a specific source like mortality profits, for all contracts or only of a group of contracts.

2. Performance-linked feature based on legal or constructive obligations with some discretionary or judgmental influence to amount or timing

This performance-linking feature may be referred to by law or in the contract, but the amount or timing of the benefit is to a certain extent discretionary or based on subjective judgement.

3. Performance-linkage feature which can be split in an obligatory and discretionary part

This performance-linking feature is similar to (2) above, but in addition discretionary payments are expected to be made (additional discretionary payments are legally possible but in some markets / jurisdictions they can be unusual, but are sometimes made for competitive reasons).

Recommendation for treatment of performance-linked features

We recommend that:

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

- (1) A definition of performance-linkage be included in the phase I insurance standard. Our recommendation is that the Board should include guidance as suggested above in the IFRS before adoption.
- (2) The Board clarifies that a legal or constructive obligation of participation in performance (either in the insurer's overall performance or in the performance on specific assets or specified sources like mortality profits) constitutes a liability, even if it is described as discretionary, provided there is sufficient precedence to establish a constructive obligation as defined in IAS 37 10.
- (3) In all forms of performance-linkage the existing accounting policy should be continued. But in any case, the unallocated surplus should be split in liability and equity considering any legal or constructive obligation to allocate amounts ultimately to policyholders as liability in the amount of the present value of such allocations as liability. For type 2 contracts, any unallocated surplus should be split between liability and equity considering the past experience of amounts usually minimal allocated to policyholders, creating at least a constructive obligation, unless there is a clear evidence that management will apply another percent in the future.
- (4) A principle-based approach should be developed in phase II of the IASB's insurance contracts project to provide for the many types of performance-linkage in use throughout the world.

In addition, to avoid a distortion in the liability adequacy test, all legal and constructive obligations for participation of policyholders should be considered.

In some cases, analogous to those resulting under IAS 12 for a deferred tax asset, the specific participation clauses might give raise to an asset. The terminology used should not be interpreted in such a way as to prohibit such a possibility, even if they are in accordance with the *Framework* and analogous to IAS 12. The liability adequacy test should be applied to the overall liability to require a higher net liability. ED 5 25 should not require that the overall net liability resulting from a contract be greater than that resulting from applying IAS 39 to the fixed element.

Linkage to unrealized gains

We believe that it would be helpful to clarify the treatment of linkage to unrealized gains. Analogous to IAS 12, the consideration of unrealized gains in the determination of the liability for performance-linked benefits would not affect the income statement. This is due to the fact that most assets will likely be reported as available-for-sale under the new standard, while being reported at amortized cost in current accounting. This latter approach will usually drive the performance-linking. In essence, the same principles as given above should also apply to unrealized gains and losses.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

General prohibition of an intermediate balance sheet category

A strict reading of the current wording in 24 (b) could lead to the interpretation that it prohibits such an intermediate item only for contracts with a discretionary participation feature as defined in ED 5. We recommend that the Board clarifies that an intermediate category other than liability or equity is prohibited in any case, which would be best stated in paragraph 10.

Technical issue concerning the definition and rules if the current reference to “discretion” remains

Here we refer to ED 5's definition of a discretionary participation feature. The definition requires that future benefits be based on performance as well as, according to the contract, being discretionary in nature. Inherently, the combination appears internally inconsistent – either a benefit is determined contractually as a function of performance or it is discretionary according contract – we do not understand how it can be both. As a result, we recommend that legal and constructive obligations be treated as liabilities and that only items that truly involve discretion in respect to timing and amount be eligible for classification as equity. Nevertheless, the availability of discretion should not be able to eliminate the effect of contractual or expected performance-linkage.

There are cases where the insurer has no explicit legal requirement or basis for using this discretion, but has a degree of freedom within its judgmental decisions about potential additional payments. In general, participation rules have the fundamental purpose to provide refunds to policyholders that correspond to an overcharge of premiums that was provided in part for prudence purposes, considering the long contract duration of the insurance coverage provided and the resulting risk of changes in circumstances and experience. Any judgment about what a “fair” share in equity represents, i.e., the refund of conservatively set premiums, is to a certain extent discretionary. The requirement of a contractual right to determine additional payments on a “discretionary” basis is not in compliance with the “substance over form” requirement of the IASB. Hence, we recommend the addition of at least “judgmental” decisions to the definition.

Technically, the reference to “payments” does not consider that participation features can provide benefits in the form of additional cover (which need not to be always paid in cash, such as paid-up additions) or which serve as an offset of future due payments. Therefore, it is recommended that a reference would be to “benefits.” It is also possible that contracts providing coverage in kind grant additional benefits from equity (e.g., additional services). Referring to additional benefits also makes reference to minimal benefits redundant.

Participation rules are usually based on a two-dimensional (matrix) allocation of the performance of the insurer. First, they are based on the experience of specified

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

groups of contracts (which may be open, e.g., based on experience of products or other group of contracts with common features, or closed, e.g., all contracts written within a certain period) or on experience of the entire company (at least the share of all participating contracts) with performance spread over these contracts, although benefits might be provided according to a specific contribution principle. Second, they may be based on either all earnings before participation of the relevant pool of contracts or just on parts of earning, usually distinguished by reference to particular components of the pricing assumptions, such as the excess of investment earnings compared with interest inherent in fixed benefits, the excess risk charges compared with insurance benefits, and the excess of cost charges compared with actual administrative cost. The reference to mainly investment earnings does not systematically reflect the background of participation features and the reference to groups of contracts is not an alternative but another dimension of specification of relevant equity.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

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?

