OICV-IOSCO

Organización Internacional de Comisiones de Valores
International Organisation of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valore

December 18, 2007

Discussion Paper: Preliminary Views on Insurance Contracts
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

RE: Discussion Paper: Preliminary Views on Insurance Contracts

Dear IASB Members:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (Standing Committee No. 1) thanks you for the opportunity to provide our comments regarding the International Accounting Standards Board (IASB or the Board) Discussion Paper about Preliminary Views on Insurance Contracts (the Discussion Paper or the Paper).

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement. Members of Standing Committee No. 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus (except where specifically noted below) among the members of Standing Committee No. 1 and are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

General Observations

Improvements in Accounting for Insurance Contracts

We believe that the IASB's preliminary views on insurance contracts would be an improvement to accounting for insurance contracts under IFRS. In this regard, we believe that the proposed accounting will increase transparency of financial information about insurance contracts providing a better reflection of the risk, opportunity, and uncertainty underlying insurance. We appreciate the significant effort of the IASB in developing these preliminary views and the effort that will be necessary for the IASB to develop an exposure draft and ultimately a final standard. We also believe that effecting these improvements through a final standard should be a high priority, especially as IFRS 4 currently allows for diversity in the accounting for insurance contracts, and

Calle Oquendo 12
28006 Madrid
ESPAÑA
Tel.: (34.91) 417.55.49 • Fax: (34.91) 555.93.68
mail@oicv.iosco.org
• www.iosco.org

its disclosure requirements are not sufficient to completely mitigate the lack of comparable and transparent financial information that it allows. We present below our general observations on the primary issues in the Discussion Paper, followed by responses to the specific questions posed in the Paper.

As a general matter, we support the body of standards in IFRS including a final accounting standard on insurance transactions that addresses recognition, measurement and presentation and that generally applies to all preparers of financial statements, regardless of whether they are insurance enterprises or non-insurance enterprises. (By "insurance enterprise", we mean an entity whose predominant business activity is issuing insurance contracts.) That is consistent with our view that one goal of accounting standard setting should be to provide uniform guidance for economically similar transactions, i.e., transaction-based standards. We believe uniform guidance is important to making financial information most useful and understandable for investors and minimizing unnecessary complexity of financial information. At the same time, economically dissimilar transactions should not be forced into uniform accounting guidance. These beliefs provide the primary basis for several of our observations below.

Current Exit Value

We understand that the Board has not yet concluded whether the measurement attribute for insurance contracts, i.e., current exit value, is equivalent to fair value. While the Board has not reached final conclusions on whether these measurement approaches are the same, the Board has not yet identified significant differences between them. We look forward to this issue being resolved prior to the issuance of a final standard on accounting for insurance contracts.

There is broad support within Standing Committee No. 1 for a measurement attribute for insurance obligations that reflects current prices. However, we have the following observations about insurance contracts that the Board should consider in its deliberations on what measurement attribute should be used for insurance contracts.

- Insurance contracts typically cannot be sold, although they can be reinsured, making it difficult to reliably determine market participant assumptions in many cases.
- Evaluation of solvency is very important to users of the financial statements of insurance companies. Consideration of changes in an entity's own credit risk in measurement of insurance liabilities may mislead financial statement users about company solvency where the deterioration in the insurance company's own credit risk leads to a reduction in the amount of the liabilities.
- The economics of insurance contracts requires consideration of cash flows beyond the term of the existing contract, because the contracts are written to be profitable over the term of the contractual relationship. There may be large upfront costs associated with writing the contract, which if immediately expensed might result in a pattern of losses and gains not reflective of the profitability of the insurance business over its life, particularly if future renewal premiums are not factored into the liability measurement when appropriate. Any measurement approach that excludes cash flows that are important to the overall profitability of insurance contracts would not improve the relevance of financial reporting for insurance contracts.
- Insurance providers are compensated for more than bearing risk because there are service elements, such as investment or claims management services, associated with many insurance policies. Appropriate revenue recognition for such service type elements should be considered in determining any measurement approach for insurance contracts.

