



30 November 2010

Ref: 10/190

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

Dear Sir David

ED/2010/8 Exposure Draft: Insurance Contracts

On behalf of members of the International Association of Insurance Supervisors (IAIS) we are writing to comment on ED/2010/8 Exposure Draft: *Insurance Contracts* (the ED). The time allowed for considering such a significant ED was very short for an organisation such as the IAIS to analyse, debate and make decisions about responses.

The Board's Insurance Contracts project has been underway for a long period of time. If the issues had been easy to resolve they would have been resolved many years ago. We are willing to provide further input to assist Board members' deliberations regarding the complex issues in this project. Reflective of the complexity of the project, the attached comments include the consensus of IAIS member jurisdictions reached on many issues but also a range of views on some key questions highlighting the points of agreement but indicating where opinions diverge. The Board will be aware that the IAIS has been, and remains, strongly supportive of the process to create a single high quality global accounting standard for insurance contracts.

It may be valuable to Board members as well as the IAIS to engage in bilateral dialogue over the coming months leading up to the finalisation of the Insurance Contracts standard. As such we believe it would be appropriate to arrange a series of meetings with IAIS representatives where as many Board members and relevant staff as possible could be present. We will be as flexible as possible with meeting arrangements.

Please contact Rob Esson, Chair of the IAIS Insurance Contracts Subcommittee (tel: +1 816 783 8131; email: resson@naic.org) or Peter Windsor at the IAIS Secretariat (tel: +41 61 280 9196; email: peter.windsor@bis.org) with any questions or requests for clarification of our response.

Yours sincerely

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Chair, Executive Committee

Monica Mächler
Chair, Technical Committee

Cc: Acting Chairman Leslie F. Seidman, US Financial Accounting Standards Board

I. General comments

Contributions of the insurance sector to the economy

1. There are three significant contributions of insurers to and within the economy:
 - i. Through risk transfer to insurers, companies and individuals can undertake projects or engage in economic activities and transactions they would otherwise not be willing to engage in due to the risk involved. This important function, often taken for granted, is a prerequisite for the supply of both labour and capital in most parts of the economy.
 - ii. The insurance sector manages risk by pooling exposures in order that aggregate losses are ultimately shared across the economy.
 - iii. Insurers have a role in investing in the economy on the asset side. Life insurers are used as long-term savings vehicles with many involved in the provision of pensions; the savings of individuals are aggregated and then invested in the real economy mainly in the form of debt and equity instruments.
2. As insurers make financial promises to policyholders, they are subject to prudential supervision by insurance supervisors a majority of them being members of the IAIS.

Insurance supervisors interest in the Insurance Contracts project

3. As you would be aware the IAIS has been a keen observer of and participant in the Board's Insurance Contracts project. However, it is worth reiterating why insurance supervisors are so keenly interested in the Board's deliberations. The role of insurance supervisors is encapsulated in the objectives of the IAIS which are to:

“(a) promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders; and to

(b) contribute to global financial stability.”

4. There are three key points of interest for insurance supervisors in accounting standards for general purpose financial reports:
 - i. The IAIS believes that it is preferable if the methodologies for calculating items in general purpose financial reports can be used for, or are substantially consistent with, the methodologies used for supervisory reporting purposes, with as few changes as possible to satisfy supervisory reporting requirements for the purposes of solvency assessment. Achievement of this aim is likely to reduce costs for regulated insurance entities and thereby policyholders;
 - ii. Accounting results drive management behaviour and supervisors would be concerned about any accounting requirements that may potentially incentivise management not to act in the interests of policyholders; and

- iii. Supervisors would be concerned with any accounting requirements which might lead to outcomes in general purpose financial reporting of insurers which could pose a threat to global financial stability.

Insurer Business Model and Asset/Liability Matching

5. Insurance differs from many other financial services by its business model which is based on an “inverted cycle of production”. This means that the product – the contractual promise to pay an agreed amount if specified events occur in the future - is sold at a price, the insurance premium. This has to be estimated before knowing the actual cost of the product which depends on probabilities of occurrence and severity of future events.