IAA Response: The IAA recognizes and strongly supports the need to move to a consistent measurement framework for insurance assets and liabilities. A consistent measurement basis could be addressed by a move towards an appropriately defined fair value framework, but such a move must be carefully defined with extensive due process and if possible, significant field-testing.

The Basis for Conclusions draws a distinction between fair value and measurement of liabilities for phase II, recognizing that “the Board proposal to require disclosure of fair values is not conditional on the measurement model that it will adopt eventually adopt for phase II. 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.”

The IAA recognizes that disclosure of fair value “will provide relevant and reliable information for users,” but only if the following three significant concerns are appropriately addressed relating to the

- measurement basis to be adopted in fair value;
- form of the disclosure statement itself; and
- timing of the disclosure.

Measurement basis

The Basis for Conclusion states that “The Board must resolve several significant issues about fair value, both conceptual and practical, in phase II.” The IAA believes that the Board must instead resolve conceptual issues with fair value more broadly prior to consideration of phase II, primarily because the fair value measurement basis itself, is insufficiently well defined to be adopted to provide “relevant and reliable information for users.”

The IAA agrees that fair value issues can be distinct from the phase II issues but we believe that the Board should first define a fair value framework for all forms of fair value reporting, particularly for all financial liabilities, and not just insurance contracts. For example, issues such as whether fair value should be based on the wholesale market or retail market or a combination of both when there is an inactive market for the contract must be resolved. This framework should then

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

apply across all industries and all projects such as business combinations and financial instruments.

For example, in June 2003, the Board made a number of important decisions relating to the fair value hierarchy and the valuation techniques to be used to determine fair value in an inactive market (i.e., “a dealer may recognize profit for an unrealized gain at the inception of a transaction involving an instrument that is not quoted in an active market only if the profit is evidenced by observable prices of other current market transactions or is based on a valuation technique incorporating observable market data. (The Board considered this issue in the context of, for example, an entity originating a financial instrument in one market, packaging a product, and laying off the risk in a different market.)”

It also extended certain decisions made in the context of the fair value of financial instruments to insurance contracts. These included a conclusion that in measuring the fair value of a financial instrument with a demand feature, its liability should not be less than the amount payable on demand (also reiterated in BC 117). Such decisions will have a significant impact on insurance contracts. As a result, this rather piecemeal approach means that it is becoming increasingly unclear on how to interpret the fair value concepts under IAS.

In addition the tentative decisions made by the Board in January 2003 in relation to phase II were significantly different than the principles proposed in the Draft Statement of Principles. It has become unclear whether these decisions for the measurement model to be adopted in phase II are moving towards or away from a fair value measurement as envisaged by IAS 32 and IAS 39.

Only after such a fair value framework has been established under IAS, should the more specific phase II discussions commence. This will allow the insurance industry to put phase II into context and assess the extent to which its contracts should be measured on their balance sheet on a fair value measurement basis.

The Basis for Conclusions argues that “insurers can begin preparing for a fair value measurement before the Board answers all these [fair value] questions. It is clear, for example, that any fair value measurement involves the need to estimate future cash flows and to identify the significant options and guarantees that are embedded in many insurance contracts”. However, it is clear that without a fair value framework, there may well be a range of “fair value” measurement bases applied to both insurance and investment contracts. This could range from local GAAP, to embedded values, to one in accordance with the Draft Statement of Principles, all of which can be argued to meet the fair value definition under IAS 32 and the “additional guidance” provided in the Basis for Conclusions.

Such a wide range of disclosure would not be comparable across entities. This range of practice can be due to a lack of uniformity in current practices and different

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

interpretation of the existing guidance in IAS 32 and IAS 39 or on different views on where acceptable phase II principles and rules are heading.

Form of disclosure

The form of disclosure statement is important if the information is to be relevant and reliable for users. The IAA strongly believes that the value of disclosure of fair value of insurance assets and liabilities without comparative statements for the previous year-end and analysis of movement in fair value over the year is extremely limited and potentially misleading. It is more important for users to have sufficient information to understand “financial position, performance and changes in financial position” as required by the *IAS Framework*, rather than to solely interpret a single set of fair value figures. It may hence be appropriate to defer the transition to such disclosure for at least another year.

In addition, it is important that sufficient information is provided on the accounting policies, assumptions and methodology used to calculate fair value and the information is provided at a suitable aggregated level. It may be helpful for the Board to consider whether additional implementation guidance should be provided in these areas prior to finalizing the IFRS for phase I.

An alternative may be to require a range of fair value disclosure where the range could vary by use of different methodologies or assumptions.

Timing of the disclosure

The IAA believes that there must be a sufficient period of time between publication of fair value guidance and its implementation. This period will enable companies to implement the methodology in a manner such that they can be suitably audited. It is important that the Board does not underestimate the time required to implement a fair value framework. BC 140 states that “the Board intends to consider whether the guidance on fair value is sufficiently advanced to require this disclosure as early as 2006.” We believe that at least two years should be allowed between the production of sufficient guidance and the first time adoption of this guidance.

On a practical note, it may be more beneficial for the fair value disclosure to be considered either as part of the transitional arrangements for phase II or as part of a wider transition to fair value if phase II does not result in a fair value measurement basis. In this way, there is a direct link between the timing of the phase II requirements and the need to disclose fair value of insurance liabilities and assets.