- Insurance liability measurements are best considered on a portfolio basis to be consistent with the way in which insurers underwrite policies and manage their risks. While acknowledging that any individual policy may result in losses, insurance contracts are intended to be profitable in the aggregate.

Because of the points noted above, we do not have a consensus within Standing Committee No. 1 at this time as to how the measurement attribute for insurance contracts should be described. If it is determined that current exit value is not fair value, some members of Standing Committee No. 1 believe that the distinguishing characteristics of insurance contracts described above are sufficiently significant to justify accounting for insurance contracts at other than fair value. Other members believe the differences between insurance contracts and similar financial liabilities that are currently measured at fair value are not sufficient to support a measurement approach other than fair value for insurance contracts.

We note further that we found it difficult to address the question regarding whether current exit value is the appropriate measure for insurance contracts (Question 5) without fully understanding how the approach may be implemented and what contracts will fall within the definition of insurance contracts. We believe the IASB should further consider the points enumerated above and how those may impact the determination of an appropriate measurement attribute for insurance contracts.

Expected Extent of Changes—Insurance Contracts Only or All Contracts?

Members of Standing Committee No. 1 are not clear how this insurance project relates to other accounting standards, such as IAS 39, IAS 18, and others, and on-going IASB projects (e.g. fair value measurement, distinguishing between equity and liabilities, and revenue recognition). For example, the adoption of the Board's preliminary views for policyholder behavior would result in the recognition of certain customer relationship assets as an offset to the insurance liability. These views could be considered inconsistent with the guidance in IAS 38 that internally generated intangibles do not qualify for recognition. Is it the intention of the Board to eventually amend IAS 38 to be consistent with the decisions in a final insurance standard? We are not clear whether the insurance project will supersede existing standards or projects (such as those we have mentioned above) or the reverse. As a result, it was difficult to respond to some of the questions in the Paper. We believe that the IASB should clarify how this insurance project relates to other standards and projects.

Calibrating the Risk Margin

We generally support basing the risk margin on the view of market participants and believe this is consistent with the current exit value notion. However, on the issue of calibrating the risk margin to the transaction price, some members of Standing Committee No. 1 believe that there should be a presumption that generally the risk margin should be calibrated to the actual premium (alternative (b) in response to Question 4 below). That said, those members believe there could be some circumstances where the presumption could be rebutted, such as the circumstances described in paragraph 17 of Part 2[1] of the Board's Discussion Paper, *Fair Value Measurement*. If the

[1] "(a) The transaction is between related parties."
"(b) The transaction occurs under duress or the seller is forced to accept the price in the transaction."
"(c) The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value."

factors that would overcome the presumption that the risk margin should be calibrated to transaction price do include whether the exit value reflects a different unit of account or a transaction in a different principal market, then it might be the case that the presumption would be overcome in many insurance transactions leading to a "Day 1" gain or loss. The unit of account for insurance contracts is typically the individual policy at issuance, but the portfolio after issuance. The principal market for many insurance policies typically is one involving individual policyholders at issuance (entry market) but involving other insurance companies after issuance (exit market). The consequence of changing units of account or markets could be that there would be a "Day 1" gain or loss on many insurance contracts. Given this possibility, we believe that the Board should consider the likelihood of Day 1 gains and losses and clarify the basis for its views in any exposure draft that the premium charged should have no higher status than other evidence of the margin that market participants would require.

Other members of Standing Committee No. 1 agree with the Board's preliminary views that the premium should not have a higher status than other possible evidence of the margin that market participants would require (alternative (c) in response to Question 4 below). However, while those members favor using an unbiased estimate of the risk margin instead of calibration of the risk margin to the premium, they would instead prefer a requirement for an explicit deferral of any "Day 1" gains as a separate liability or in equity.