6. Thus in the insurance sector the establishment of adequate technical provisions (for future claim or benefit payments) and requirements for adequate investments matching the liabilities are crucial. Often the obligations of insurers to meet contractual promises are fulfilled over many years, sometimes decades, after the start of a contract. Insurers that issue long-term insurance contracts have a business model that relies on their ability to invest premiums received from policyholders in assets that provide appropriate cash flows, over the long-term, to enable those insurers to meet their long-term obligations to policyholders. An important feature of long-duration insurance business is that assets are usually managed in respect of liabilities and the fulfilment thereof. The interaction between the two is at the core of Asset-Liability-Management (ALM) which forms an important part of those insurers’ enterprise risk management activities and a primary driver of their performance.

Discount rate and the economics of insurance

Measurement of assets and liabilities

7. The ED proposes a current measurement approach for insurance contract liabilities including a current discount rate based on a risk free discount rate with an illiquidity adjustment. This is a significant issue for some insurers with portfolios of predominantly long-term contracts and their supervisors.

8. Fluctuations in these current discount rates will result in changes in the value of the insurance contract liabilities being immediately recognised in profit or loss. For long-term insurance contract liabilities, a small change in discount rate will result in a significant change in the value of the liability. Recognition of changes in these liability values will result in significant amounts being recognised as losses or gains due solely to the change in discount rate despite there having been no change in the requirement to fulfil the contract many years into the future.

9. Most assets that insurers use to back their insurance liabilities are financial instruments. While all financial instruments are initially measured at fair value minus transaction costs, IFRS 9 provides for three possible measurement attributes for subsequent measurement of financial assets:

- Fair value through profit or loss
- Fair value through other comprehensive income if an equity investment is not held for trading (subject to an irrevocable election at initial recognition)

- Amortised cost

10. If the ED is implemented in its current form, it is likely that many insurers will elect the fair value through profit or loss attribute to remeasure their portfolios of financial instruments as this may most closely align with the proposed current value measurement of insurance contracts. The use of the fair value through OCI category may be of limited applicability. While in many cases, insurers use ALM to match their assets reasonably closely to liabilities, in some cases insurers do not do so precisely and it is not possible for insurers with long-term contracts that have durations extending beyond an observable yield curve to do so. The result can still involve significant volatility in the profit or loss of insurers with long-term contracts. This volatility will be the result of recognition of gains and losses on both the asset side and liability side of the balance sheet where such gains and losses do not match each other.

11. The position on the asset side of the balance sheet is different between IFRS 9 and the former position under IAS 39. IAS 39 allowed financial instruments that were designated as available for sale (AFS) to be held at fair value through other comprehensive income (OCI). IFRS 9 only allows equities not held for trading to be at fair value through OCI. In addition, the IAS 39 AFS category allows for recycling but the IFRS 9 fair value through OCI category does not. This means that more of the perceived volatility in asset values of insurers will be reflected directly in profit or loss under IFRS 9 than IAS 39.

12. Considering what would happen if the proposals in the ED were implemented along with full implementation of IFRS 9, many IAIS jurisdictions question whether reflecting all short term gains and losses in profit or loss properly reflects the annual performance of insurers whose assets and liabilities are designed and managed on a long term basis. Therefore, many IAIS jurisdictions have concerns about the level of volatility in profit or loss which would be a result of the implementation of the ED in its current form.

Non-economic volatility

13. Given a long-term fulfilment value objective, many IAIS jurisdictions believe at least part of that volatility does not represent the economic performance of an insurer – this is termed in this letter as non-economic volatility. Many IAIS jurisdictions believe that short-term volatility induced by short-term changes in the yield curve reflected in the profit or loss of insurers with long-term fulfilment obligations would not represent the economic performance of those insurers and would thereby be such non-economic volatility.

14. The IAIS recommends that the Board consider the paramount influence that income statements, and in particular aggregated elements such as profit or loss, have on market participants' behaviour and on managerial and corporate decisions.

15. For those jurisdictions concerned about non-economic volatility, a key issue is that profit or loss is used as a basis for determining amounts that can be distributed to shareholders as dividends. Once profit or loss is recognised, in most jurisdictions, this amount can be legally distributed to shareholders provided they meet capital adequacy and other regulatory requirements. It would be problematic if insurers endeavoured to make distributions to shareholders based on a profit that is misleading that may then be reversed in subsequent reporting periods. While supervisors have the tools to prevent such distributions, our preference is that both supervisory and general purpose reporting align as much as possible on this key metric (see paragraph 4 i). Non-economic volatility in the profit or loss does not provide

a sound basis to either assess the performance of an insurer during a particular reporting period or as an indicator of future performance. Measurement and re-measurement of insurance liabilities must take account of inherent uncertainty and judgment. Care must be exercised in determining what fluctuations in value are relevant to the performance of the management of a company and distributable to shareholders.