In the absence of phase II, it may be more appropriate to recommend a hierarchy of possible measurement of fair value calculations such as:

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

- Fair value calculated using appraisal techniques in the wholesale market. The IAA would be willing to consider the production of guidelines by which calculations would be done based on our experience of such calculations.
- Fair value as commonly calculated in the market in which the entity is listed. Suitable guidelines may be produced national actuarial associations.
- Value-based reporting as determined by an individual entity with suitable disclosure of the methodology and assumptions used.

Recommendation

Although the IAA recognizes that the Board is keen for insurers to begin the process of calculating fair value as soon as possible, the IAA believes that any public disclosure should proceed with caution. In summary, we recommend that Board must instead:

- resolve conceptual issues with fair value more broadly prior to consideration of phase II;
- in the absence of a phase II standard, consider a hierarchy of the appropriate measurement basis that can be used;
- provide clarity on the form of disclosure; and
- allow at least two years between publication of fair value guidance and the first time that it is required to be implemented.

The IAA also believes that widespread, comprehensive field testing of various fair value methodologies is desirable and that to encourage company cooperation, securities commissions' consent for any such "selective disclosure" to standard setters and their professional association advisors be obtained.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

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 IFRS, 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 IFRS already require for other items.

IAA Response: The IAA generally agrees with the disclosure requirements in paragraphs 26-29, but has specific concerns about how those requirements are stated. The disclosure requirements in paragraph 26 require the disclosure of information that “identifies and explains”. However, paragraph 28 requires the disclosure of information that “enables users to understand”. While the paragraph 28 phrasing appears to be similar in scope to paragraph 26, “enables users to understand” could easily be misinterpreted as requiring more extensive and detailed disclosure than “identifies and explains”. Consistent language should be used to avoid the potential misinterpretation that the different levels of disclosure are expected in these two paragraphs. The “identifies and explains” language appears to be more appropriate as it does not imply that the financial statements are required to educate users. The IAA recommends that “identifies and explains” should be also used in paragraph 28 to avoid any misinterpretation that the different language requires different levels of disclosure.

The IAA believes that disclosure requirements in paragraphs 27 and 29 are general enough to allow individual entities to provide information that is appropriate for their situation. IG 1(c) introduces the implementation guidance for disclosures referencing the IG paragraphs that discuss how an insurer “might satisfy” the disclosures. Nevertheless, the extensive list of subjects and items discussed in IG 7-59 would be very difficult for most entities to select the most meaningful information, particularly for more complex entities and indeed due to the variety of companies offering insurance products and their circumstances, many of the items described would not provide useful information.

Even though the proposed IFRS does not require all the detailed information and explanations, insurers will be expected by some to provide such extensive disclosures or explain why such disclosures do not apply to them. The disclosure information described in the draft Implementation Guidance could prove to be quite onerous to

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

compile and maintain for many insurers, particularly those with diverse products or operating in multiple jurisdictions. Also, many of the particular suggestions are significantly more detailed than insurers currently provide for their other reports to regulators, analysts, shareholders, policyholders or other stakeholders.

Aside from the difficulties that insurers are likely to experience in developing appropriate disclosures that are consistent with the draft Implementation Guidance, several of the IG paragraphs propose disclosures about risks, uncertainty and sensitivity to assumptions and other elements. The suggestions about such detailed disclosures are comparable to those found in some very detailed actuarial reports that address risks and uncertainties. However, such reports generally address risks, uncertainties and sensitivities at an overall level of aggregation. While IG 34 discusses the problem of overburdening financial statements with excess detail and obscuring significant information, the guidance lacks clarity in how to accomplish these objectives. The IAA is concerned that insurers will provide much more detail than was intended because the repercussions of failing to disclose risks are potentially much more severe than problems that may arise from disclosing too much information. The guidance provided appears to promote and encourage the proliferation of disclosures. The extent of disclosures appears even more substantial than typical for an offering memorandum.

In sum, the nature and objectives of ED 5 disclosures are, in our view, directionally correct and should help to promote better understanding of insurance risks and how these are managed. We also understand and respect the need for principles to provide a context for the preparation of more specific qualitative or quantitative information. However, we are concerned that the relatively limited specificity of the Implementation Guidance provided in ED 5 may result in wide-ranging diversity in the depth and quality of disclosures during this period. The IAA intends to submit a separate letter to the IASB staff containing a series of recommended edits to the IG paragraphs to improve the guidance provided and reduce the IAA's concerns.

Bank products and those offered by consumer product purveyors tend to be relatively simple and uniform across jurisdictional boundaries. The same disclosures as are currently included in IAS 30 (and the current draft of the IASB's Disclosure project) seem to focus on risks that are very short-term in nature. Appropriate disclosures for insurance contracts and institutions providing these products are far different and more complex. We encourage the IASB to address these differences in the current IASB Disclosure project.

Life insurance contracts, for example, especially the many which provide very long term coverage, can be very complicated in their multiplicity of risks covered, benefits and options incorporated in single contracts and in the contract language required to describe the obligations. Further, the risks associated with similarly named plans can differ significantly from one jurisdiction to another because of jurisdictional histories and cultural backgrounds as well as current legal and tax environments. Consequently, it will be difficult for multinational insurers, (i.e.,

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

those most likely to be subject to the requirements of phase I) to aggregate contracts into a small number of meaningfully homogenous disclosure categories. Either each category will be so diverse as to provide misleading or meaningless information, or the number of categories will be so large as to inundate the reader with volumes of minutiae.