Policyholder Behavior

The members of Standing Committee No. 1 believe that determining when to consider nonmandatory policyholder behavior in accounting for insurance contracts is a difficult issue made more difficult by the lack of a uniform principle in IFRS for when to include cash flows associated with the expected, but not required, behavior of a counterparty to a contract. Such a principle would be the basis for determining what cash outflows and inflows should be included in measuring insurance liabilities, while considering factors that might be more commonly found in insurance contracts than elsewhere. Given that the preliminary views of the Board support a current exit value model, some might consider the answer dictated by such a model to be including all cash flows a market participant would consider in determining the amount he or she would demand to assume the insurance contract. However, the Board in its preliminary views favors only recognizing cash inflows necessary to retain guaranteed insurability. While generally agreeing with the Board's position on this issue, we encourage the Board to clarify further how its views on this issue are consistent with a current exit value model and with the prohibition in IAS 38 on recognizing internally developed intangible assets.

With regard to insurance contracts, we believe the Board should adopt a principle for including cash flows associated with the expected, but not required, behavior of a counterparty to a contract that would at least encompass criterion (a) of Question 7, namely cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability. We believe including such cash flows are important in the insurance context because not including them could allow insurers to avoid recognizing losses associated with adverse selection. If there is a right to guaranteed insurability, policyholders that have had an increase in riskiness (e.g., become more unhealthy) will renew in greater numbers and generate higher per policy losses. However, healthy policyholders with the same rights would be expected to renew as well, but with lower expected per policy losses. Given these joint expectations, we believe that criterion (a) implicitly

---

"(d) The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market."

acknowledges that the policies may be priced to be profitable on a portfolio basis by allowing for the inclusion of guaranteed renewable premium from all holders of these policies. This criterion thus appears to be reasonably consistent with the business model for insurance companies.

While we have not determined precisely where the line should be drawn beyond criterion (a) on which cash flows should be included in measurement of the net insurance liability, we believe the approach developed should be reflective of the business model for insurance but not give rise to gains or losses at the inception of the contract because of differing criteria for exclusion of cash inflows versus cash outflows. We believe the Board should also consider the extent to which cash flows are required or permitted under the provisions of the contract itself, under applicable statutes, or because of consistent practice within certain jurisdictions. This is pertinent to the concept of guaranteed insurability, as well as to other potential approaches, since in some jurisdictions, the right to renew without re-underwriting the contract is not necessarily a contractual right; it may be a statutory right or a practice generally followed.

Service Margins

While we do not oppose the concept of the service margin, the members of Standing Committee No. 1 find the discussion of service margin versus risk margin somewhat confusing. The discussion of a service margin indicates that this would be added when other activities besides providing insurance are required by the contract. An example given of other services that might be provided is investment services. The Discussion Paper indicates that it is not reasonable to expect that an investment manager would take on such services without expecting compensation. While it is true that there is compensation for all the activities that the insurer must undertake under the insurance/investment contract, the segregation of the margin into risk margin and service margin implies that it is possible to separately estimate the service margin in the contract. In fact, the service margin on a universal life contract, for example, may not be separately priced by the company and hence the separate estimation of such a margin may be difficult to accomplish. If the investment portion of the contract is significant, that might suggest the need to unbundle the "risk taking" portion of the contract from the "investment" portion of the contract and estimate the liability components separately. Also, it is not entirely clear how to separate the service margin for managing investments (Example 4 in Appendix G) from the service margin for managing the portfolio of contracts (Example 5 in Appendix G). In that regard, discussions in paragraphs 84(b)(iii) and 85 seem to imply that the margin for managing a portfolio of contracts is actually part of the risk margin on the contracts rather than part of the service margin. The Board could simplify the discussion of the margin (above the basic discount rate) by indicating that the margin should consider both risk bearing and services, without implying that there would be two separate margins to apply. In addition, the Board could make it clearer that the margin in no way should provide for "shock absorption" or the "smoothing" of earnings.