16. However, a number of jurisdictions support the Board's proposal that the effect of all changes in discount rates used for insurance liabilities should be recognised immediately in profit or loss. These jurisdictions believe that any resulting volatility should be addressed in disclosures. Thus the effect of the different factors which result in this volatility can be assessed by the user of the financial statements. In addition, these jurisdictions believe that the presentation of short-term fluctuations in the income statement is appropriate as they are of the view that such fluctuations arise from a genuine accounting mismatch. They are not convinced that such fluctuations need to be measured or presented separately. These jurisdictions are concerned about the reliability and practicality of alternatives to full recognition in profit and loss particularly if guidance on separation is unclear or lacking. OCI does not change the balance sheet measurement and these jurisdictions believe this information could be provided through note disclosure. Until the Board has given a fuller consideration to the principles behind what OCI represents, these jurisdictions are reluctant to encourage the Board to extend the use of OCI.

Possible alternatives to recognising perceived non-economic volatility

17. Those jurisdictions who do not support the board's proposal in this area believe that the use of OCI can form one solution to addressing the perceived non-economic volatility created by the use of discount rates that exhibit such short-term volatility. IAIS members have identified two ways in which OCI could be used to address non-economic volatility.

18. A number of jurisdictions believe that this non-economic volatility issue can be addressed in the determination of profit or loss by utilising an insurer's more stable view of the time value of money over the long term consistent with the approach the insurer used to determine asset cash flows in its product pricing. This rate would be a conservative rate that takes into account possible default by counterparties to the insurer's asset portfolio. Insurance contract liabilities on the balance sheet can be valued using a financial market-derived discount rate. The changes in value between the insurance contract liabilities determined using the two different rates would go into OCI. In this way, measurement would better consider more stable and appropriate performance metrics for insurers with long-term fulfilment obligations, providing useful information on changes in an insurer's long-term investment cash flow expectations. This proposal would also allow the balance sheet to reflect the current but less stable financial market economic view of the time value of money on the insurance liability.

19. Other jurisdictions believe that it is inappropriate to consider non-economic volatility in the statement of comprehensive income only in respect of the insurance contract liabilities of an insurer. Both the ED and IFRS 9 focus on the measurement of liabilities and assets respectively from the perspective of the balance sheet and changes in values reflected in the statement of comprehensive income are simply a result of the measurement approach. It is understood that the Board is reluctant to reopen IFRS 9 to address this issue and to allow insurers to recognise more of their asset value volatility in OCI. These jurisdictions would encourage the Board to consider a holistic OCI solution that includes recognizing short-term volatility arising from current valuation of both the asset side and liability side of an insurer's balance sheet. It is

notable that in the ED there is already essentially a modification of IFRS 9 in paragraph 102 to allow, on transition to the new standard, redesignation of financial assets to fair value through profit or loss. It may therefore be entirely consistent to create an OCI category for financial assets within an insurance contracts standard without reopening IFRS 9 per se.

20. In the event that the Board chooses not to deal with the issue of volatility in profit or loss through an OCI solution, another approach to addressing the perceived non-economic volatility would be the inclusion of an option to use a discount rate locked-in at initial recognition for valuing liabilities which is then matched on the asset-side with assets measured at amortised cost. However, many jurisdictions are concerned that such an option, if applied, may result in an inappropriate basis for measurement of insurance liabilities. It is a possible secondary option for some jurisdictions. If this approach were implemented, it would only be appropriate where the products issued by the insurer meet a business model requirement in a similar way to the business-model requirement in IFRS 9 where assets are measured at amortised cost. This may create a more level playing field with other financial institutions which are able to measure both their assets and their liabilities using amortised cost. If the Board is not able to develop an OCI solution to non-economic volatility in profit or loss, then this seems to be the only other option to address the issue within the current framework of IFRS.

21. The Board's proposals need to work for insurers with portfolios of short duration contracts and those insurers with portfolios of long-duration contracts. The standard needs to provide adequate flexibility in order that insurers can appropriately reflect the economics of their business. However, the Board must guard against optionality that might be misused.