A further problem for life insurance is an administrative one. As noted above, many life insurance contracts are very complex products, whose administration over decades requires highly-sophisticated administrative systems. These systems are normally specific to the local entity, reflecting the local products and legal requirements. Hence, large international groups have a large number of such potentially different systems. The purpose of phase I has been stated to be to avoid costly intermediary system changes before a final accounting methodology is adopted in phase II. Many of the proposed disclosure requirements or suggestions involve information that is not currently produced and whose disclosure, especially at high aggregation level, will be of limited value. Thus, substantial system changes, on a world-wide basis in a large number of diverse systems will be needed to comply with the requirements and suggestions of ED 5, in some cases of questionable utility in the period applied.

In respect of a large international group of insurers, terms like “greatest effect” and “material effects” are generally not suitable, since it will generally be impractical to identify which items in the group have the greatest effect compared to simply a material effect. Although a few risks are global (general interest conditions in some jurisdictions / regions) others are quite local (persistency, expense or reputation risks) and can vary even within a single jurisdiction. The variety of risks within a group reduces the relevance of any individual assumption. Often more important are general and global long term trends as well as any group-wide monitoring and measurement systems.

Of particular importance are those procedures applied in deciding whether a new product is introduced, how profitability is measured, and how risks are monitored and managed. Approaches to monitoring administrative adequacy, initial risk selection and claims settlement accuracy should be disclosed. Other significant factors relating to the success of acquisition are important, including the approaches taken and the manner of controlling and monitoring sales success and sales cost. They usually are available on a group level, can be explained in a reasonably short and understandable manner without major data collection requirements and without system changes. In addition, although many insurers bear financial risks that are similar to those of other financial institutions, because of their much longer duration, the focus on disclosure of an insurance contract standard should concern the existence and management of insurance risk.

Certain of the disclosure requirements of IAS 32 may cause particular difficulties. IAS 32 77 requires that the fair value of classes of all financial assets and liabilities subject to IAS 32 be disclosed. According to ED 5 C 4, these rules are applicable to

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

investment contracts with discretionary participation features. According to ED 5 C 1, IAS 32 applies as well to any embedded derivative inherent in insurance contracts. Considering that for both insurance contracts and investment contracts with a minimal participation feature a loss recognition test based on future cash flows is required, a fair value disclosure may not add significant value for phase I while at the same time imposing material additional effort, generally intended to be avoided in phase I. Considering the number of potential embedded derivatives inherent in insurance contracts and investment contracts, a fair value disclosure would materially limit the benefit of a phase I. Hence, we recommend excluding those contracts from the scope of IAS 32 disclosures or leave it to the individual company to identify, quantify and report on the major risks that it believes that it faces.

Further, we do not believe that the wording and the intent of ED 5 27 (c)-(e) and 29 (b)-(d) provide significantly useful information. The requirements as interpreted in the Implementation Guidance appear to be written with a single local entity with a very narrow product range in mind, mainly consisting of contracts which expose the entity to market risks. However, such an entity is not the main type of company that will be subject to phase I requirements. Consequently, the Implementation Guidance appears somewhat inadequate. We recommend that the level of aggregation be further addressed through a principle-based approach prior to adoption of ED 5.

- (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?

IAA Response: Overall, we agree with the approach taken, that is, on the basis of high level principles, with sufficient examples to determine in what way those principles could be applied in practice. Most of the problems that we have that are described in (a) above relate not to the principles involved, but rather to the rules in the Implementation Guidance. In fact, none of the rules should be required. Rather, they should be suggestive or interpretive in nature. The current draft guidance should be changed to make that clear.

- (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?

IAA Response: *The IAA agrees that this transitional relief is reasonable.*

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

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?

IAA Response: The IAA does not believe that the transferor of an insurance 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 if the financial guarantee meets the proposed definition of an insurance contract.

For example, suppose an entity's insurance liabilities are transferred to another party and a financial guarantee is retained in connection with the transfer such that a cap is provided on the ultimate value of the insurance liabilities transferred. Such a financial guarantee should be recognized as an insurance contract and therefore excluded from IAS 39. However, suppose a block of business involving insurance assets and insurance liabilities is transferred where a minimum profit on the block of business is guaranteed. Such a financial guarantee would not meet the proposed definition of an insurance contract unless there is a significant risk of an adverse effect on the policyholder or beneficiary (i.e., the buyer of the book of business). Consequently, the IAA recommends that IAS 39 should only apply if such financial guarantees do not meet the proposed definition of an insurance contract.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Question 13 – Other comments

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

No IAA Response

APPENDIX

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American Society of Pension Actuaries (United States)

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IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Demand Deposit Floor

Introduction

In the Basis for Conclusions to ED 5, the Board express its intent to modify IAS 39 to make clear that the fair value of a financial liability with a demand feature is not less than the amount payable on demand ("APD").

BC117 (e) states

"The fair value of a financial liability with a demand feature (e.g., an investment contract that the investor can cancel at any time) is not less than the amount payable on demand. This precludes a liability measurement based on expected surrender patterns... if the latter amount is less than the amount payable on demand."

We believe a minimum liability of the APD is not consistent with concepts of fair value for insurance contracts or long-duration investment contracts sold by insurers and not consistent with the existing guidance for fair-value measures found in IAS 39. The imposition of this requirement will cause insurers to present their financial position and financial performance in a way that is misleading. Our reasons for this view and our recommendation to the Board are given in the remainder of this section.