Unbundling

The members of Standing Committee No. 1 generally accept the Board's preliminary views regarding unbundling because we believe that to the extent that a deposit or service component would be recognized or measured differently than the insurance component, then unbundling provides more useful information for users. However, we believe that if the deposit and insurance components are interdependent, but can be measured separately on a basis that is not arbitrary (paragraph 228(c)), it is not clear why the best approach is to measure the deposit component first, with the insurance component as the residual. Perhaps the Board believes that the measurement of the deposit component is more objective, i.e., less subject to estimation error. Or, perhaps the

Board is concerned that assigning less than the full value of the deposit to the deposit component would result in an immediate adjustment of the liability to the deposit amount and a "Day 1" loss, if that is the amount that could be demanded at the balance sheet date. The reasons for the Board's approach to such contracts should be clarified in any future documents and comments solicited thereon. In absence of a clarification of the rationale for the Board's view, the Board may want to consider a relative fair value approach to allocating the value to the deposit and insurance components.

Responses to Questions and Specific Comments

Question 1

Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

Please refer to our above General Observations under *Improvements in Accounting for Insurance Contracts*. We believe the recognition and derecognition requirements for insurance contracts should be consistent with those in IAS 39 for financial instruments. We are not aware of sufficient differences between insurance contracts and financial instruments that are relevant to the recognition and derecognition issues to justify these requirements being inconsistent.

In addition, we believe the Board should address the derecognition of insurance assets. As the Discussion Paper would have insurers recognize certain insurance assets as a reduction to the insurance liability, it may not be appropriate to have different derecognition guidance for components of a single recognized amount. As such, we believe derecognition of both assets and liabilities should be addressed prior to the issuance of an Exposure Draft on accounting for insurance contracts.

Question 2

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

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

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

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

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

Please refer to our above General Observations under *Improvements in Accounting for Insurance Contracts* and *Current Exit Value*. If the Board's final views are that insurance liabilities should be measured at current exit value, we believe an insurer should measure all of its insurance liabilities using the three building blocks. However, we believe the Board should clarify whether the blocks should be independently determined and, if so, the Board should ensure that the measurement of one block would not be allowed to duplicate the measurement of the other blocks, such that the insurance liability is either overstated or understated. In addition, we believe insurers should use market participant assumptions where possible, as this is critical to the current exit value principle.

We believe that the Board should clarify how the building block model applies to claim amounts once these have become fixed and determinable. It is not entirely clear why a risk margin, discussed as the margin for the service of bearing risk, should be applied to cash flows where the amounts are certain. Applying a risk margin to known, future claims payments might imply that uncertainty exists where there is instead no uncertainty at all.

Question 3

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

If the Board's final views are to follow the current exit value approach with the three building blocks, we have the following observations:

- We believe the guidance should indicate that identifying the cash flow scenarios may require the "branching" of possibilities, similar to a lattice model. In other words, an insurer may need to consider the various permutations of holding some assumptions constant while considering reasonably likely changes in others. For insurance contracts with numerous assumptions, this could create more cash flow scenarios than an insurer might expect to employ.

  We believe it would also be possible for insurers to incorporate certain cash flows, discount rates and risk margins that would be either duplicative to or different than those contemplated by the Board. In this regard, the guidance should clarify whether each building block should be determined separately and provide guidance to ensure that the effects of the different building blocks are not duplicated.

- We are concerned that some portions of Appendix E may obscure the principle of using market participant assumptions, as opposed to entity-specific assumptions. For example, regarding paragraph E15(e), the guidance should elaborate on the notion of reinsurance prices not generally being true exit prices because the cedant's obligation is typically not extinguished. In this regard, it is unclear if the distinction is based on legal versus economic extinguishment. Also, regarding paragraph E18, the Board should consider not citing actuarial "credibility" techniques in accounting guidance, as it may instead be better left to auditing and/or actuarial guidance, or instead elaborate on why it is necessary and relevant to determining current exit value. In addition, regarding paragraph E27(c), the guidance should clarify what an insurer should do when an insurer notes that other insurers incur higher or lower servicing costs because of differences in efficiency and how this impacts the insurer's accounting under the proposed model.