In-depth debate about insurer performance

22. As a result of the concerns raised above and the range of possible methods to address them, the IAIS urges the Board to have an in-depth debate about what an insurer's annual performance should reflect. The IAIS recommends that the Board establish a Technical Advisory Group to consider the appropriate performance reporting for insurers with a particular remit to consider solutions to the perceived non-economic volatility about which some IAIS members have expressed concerns. This Technical Advisory Group should be established as soon as possible and be required to report early in 2011 to provide the Board with adequate time to consider its recommendations in relation to this project.

23. The IAIS notes that, whichever proposed solution is adopted (if any,) adequate disclosure can assist in ameliorating any resulting concerns.

Discount rates on long-term liabilities

24. There appears to be an inconsistency between the ED and IAS 19. Pension liabilities and many life insurance liabilities share some common characteristics, with liability duration stretching many years, and decades at times. The Board has not, at this stage, altered the guidance in IAS19 regarding discounting for long term pension liabilities. This is characteristic of a lack of world-wide consensus about how to deal with these issues.

25. The IAIS also recommends that the Board initiate a cross-cutting project to consider the appropriate discount rate for long-term liabilities that are not actively traded. The IAIS recognises that such a project is not likely to be finished in the timeline for the Insurance Contracts project and consequently those jurisdictions concerned by the treatment and

presentation of non-economic volatility would expect that there may need to be interim solutions to the non-economic volatility created by the use of any current market discount rate. The IAIS emphasises that completion of the Insurance Contracts project should not be dependent upon the completion of such a project.

Diversity of insurers and markets

26. Across IAIS jurisdictions there is great diversity in insurance markets. The most obvious distinction is that between life insurers and non-life insurers. Perhaps a more helpful distinction however is to consider insurers with portfolios of predominantly short-term contracts and those with portfolios of predominantly long-term contracts. However, between jurisdictions there are often differences in what might seem, prima facie, the same types of insurers. Long-term products are prevalent in some jurisdictions, not in others. The IAIS also has members from developed economies and those from emerging economies and often these different types of jurisdictions have different characteristics and needs. These distinctions, in part, contribute to the differing views among IAIS members on issues related to this ED particularly in relation to the issue of volatility and discount rates described above. This diversity is also an issue in relation to comparability.

Comparability

27. While the need for comparability is understood, it is important that the standard is sufficiently principles-based to cover a wide range of situations. More detail is provided in the answers to particular questions, but in summary:

- Perfect comparability across borders may be difficult to achieve in all cases. Thus, adhering to principles – and relying on a local regulator to ensure comparability within a jurisdiction by being specific where needed – is likely to be sufficient, provided the specificity can be shown to be in accordance with the principles.
- Insurance is intrinsically uncertain, and the exact present value of settlement amounts is rarely known in advance – so liability valuations based on the modelling of cash flows is unavoidable.
- For example, the Board has been restrictive on methods for determining risk adjustments in the apparent interest of ensuring comparability, yet the range of possible reasonable calculations and judgements of the value of fulfilment cash flows is likely, and unavoidably, to far outweigh any possible levels of apparent incomparability in the risk adjustments.
- Models are by nature inherently imperfect constructs for predicting the future, and care needs to be taken not to imply that the use of certain modelling methodologies, even if conceptually viewed as best practice, will provide a precise and strictly comparable measurement of insurance cash flows.
- There are likely to be unforeseen consequences of being restrictive (e.g. requiring the use of a modified approach for short-term business may catch business that is not intended to be caught - such as short-term life business - or miss business which should be caught - such as longer-term general insurance business).

Further field testing

28. Due to the importance of insurers to the global and national economies and also due to the diversity of insurers the IAIS believes that field testing of the Board's proposals is vital. The IAIS notes that the Board intends to continue its investigation of "difficult conceptual and practical issues relating to the discount rate" (BC104) with "insurers that have participated in the field testing exercise". The IAIS would encourage the Board to expand its field testing exercises and extend them into the finalisation period. However this should not necessarily be interpreted as requiring an extension of the deadline for completing the project. The IAIS would be happy to discuss this further with the Board during our suggested bilateral meetings.