Background

Insurance and investment contracts issued by insurance enterprises are primarily sold for purposes that relate to protection or to systematic long-term savings. They are not sold to serve primarily as demand deposits. Insurance contracts are sold to mitigate the financial consequences associated with a contingent event. Investment contracts provide a long-term plan for savings, typically related to planning for retirement. Policyholders terminate contracts when their need for insurance or for long-term savings changes or when they desire to replace their contracts with similar financial instruments.

In short-duration contracts, such as motor insurance or homeowners insurance, the APD is the rescission value, which is a refund of the proportion of the premium representing the amount paid for the period of coverage remaining after the termination date.

In long-duration contracts, the APD is the cash surrender value, which represents the amount accumulated from past premiums for the purpose of funding the ultimate benefits. Traditional concepts of equity, competitive market-place considerations, and regulation all contribute to the determination of the amounts available to policyholders if they terminate their contracts before death or maturity.

Insurance and long-term investment contracts sold by insurers are not like checking or similar contracts that are commonly referred to as demand deposits. They are not repositories of money maintained for the purpose of frequent deposits and withdrawals or for ready access to cash. Accessing the cash value of an insurance or investment contracts typically requires terminating the contract, reducing the insurance benefits, or creating a policy loan. Penalties may apply and the policyholder may incur a tax liability.

Fair Value Concepts in IAS 39

IAS 39 provides general guidance on fair value methodology. For lack of an observable market for insurance and investment contracts, insurance enterprises are likely to use discounted cash flow models to calculate the fair value of liabilities. Consistent with

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Demand Deposit Floor

the definition of fair value, IAS 39 states “The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arms-length exchange motivated by normal business conditions”. This objective is supported by the general requirement in IAS 39 that “...an entity calibrates the valuation technique and tests it for validity using prices from actual transactions”.

Valuation techniques for insurance and investment contracts depend on many assumptions, one of which is the rate at which contracts terminate or are surrendered. IAS 39 recognises that use of assumptions is necessary for fair value techniques and states, “In applying valuation techniques, an entity uses estimates and assumptions that are consistent with available information about the estimates and assumptions market participants would use in setting a price of financial instrument”.

Applying IAS 39 Concepts to Insurance and Investment Contracts

Assumptions and scenarios

Market participants in transactions for these contracts are insurance enterprises. In pricing, they use realistic assumptions for expected contract terminations, based on studies of historic surrender patterns. A proper fair value method also considers the possibility of a contract terminating. When using discounted cash flows, the fair value is the weighted average of the present values of cash flows under a robust set of scenarios, taking into consideration all features of the contract and hence all possible cash flows.

Imposing a minimum liability of the APD is an artificial constraint on a fair value method that effectively places undue weight on one scenario and one feature, namely that one in which all policyholders terminate their contracts. This scenario is not a plausible one for an entity that is a going concern. Its use is not consistent with the expectation of the IASB Framework that the enterprise is a going concern.

Unit of Account

The market for investment and insurance contracts is for portfolios of contracts or blocks of business. Transactions include mergers, acquisitions and reinsurance. Fair value measures relate to groups of contracts with similar economic characteristics, rather than to individual contracts. Transactions involving single contracts, other than policy terminations, are rare. The settlement value on termination is set by contractual terms and cannot be considered to be arms-length.

The requirement of a minimum liability of a contract is the APD creates an ambiguous unit of account. An APD applies to a single contract, but the fair value measure relates to a group of contracts. The fair value of a single contract is only a notional amount; the proportionate part of the value of the portfolio. The fair value of portfolio has an underlying presumption that an entity has the ability to manage the portfolio to profitability and can, for example, diversify or hedge risk.

An individual must consider the value from a perspective different from that of the issuer. It is not correct to say that the best financial decision for the policyholder is to

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Demand Deposit Floor

surrender the contract when the APD is greater than the insurer's notional fair value. In fact, the issuer's valuation is irrelevant to the policyholder. Because the issuer places a notional value on the contract does not mean that the policyholder can replace the contract for this amount. The policyholder is risk adverse and cannot take cash unless the contract can be replaced for the same or a smaller amount of money.

Assumptions about Economic Behaviour

In most cases, the assumptions for rates of termination are supported by abundant evidence of policyholder behaviour. The fact that policyholders do not always terminate their contracts when it might appear to be to their advantage to do so, and sometimes terminate their contracts when it may appear to be disadvantageous, can be explained by factors such as

- The influence of agents or others on an individual's decision making,
- A cash demand unrelated to the insurance or investment contract,
- Brand loyalty,
- Lack of initiative, and
- Lack of sufficient benefit to justify the effort

There are many other factors, some of which are not known. The phenomenon of policyholder behaviour is just an example of financial decision-making that is not always economically efficient. In behaviour economics, an increasingly popular field of economic study regarding economic behaviour, economists recognise that people frequently make decisions that cannot be explained by objective financial consideration alone. They give credence to what insurers have considered in pricing contracts for decades; namely, that there is a pattern or behaviour that is not fully explained by financial considerations but is sufficiently well understood to make reasonable assumptions for pricing and for valuation.

Consistency with Measurement of Assets

The constraint of an APD floor is not consistent with fair value approaches to financial assets. There is no corresponding requirement, for example, that the fair-value measure of mortgage loans be capped at the amount that would be received if the loans were prepaid. Neither is reinsurance receivable capped at the APD.