  Regarding paragraph E28 and estimates of nonmarket variables, we believe the Board's statement that "there will rarely be persuasive evidence that the insurer's estimates differ from estimates that other market participants would make" is an overgeneralization subject to being misconstrued. We suggest replacing it with a statement to the effect that the company does not have to undertake exhaustive efforts to determine whether market participant assumptions differ from the entity's own assumptions in such cases. Finally, the Board may want to consider further: (a) distinguishing market participant and portfolio-specific assumptions from entity-specific assumptions, as this was still unclear to some, and (b) providing further guidance about when entity-specific assumptions are prohibited and when they may be allowed.

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.

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

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

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

(d) Other (please specify).

Please refer to our above General Observations under *Calibrating the Risk Margin.*

Question 5

This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.

(a) Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?

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

Please refer to our above General Observations under *Current Exit Value.*

Question 6

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

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

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

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

Please refer to our above General Observations under *Policyholder Behavior*. We prefer alternative (b) above, in that whatever expected future cash flows are incorporated by an insurer should reduce the current exit value of insurance liabilities. However, we believe the Board should elaborate on the basis for this presentation, as the cost-benefit analysis described in paragraph 144 of the Paper is, in and of itself, not a sufficient basis to justify this presentation. In this regard, it is not clear why it is either less costly or more beneficial to reduce the liability, as opposed to separately reporting an asset.

In addition, paragraph 156 of the Discussion Paper says there could be circumstances when the reduced liability could be negative. As such, we believe the Board should address how a negative liability should be presented and explain the basis for that presentation. If it should be presented as a contra liability, the Board should specifically address how other contracts with positive liabilities would not be understated. If it should be presented as an asset, the Board should specifically address whether doing so would result in the recognition of a customer relationship asset and why that would be appropriate in light of the guidance in IAS 38. If it should be recognized at zero, the Board should explain why and illustrate this accounting and the accounting required if a positive liability subsequently results.

Question 7

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

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

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

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

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

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

(f) Other (please specify).

Please refer to our above General Observations under *Policyholder Behavior*.

Question 8

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

Consistent with our general observations under *Improvements in Accounting for Insurance Contracts,* we believe acquisition costs should be expensed when incurred, as they do not meet the conceptual definition of an asset and are generally expensed by non-insurance enterprises that engage in insurance activities.

Question 9

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

We believe rights and obligations under insurance contracts acquired in a business combination should be recognized and measured like any other rights and obligations acquired in a business combination. To the extent the Board retains the expanded presentation now permitted by IFRS 4, we believe the Board should provide guidance to address any situations when the difference contemplated by paragraph 31(b) of IFRS 4 would be a net liability. These situations could conceivably occur when either: (1) the fair value of the contractual insurance obligations assumed exceeds the fair value of the contractual insurance rights acquired or (2) the amount described in paragraph 31(a) of IFRS 4 exceeds the net fair value of the rights and obligations. In addition, the Board should elaborate on how an intangible asset should be measured on a basis consistent with the measurement of the related liability, which presumably would be the amount described in paragraph 31(a) of IFRS 4. On portfolio transfers, the Board should consider whether the remaining difference described in paragraph 172 of the Discussion Paper (the difference, after recognizing an intangible asset, between initial measurement and the consideration transferred) could instead result from an error in determining the current exit value.

Question 10

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

Consistent with our above General Observations under *Improvements in Accounting for Insurance Contracts,* we believe assets held to back insurance liabilities should be measured the same as if the same assets were not backing insurance liabilities or were held by non-insurance enterprises.

Question 11

Should risk margins:

(a) *be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?*

We believe that risk margins (the third building block) generally should be determined for a portfolio of insurance contracts, but we believe that the Board should also consider whether the other two building blocks could also be determined on a portfolio basis. However, we also believe that some insurance contracts may be sufficiently unique to have all three building blocks be determined on a contract basis.