Question 1 – Relevant information for users (paragraphs BC13–BC50)

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer’s financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

29. The IAIS in general supports much of the proposed measurement model although with matters of detail where it differs from the Board’s view in some matters of detail as set out in the remainder of this letter. The building blocks of estimates of cash flows that will arise through fulfilment of insurance contracts, time value of money and a margin or margins provide a useful framework for measurement with the provisos following.

30. Notwithstanding the above, the US and India strongly prefer a two-model approach whereby life insurance contract accounting is separate and distinct from non-life insurance contracts, noting the success of the two-model approach during recent and historical periods of economic stress. Some of these points will be dealt with later under Question 8.

31. They believe that the two-model approach would allow for better financial statement comparability within and across those many jurisdictions where composite insurers do not, or rarely, exist as single legal entities. There are differences between life and non-life contracts that are identifiable and distinct and that will result in substantively different inter-relationships of the discount rates and risk margins.

32. All IAIS members are willing to work with the Board to implement a viable model for insurance contract accounting and answers to the remaining questions are within the context of the Board’s proposed approach.

Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)

(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?

(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

Question 2(a)

33. The IAIS supports the measurement of insurance contracts based on the probability-weighted expected future cash flows to fulfil those insurance contracts taking into account both future cash inflows and outflows. However, the IAIS recommends the wording of paragraph 17 be amended. It is drafted as if measurement is to occur at the level of an individual insurance contract which is not supported by the remainder of the wording of the standard. In particular, paragraphs 23 and 36 indicate that probability-weighted expected future cash flows and the risk adjustment are to be measured at the portfolio level. We recommend that the entire standard be reviewed to unambiguously require measurement of portfolios of insurance contracts rather than measurement of insurance contracts at the individual contract level. Insurance contracts are managed at a portfolio level and economic decisions are taken at this level rather than for each individual contract.

Question 2(b)

34. There are two sets of issues which the IAIS wishes to comment on: the interpretation of probability-weighted cash flows and possible departures from fulfilment cash flows, including taxation.

Interpretation of probability-weighted cash flows

35. The IAIS has concerns regarding potential misinterpretation regarding the Board's intentions surrounding the use of the terminology "unbiased and probability-weighted estimate (i.e. expected value) ... cash flows", particularly paragraphs B38-41. These concerns are explained further below.

36. The IAIS strongly supports the Board's revisions to the original proposed measurement model, as presented in the ED, which reflects the approach by insurers to generally fulfil contracts directly to policyholders, rather than by transferring the contracts to a third party. Furthermore, the IAIS strongly supports the current guidance that prohibits the reflection of non-performance risk by the insurer in the measurement of insurance contract liabilities. The IAIS has significant concerns about reducing liabilities in advance of legal relief. Due to the nature of insurance contracts, the IAIS agrees it is inappropriate to allow a reduction of liability on the basis of the insurer's own-credit standing. (BC50a and BC51).

37. As noted below, the IAIS has a number of suggestions regarding the draft application guidance within Appendix B, but would agree that it is generally at the right level of detail.

38. The Board could do more within the application guidance to highlight when the use of proxy methodologies might be reasonable, so as to better reflect the realities of insurer valuation approaches and cost-benefit considerations. For example, paragraph B39 highlights that it is not always necessary to develop explicit scenarios, but then goes on to suggest stochastic modelling may be necessary where complex cash flows exist. A number of countries would suggest that much of life insurance involves complex cash flows, but stochastic modelling is currently used to value mainly the most complex of products. Smaller insurers could especially benefit from a greater focus of the application guidance on the reasonable use of proxy methodologies.

39. For non-life insurance the IAIS has concerns regarding paragraphs B38-41 which relates to the historic difficulty of predicting jury and judicial decisions, future economic changes, future societal changes, etc. The point is that determining a statistical mean estimate of outcomes does not require identification of the full range of possible scenarios which is very difficult for the following reasons:

- It is very challenging to produce probability distributions for future claims as past events on which probability distributions are based do not reflect changes in circumstances.
- There are difficulties in continuous re-evaluation of probability distributions. A probability distribution is created for a past data set, and then the probability range around the mean is assumed to apply to the new data set for which only a mean estimate is currently available.
- It is not possible to estimate “all possible scenarios” although it is possible to quantify all possible outcomes. For a large portfolio of non-life contracts, the range of possible scenarios generating a loss ratio of, say, 70% is essentially infinite.
- For particular one-off events, it is impossible to determine a reliable estimate of the probability of those events or validate those probabilities subsequently. Determining the probability of a seminal judicial decision such as that made by Judge Janis Jack that changed asbestos and silicosis claim liabilities is an example of such a one-off event. Some events cannot be predicted simply because there is no awareness of the risk: for example scientists did not know a Northridge fault line existed prior to the Northridge Earthquake.