Intangible Asset

It is sometimes argued that there is an intangible asset that accounts for the difference between the APD and the calculated fair value. The intangible asset might represent the value of the customer relationship or renewal options rights. The difficulty with this view is that the pricing of contracts considers only the contractual cash flows, not cash flows for future sales or renewals beyond the contract period. That there is not an intangible asset is most apparent when the contracts are reinsured. The price for reinsurance is often less than the APD, even though the reinsurance agreement does not transfer the customer relationship or renewal possibility to the reinsurer. Further, the discounted cash flow measure is sometimes greater than the APD. To say that there is an intangible asset for the difference would mean that the intangible only has value in

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Demand Deposit Floor

those economic scenarios that produce a discounted cash flow measure that is less than the APD. An intangible, if there is one, is independent of the value of the contract and cannot explain nor is necessarily related to the difference between the APD and the discounted cash flow measure.

Consequences

The use of a fair value measure that has a minimum value of the APD results in performance measurement that is driven by an accounting approach that is driven by one contract feature rather than by the totality of the contract and the events of the period. For example, in most economic environments, the movement in the value of a contract with a surrender charge that decreases with policy duration will reflect the decrease in the surrender charge rather than the effects of changes in interest rates during the period. This could lead to a liability that would be excessive in many economic scenarios compared to a realistic measure, leading to an understatement of equity. In such a situation, companies could be motivated to present supplemental non-GAAP information in order to provide users of financial statements with a more relevant measure of the financial performance of the company.

Conclusion

The view that the fair value of a financial liability should not be less than the amount payable demand is not one that the insurance industry or the actuarial profession would have reached, either based on common pricing practices or based on the existing fair-value guidance in IAS 39. It is not consistent with guidance for financial assets.

The imposition of a requirement that the value of a contract cannot be less than the amount in the APD places a significant constraint on the fair-valuation process that limits the ability to calibrate the valuation to market transactions, distancing it from fair-value concepts. Requiring the APD of a contract to be its fair value floor is not valid and the comparison should not be allowed to influence the measurement of the liability.

Imposing a minimum liability of an APD has the potential to create misleading financial statements. Companies are likely to seek alternative measures, presented in supplemental information, to provide more relevant information to users of the financial statements.

Recommendation

We recommend that the IASB Board reconsider its view of fair value and that that the Board should not impose the constraint of a minimum liability of the APD on the valuation of contracts that are not sold primarily for their demand deposit features. We recommend instead that the final guidance in IAS 39 should emphasise that fair value methods consider all contract features and be calibrated to transactions involving similar contracts.

IAA (DRAFT) COMMENTS ON IASB'S EXPOSURE DRAFT 5 *INSURANCE CONTRACTS*

FAIR VALUES

Introduction

Fair-value measures are not currently in wide use in the insurance industry. Indeed, the proper application of fair-value methods to accounting, while it has generated much interest and debate, has not been settled. With the advent of IAS 39, fair value measures will be applied to the liabilities of investment contracts and portions of many insurance contracts. When classified as trading, investment contracts are measured at fair value. They must be re-measured at each reporting date with the change in their fair value going through income. The IASB Board in its ED 5 has currently concluded that the fair value of insurance contracts should be disclosed no later than as of 31 December 2006 and it may be that fair-value measures of insurance contracts will appear in the balance sheet beginning in 2007.

The application of fair value techniques to insurance and investment contracts will challenge many issuers of those contracts with the degree of challenge reflecting their current accounting policies and systems. While there is currently no commonly accepted view as to what constitutes fair value of a liability in the insurance industry and related professions, there are standard approaches in the industry to cash flow projections and discounted cash flow measures. For purposes of reporting under IFRSs, practices should evolve to follow a common set of fair-value estimation principles. We believe that this can be accomplished by focusing on how existing modelling capabilities in the industry can be used to meet the expectations of IAS 39.

Background

Existing guidance for fair value measure is found in IAS 39. Its definition is:

“The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction”.

IAS 39 does not prescribe a specific fair-value methodology but provides some considerations in paragraphs 98-100. The key points are:

- fair value should be based on the presumption of a going concern
- the best evidence of fair value is a quoted price in an active market
- when there is an active market with quoted prices, the fair value is measured serialtim
- when there is not an active market the best evidence is obtained by recent market transactions, adjusted for changes in market conditions
- when there is not sufficient market evidence, other valuation techniques may be used.

As insurance and investment contracts issued by insurers are not traded in active markets and as market evidence related to transactions of reasonably comparable contracts is sparse,

IAA (DRAFT) COMMENTS ON IASB'S EXPOSURE DRAFT 5 *INSURANCE CONTRACTS*

FAIR VALUES

insurers are likely to use the approaches described in paragraph 100A-D under the caption *No Active Market: Valuation Techniques*.

100A. If an entity cannot otherwise determine fair value, it uses a valuation technique to estimate fair value. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. An entity calibrates the valuation technique and tests it for validity using prices from actual transactions. For example, when the instrument being valued is purchased or sold in an arm's length transaction, the valuation technique would be expected to result in an amount that equals the fair value of the consideration given or received.

100B. Valuation Techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

100C. In applying valuation techniques, an entity uses estimates and assumptions that are consistent with available information about the estimates and assumptions market participants would use in setting a price for the financial instrument. In applying discounted cash flow analysis, an entity uses the discount rate(s) equal to the prevailing rate of return for financial instruments having substantially the same terms and characteristics, including the credit worthiness of the debtor, the remaining terms over which the contractual interest rate is fixed, the remaining term to repayment of the principal, and the currency in which payments are to be made. When the term of an instrument extends beyond the period for which market prices are available, the valuation technique uses market prices for the period they are available and reasonable extrapolations of those market prices for later periods on the basis of historical experience of price changes under normal market conditions and all other available information. In particular, any assumed change in market prices is supported by reasonable evidence consistent with any available market forward prices.