In addition, we believe the Board should reconsider the definition of a portfolio in IFRS 4 to ensure that it is consistent with the measurement objective for insurance contracts. For example, the definition in IFRS 4 considers how contracts are managed. However, if the measurement objective is to assume a transfer of the contracts, the Board should consider basing the definition on how contracts would be transferred. Otherwise, how contracts are managed would apparently be an entity-specific assumption. To the extent that the Board believes that grouping contracts based on how they would be transferred is either impracticable or would generally be consistent with how they are managed, the Board should consider clarifying its belief so that this guidance is not inconsistent with the measurement objective.

Regardless of whether a portfolio is defined based on how contracts would be managed versus transferred, it would seem that the composition of a portfolio could change during the term of insurance contracts. As such, the Board should be aware that these changes alone may result in a change in how the related liabilities are measured and therefore the Board should consider providing guidance to limit the circumstances when changes to the portfolio could, by themselves, result in a profit or loss on the affected insurance contracts.

(b) *reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?*

We believe that the risk margin should not reflect the benefits of diversification between (and negative correlation between) portfolios. To the extent the operations of a company are primarily comprised of issuing insurance contracts, considering multiple portfolios could effectively result in trying to measure the value of the whole company or could require guidance on grouping portfolios.

Question 12

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

We believe a cedant should measure reinsurance assets on the same basis as the related insurance liabilities, for which the preliminary view is current exit value.

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

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

If both reinsurance assets and insurance liabilities are measured at current exit value, we believe a risk margin increases the measurement of the reinsurance asset. This belief is based on our understanding that the insurance liabilities and the reinsurance assets would be transferred together and that the price a market participant would pay for both would consider the risk margins of both. As a market participant would consider the reinsurance assets to economically offset the insurance liabilities, the risk margin should move both the reinsurance assets and insurance liabilities in the same direction. Thus, as the risk margin increases the insurance liabilities, the risk margin would increase the reinsurance assets.

We believe that the risk margin for the reinsurance asset may not always equal the risk margin for the corresponding part of the underlying insurance contracts. For example, there are instances where the reinsurance protection often covers only part of the cedant's liability (as noted in paragraph E15(e)). For example, the reinsurance coverage may not be proportionate to the underlying insurance coverage, such as where the insurance is on a stop-loss or excess-of-loss basis. In addition, paragraph E15(e) also notes how reinsurance differs from a true transfer of the insurance contract. In light of all this, the risk margin for the reinsurance asset may not always equal the risk margin for the underlying contracts.

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

If both reinsurance assets and insurance liabilities are measured at current exit value, we agree that an expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.

(iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

If both reinsurance assets and insurance liabilities are measured at current exit value, we believe the current exit value of the contractual right to obtain reinsurance for contracts not yet issued could be material. Otherwise, if the Board concludes that it could not be material, the Board should consider the extent to which significant profits or losses could arise at inception of insurance contracts.

Question 13

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

Please refer to our above General Observations under *Unbundling*. Regarding paragraph 228(b), the Board should clarify why it appears to believe that the components can be separately measured other than arbitrarily solely because they are not interdependent. Otherwise, the Board should consider providing guidance similar to the guidance for components that instead are interdependent in paragraphs 228(a) and 228(c). In addition, the Board should consider clarifying whether service margins would still need to be estimated for the insurance component, once separated from the deposit component.

Question 14

(a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?

(b) Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?

We believe the measurement of the liability should neither improve nor impair its credit characteristics and should reflect characteristics at inception and any subsequent changes. In addition, we believe this should be clear in the guidance on estimating the amount, timing and uncertainty of future cash flows. However, we believe the Board should consider the views of financial statement users as to whether they believe an insurer should use its own credit characteristics to measure the insurance liabilities, as some users may disagree with recording a lower liability when the credit of an insurer deteriorates.

Question 15

Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

Please refer to our above General Observations under *Improvements in Accounting for Insurance Contracts* and to our Specific Observations above under Question 2. We believe that it may be appropriate after revision of the conceptual framework for the Board to consider developing a cohesive model that addresses the measurement of liabilities within the scope of IFRS 4, IAS 37, and IAS 39 generally, and not merely IAS 39. For example, the model could address how insurance contracts and IAS 37 provisions would be measured once amounts to be paid become fixed and determinable. In any case, reconsideration of how to measure liabilities should consider differences in economics and user information preferences, among other factors. These factors would determine whether different or the same treatment is appropriate for financial, insurance liabilities, or other liabilities.