40. The IAIS expects that the Board and staff are in fact aware of these issues but believe that the drafting could be improved and recommend that paragraphs B38-40 be replaced with the following:

The requirement to produce a probability-weighted (i.e., expected value) estimate of future cash flows defines the measurement objective.

This is not meant to dictate a particular method for the production of that estimate, as long as the estimate represents an estimate of an expected value in statistical terms (otherwise known as a statistical mean) and appropriately includes management’s judgement.

Several different methods may exist that produce an estimate of the statistical mean. These may involve the use of probability distributions to determine a probability-weighted

estimate, the use of sample means (to the extent that the sample is not biased or otherwise unrepresentative of tail events), the identification of representative alternative scenarios weighted to reflect their relative likelihood, or other suitable approaches that produce estimates of the statistical mean cash flows.

In some situations, the use of stochastic approaches or detailed scenario approaches may be necessary, such as in the valuation of certain policyholder options related to financial values. This standard, however, does not require such approaches as long as the alternative approach used suitably meets the measurement objective.

41. B62(a) should be clarified so that it applies not only to participating insurance contracts but also unit linked contracts. This could simply be achieved by making the following drafting change in B62(a).

[...] However, the measurement of a participating insurance liability **or unit-linked contract** is affected by the cash flows, if any, that depend on the investment returns [...]

42. The discussion of the use of market variables in B43 to B47 does not address markets that may not be sufficiently active to provide reliable inputs and what to do in such situations. The IAIS suggests expanding this section to provide such guidance.

Possible departures from fulfilment cash flows

43. The IAIS also urges the Board to take a closer look at where the ED departs from a fulfilment value objective by excluding certain cash flows that are relevant to the fulfilment of an insurance contract. Clearly, any rational insurer will look to include the full cost of fulfilling their insurance obligations into the premiums charged to policyholders.

44. Many jurisdictions believe these will include general overheads which exist as the result of insurance business but do not vary in proportion to the volume of contracts. To the extent that such premiums adequately consider the full costs of fulfilment, the initial liability would not be understated given the ED proposal to calibrate a residual margin to premium, but the earnings emergence may not best reflect the pattern of future fulfilment expenditures that have been priced into the premiums. The same would be true if a composite margin approach were selected. The ED proposals would not enable the recognition of a loss where policy premiums have been set at a level that does not adequately consider the full cost of insurance contract fulfilment. The initial liability would, in fact, be understated with this effective 'premium deficiency' not captured as a loss until those future fulfilment expenditures, such as general overheads, actually occur.

45. A number of jurisdictions believe that consistency of revenue and expense accounting across standards/industries is an important objective to improve comparability and hence they are inclined to agree with the exclusion of certain cash flows suggested by the Board. They are therefore uncomfortable with the implication that the cash flows should be seen to include all items included within pricing, since this is also likely to consider items that they believe are appropriately excluded from the accounting measurement of the insurance obligation.

46. Certain jurisdictions have also brought to our attention an issue that relates to the guidance on the fulfilment cash flows in situations where tax is payable on behalf of

policyholders. The IAIS understands that these jurisdictions will be communicating directly with the Board and recommends that these issues be considered carefully.

47. These jurisdictions suggest that taxes paid on behalf of policyholders in respect of investment returns those policyholders receive or are deemed to have received should be included in B61(h) as well as the transaction-based taxes specified therein. Such taxes may also arise directly from existing insurance contracts or can be attributable to them on a reasonable and consistent basis. An appropriate distinction needs to be made between taxes imposed on the profits of an insurer and dealt with under IAS 12, and those imposed on the insurer as a proxy for taxes on policyholders, which, directly or indirectly, affect the benefits payable to those policyholders.

Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)

(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?