100D. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument...

Paragraphs 100A and 100D suggest that part of the calibration is the comparison of fair value to net proceeds at inception. The statement "the valuation technique would be expected to result in an amount that equals the fair value of the consideration given or received..." may not require that the initial fair value exactly equal the net proceeds, but suggests that a large discrepancy may indicate a problem with the valuation technique, assumptions, or discount rates. It does seem to imply that a valid methodology reproduce contract prices.

IAA (DRAFT) COMMENTS ON IASB'S EXPOSURE DRAFT 5 *INSURANCE CONTRACTS*

FAIR VALUES

Discussion

A practical approach

The guidance regarding fair value is limited, but encourages practitioners to use accepted methods. Paragraph 100A establishes the principle that fair value should relate to transaction prices and requires calibration to market transactions. For insurers the best available market evidence in stable markets may be found in the prices that they charge to their customers at issue, as well as in reinsurance agreements and purchases of blocks of business or of companies after issue. Note that it can be argued that the unique character of certain contracts or blocks of business can cause prices for sales of business to reflect considerations not normally thought to be part of fair value methodology.

However, in cyclical markets, there are strongly held views that the best available entry price is not the price charged to a customer and that use of these prices may impart irrelevant information to the investor. The IAA offers the observations of one of its well known experts in cyclical markets for the consideration of the Board.

“The issue may be that the usual retail general insurance transaction (and most reinsurance transactions as well) violates the implied assumptions of equal eagerness and equal bargaining power in the hypothetical transaction that defines fair value.

Part of the explanation for this lies in the fundamental asymmetry that underlies the concept of insurance and makes it viable – the value to the insured of the reduction of uncertainty achieved by insurance is much less than the corresponding cost to the insurer of the much lower relative uncertainty assumed by the insurance pool. I find it helpful, in explaining this to non-actuaries, to use a numerical example.

Consider a pool of 1,000 independent, identically distributed risks, each with gamma distributed losses (i.e., a relatively “fat tail”) with expected value \$10,000 and standard deviation \$31,623. If this pool is prepared to accept a 0.01% probability of failure in a given year, it needs capital of \$4.153 million, over and above the expected amount of losses (\$10 million). Assuming that it can obtain this capital at a net cost (over its earnings on investing this capital) of 5% per annum, it needs to charge a profit margin of \$208 per risk. For any individual risk, however, the amount needed to ensure the same 0.01% probability of failure, is \$531,624, with a cost of capital of \$26,581 per risk. Even if the individual is prepared to accept a higher probability of failure, say 1%, the cost of capital is \$7,942. It is not till the acceptable probability of failure is about 5% that the cost of capital, at \$2,902, is close to the transaction costs of the insurance, which might be around 25% of the expected losses, or around \$2,500.

The other part of the explanation lies in the insurance cycle. When there is excess capital chasing imaginary profits, prices in the general insurance market are driven down. Where risk premiums are reasonably well known, this effect is relatively small, but for long-tail classes with highly diverse risks the premiums charged can easily be less than 80% of what, with hindsight, turns out to be the cost of claims alone. Those insurers that recognize that premiums are too low are in a bind. If they do not follow the market down, they will lose

IAA (DRAFT) COMMENTS ON IASB'S EXPOSURE DRAFT 5 *INSURANCE CONTRACTS*

FAIR VALUES

contact with their customer base and find it very hard to write business in the subsequent hard market. They have little choice but to try to minimize losses by selective underwriting. In effect, the bargaining power of potential insureds is greatly increased by the presence of naive competition.

When enough naive capital is burnt out of the market, the survivors raise their prices to well above what, again with hindsight, turns out to be needed, profits are reported, which in turn attracts more naive capital and the cycle starts again. During the hard phase of the market, the balance of bargaining power swings to the insurers. Because their prices remain below, in most cases, the perceived value of the uncertainty that insureds are trying to lay off, the demand for insurance is relatively inelastic.

While it is arguable that Fair Value should track these swings, accounting on this basis for general insurance would be an absolute disaster. It would reinforce the impressions of the naive investors who drive the insurance cycle, increase the amplitude of the price swings, and result in a substantially higher level of insolvencies each time that the true costs are recognized and the cycle turns up. It is absolutely vital, for a stable industry, that general insurance provisions should be based on reasonable estimates of the probable cost of claims, independently of what are usually distorted prices.”

While there has been significant investigation into the subject of fair value measures for insurance and investment contracts, there is no commonly accepted practice for the application of the concepts and there are many theoretical and practical implementation issues that are not resolved. A practical approach to meeting the expectations of IAS 39 within the current state of the art of cash flow modelling could be to focus on the initial value, or the fair value of considerations received in stable markets.

One approach would use the discounted cash flows at issue as calibrated to the initial value by means of an adjustment to cash flows or by an adjustment to the discount rate. This adjustment factor would become a part of the basis for future valuations of the subject contracts as credible evidence expectations about material contingencies are changed. The adjustment to cash flows or discount rates would only change if there was compelling evidence that the market prices for similar contracts would have a different calibrating factor. The use of initial values must of course be supported by the view that the methods and assumptions in the calibrating models can be seen to be reasonable.

However, for markets that are observed to be cyclical, a different method of establishing the initial fair value will likely be required. Valuable research in these markets is being conducted in a number of jurisdictions of which Australia appears well advanced.