Question 16

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

We believe that the cash flows for each scenario should incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation as currently defined in IAS 37 that exists at the reporting date.

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

We believe that additional guidance is necessary for determining if a legal or constructive obligation exists, for both insurers and non-insurers. In this regard, please see our comments (in response to Questions 2, 4, and 5) in our 21 November 2005 letter on the proposed IAS 37 amendments. In addition, we believe the Board should address any potential conflict between its preliminary view and the definition of a financial liability in IAS 32, as we see no basis for any conflict.

Question 17

Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?

(a) Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).

(b) Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).

(c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).

(d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).

Consistent with our general observations under *Improvements in Accounting for Insurance Contracts,* we believe the Board should do nothing to eliminate the so-called "accounting mismatches" that could arise for unit-linked contracts. If the Board did some or all of the things suggested in Question 17, the effect apparently would be to create "accounting mismatches": (a) between certain insurers and other insurers, (b) within the financial statements of insurers with unit-linked and other insurance contracts, and (c) within the financial statements of conglomerates comprising both insurers and other financial institutions. To the extent users need additional information about the assets "linked" to unit-linked contracts, the Board could require that this information be consistently disclosed. However, if the Board does something, we believe that the accounting should be required, as only permitting the accounting would result in unwarranted inconsistencies among insurers. Whether the Board requires additional disclosures or requires different accounting, we believe the Board should carefully define unit-linked contracts so they are sufficiently restrictive to warrant a difference from other IFRSs.

Question 18

Should an insurer present premiums as revenue or as deposits? Why?

Question 19

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

Question 20

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

Response to Questions 18-20

Consistent with our general observations under *Improvements in Accounting for Insurance Contracts*, we believe that any financial information provided by insurers should be consistent with how non-insurers provide comparable information. Similarly, we believe the nature and extent of this information should be consistently presented by all insurers. Also, while not specific to these questions, the Board should also provide guidance on how to present the effect of reinsurance activities, as diversity appears to exist.

In addition, we believe that an insurer should provide the information necessary for a user to understand the results of its operations. However, we do not currently have a view as to how this information should be provided, including the extent to which it should be provided on the face of insurer financial statements or in the notes thereto. We encourage the Board to engage a diverse group of users to determine what presentation and disclosure content and format would be most helpful to users of insurer financial statements and to incorporate those findings into proposed principles and requirements in a future Exposure Draft on insurance contracts. In so doing, we encourage the Board and users to consider the extent to which insurance contracts are similar to contracts measured at fair value and what method of measuring and presenting revenue would be appropriate for insurance and similar contracts.

Question 21

Do you have other comments on this paper?

We have the following additional comments:

- Disclosure of entity-specific cash flows – We believe insurers should disclose entity-specific cash flows that are materially different from those permitted to be considered in determining current exit value. As insurers are not likely to transfer insurance contracts, this information would be useful to better understanding the cash flows the entity expects to ultimately incur.

- Participating contracts – Paragraph 261 of the Discussion Paper says "[a]n insurer would need to measure the asset-dependent cash flows for participating contracts on a basis consistent with the measurement of the underlying assets." To the extent this is included in an Exposure Draft, we believe that it should be better explained and clarified to indicate, if true, that it does not address recognition.

- Mutual fund recognition – Paragraph 270(e) of the Discussion Paper notes that if assets in a fund are not insulated, that fact may be an important difference from most mutual funds. While it says this difference may be relevant to whether the insurer should recognize the assets of the fund, it did not appear that this was sufficiently addressed. We believe this should be addressed in the Exposure Draft.

* * * *

We appreciate your thoughtful consideration of the comments raised in this letter. If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact me at 202-551-5300.

Sincerely,

Julie A. Erhardt
Chairman
IOSCO Standing Committee No. 1