IAA (DRAFT) COMMENTS ON IASB'S EXPOSURE DRAFT 5 *INSURANCE CONTRACTS*

FAIR VALUES

Prescriptive guidance

At various times in its deliberations the Board has expressed its views about certain factors that must be considered in a fair value measurement. Among these are the statements that the fair value of a financial liability cannot be less than the amount payable on demand and that the fair value measurement should not take into consideration the performance of invested assets. While there are many specific aspects of fair-value measures that must be considered and resolved, it is difficult to address them individually, as in the end the results must be seen to be consistent with the market view. It is important therefore that the specific issues be considered collectively as part of a model that is intended to model the markets, and that the final decision about the resolution of the individual issues should be decided based on how they contribute to the validity of the models as tested against the markets.

Recommendation

We believe that fair value measures can be developed within the guidance of IAS 39. We are committed to exploring approaches such as calibration to prices of insurance and investment contracts observed in the markets for stable markets and risk modelling in cyclical markets. We recommend that the Board affirm the principles it has expressed in IAS 39 and not give prescriptive guidance that can have the effect of requiring valuations that deviate from the more general principles found in IAS 39.

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Investment Spreads

Introduction

In the Basis for Conclusion to ED 5, the IASB Board provides its tentative conclusions for phase II of the insurance project. Among the tentative conclusions is the statement in BC6(c) that:

“As implied by the definition of fair value:

“

- (ii) expectations about the performance of assets should not be incorporated into the measurement of an insurance contract, directly or indirectly (unless the amounts payable to a policyholder depend on the performance of specific assets).

...”

Most actuaries believe that a fair value measure, that is, one that is calibrated to transactions involving insurance contracts, must include some consideration of asset performance since product pricing, reinsurance and observed market transactions are observed to reflect this feature.

Background

Market transactions involving insurance contracts are generally priced by actuarial appraisals or embedded valuation methods that calculate the value of inforce (VIF). These approaches, (which are equivalent if all assumptions are the same), calculate the VIF as the present value of the incremental contribution to the distributable earnings that the contracts can be expected to produce adjusted for risk based capital requirements – or risk adjusted capital expectations. Note that when embedded derivatives, options and guarantees are contained in the contracts, best valuation techniques reflect the extent to which they “are in the money” or “may come into the money”. From this perspective, the VIF is an intangible asset that represents the value of the ultimate cash flows as they become available to shareholders from the contracts; namely the amounts that could be paid in dividends to shareholder that are attributable to those contracts.

In addition, market evidence supports the view that a block of business is worth the value of its distributable earnings. The earnings projections in a VIF calculation usually include expected investment spreads.. It is the net cash flows of the insurance contracts that provide the investable funds, and the investment income is an essential part of the revenue required to meet the obligations of the contracts and to provide a profit to shareholders. Hence it is logical that they would be included in an assessment of VIF.

Fair Value Accounting

We acknowledge that the Board has not been inclined to allow the recognition of a self-generated intangible asset, in part because the intangible asset depends on the measure of the liability. Yet in a business combination when the intangible asset is paid for, the Board does grant it recognition. The intangible asset might be seen in this light to be the difference between the carrying value of the liability and the fair value of the contracts. If so, a consistent fair value measure of the liability obviates the need for an

IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Investment Spreads

intangible asset and reconciles the difference between originating entity and purchase accounting.

It is possible to calculate a fair value measure of liabilities using discounted cash flows by a method that can be equivalent to the actuarial appraisal method.¹ This method, known as the option pricing method ("OPM"), uses realistic cash flows with adjustments for risk in the discount rate. The cash flows do not include investment income. Rather, the discount rate is the risk-free rate plus a liability spread. But when calibrated to market pricing, the liability spread can be seen to include a portion of the asset spread. The parameters in the OPM can be set by market consideration as well as by entity – specific factors, if market information is not available. The use of entity-specific parameters should approximate market considerations as insurers operate in a competitive environment.

We acknowledge that the concepts of the fair value of insurance contracts are not fully developed or universally agreed inside the actuarial profession or inside the insurance industry and that there are many issues to be resolved before they can be put into application for financial reporting purposes. The objective should be to find an approach that provides a reliable measure of the market-view of liabilities that is free of bias and practical to implement. The IAA urges the IASB to conduct extensive, and comprehensive, field test of various methodologies before deciding on what constitutes acceptable fair valuation methods for insurance contracts.

We note that the actuarial appraisal methods referred to in this communication are those that have been observed in varied markets and may be different in some respects from those in use in achieved profits reporting in the UK and elsewhere, and from actuarial standards for appraisals in the United States. We expect that evolution, convergence and refinement of methods will occur as a result of the introduction of an insurance IFRS and the possible future introduction of international risk based capital requirements. Thus, the fair value of liabilities can be expected from time to time to be affected by future changes.

We believe that the approach discussed above is consistent with fair value guidance found in IAS 39. We recommend that the Board should not, without widespread field testing, commit itself to more prescriptive guidance than is already found in IAS 39. The Board should instead focus on how the principles embodied in that standard can find application to insurance contracts. The IAA intends to expose this concept further and wishes to collaborate with the Board. We believe that if we work together we can develop an approach to the valuation of insurance contracts that meets the objectives of the Board and can be seen by the insurance industry and the actuarial profession to be a reasonable and reliable measure of insurer's liabilities.

¹ Girard, Luke N. 2202, Market Value of Insurance Liabilities: "Reconciling the Actuarial Appraisal and Option Pricing Methods," *The North American Actuarial Journal*, volume 4, No. 1: 31-62