(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

48. IAIS jurisdictions have identified four families of discount rates for insurance liabilities, and have yet to converge on any one family. These are:

- a. Risk-free discount rate
- b. Risk-free discount rate with liquidity adjustment
- c. Yield on high quality corporate bonds (or where there is no deep market in such bonds, the yield on government bonds) consistent with IAS 19 requirements
- d. Economic default adjusted rate

49. The following answers to question 3 represent the summarised views of the IAIS jurisdictions, reflecting their positions with respect to the families of discount rate. However, the supporting arguments for the use of each of these families of discount rates are more fully described in Appendix 1.

50. Notwithstanding the views expressed in Appendix 1, there may be some flexibility amongst jurisdictions regarding what rate is used in the balance sheet and what rate is used in the profit or loss, as mentioned in paragraph 18.

Question 3(a)

51. The IAIS agrees with the first part of the question that the discount rate used by an insurer for non-participating contracts, and indeed also participating contracts, should reflect the characteristics of the insurance contract liability, or accurately in the IAIS' view "the economics of the insurance obligations in (the) jurisdiction including the nature, structure and term". This is broadly consistent with the IAIS' current proposals for solvency purposes (see Appendix 2).

52. The basis for difference among the jurisdictions is in how best to approach developing a discount rate that appropriately reflects the characteristics of the insurance liability.

Question 3(b)

53. All IAIS jurisdictions recognise that illiquidity is a characteristic of most insurance contract liabilities. However, there is significant debate about how best – or indeed whether – the effect of that illiquidity should be incorporated into the discount rate. This is explained further in Appendix 1. Concerns arise as insurance contracts do not trade on deep and liquid financial markets where market based discount rates for insurance contracts can be directly observed and the fact that there is no consensus on how best to model or measure the effects of liquidity on insurance contracts (as per BC 100).

54. As a result and as set out above, the IAIS has identified four families of discount rates, based on differing views regarding the validity or degree of reliability possible in directly measuring the liquidity premium, and also the extent to which other proxy measures may be more suitable for establishing an insurance contract discount rate for financial statement reporting purposes. Consequently, the IAIS would conclude that the guidance is largely insufficient for clarifying how (and for some jurisdictions, why) to incorporate the effects of liquidity into the discount rate for insurance contracts.

Question 3(c)

55. The IAIS strongly agrees with the Board's conclusion that that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer. As the objective is to measure the current financial position and financial performance of the insurer, the risk of non-performance should not be anticipated. Insurers are required to fulfil their insurance contracts with a high degree of certainty i.e. with no or negligible credit risk. The perceived volatility issue could not and should not be addressed through measurement of non-performance risk.

56. The IAIS believes that the issues surrounding the appropriate discount rate for long term liabilities are neither straightforward, nor without significant implications for economies world-wide.

57. As explained in the general comments at the beginning of this submission, many IAIS jurisdictions are concerned about non-economic volatility that would be reflected in the profit or loss of insurers as a result of the proposals in the ED. Without repeating all of the arguments in the general comments, the major concern is that reflecting the entire amount of changes in the value of insurance contracts due to changes in the current discount rate in the profit or loss of an insurer does not reflect the economic performance of an insurer within a reporting period. In the general comments, those jurisdictions concerned with perceived non-economic volatility have proposed some solutions but more importantly have proposed that the Board has an in-depth debate about how an insurer's reporting period performance is presented. The IAIS proposes that a Technical Advisory Group be established to consider this issue. Also, the Board needs to consider, on a cross-cutting basis, how discount rates for long-term liabilities that are not actively traded should be determined.

58. Some other jurisdictions however support the Board's proposal that the effect of all changes in discount rates used in insurance liabilities should be recognised in profit or loss. These jurisdictions believe that any resulting volatility should be addressed in disclosures. Thus the effect of the different factors which result in this volatility could be assessed by the users of the financial statements.

59. The IAIS notes that, whichever proposed solution is adopted, if any, adequate disclosure can assist in ameliorating any resulting concerns. This is relevant to our answer to Question 14(c) about possible additional disclosures. It is not possible to be definitive at this point about those possible additional disclosures as it will be dependent on the outcome of the Board's consideration of the appropriate performance metrics of an insurer.

60. Interest rate term structures can be observed in the market covering certain timeframes. However, the nature of long-term insurance liabilities is such that they may exceed the timeframes for which observable inputs are available. The ED has no guidance on extensions of the yield curve to address issues such as the appropriateness of using mechanical extrapolations and the considerations of the significant estimation risks involved with such long-term forecasting. Consequently, disclosure requirements should be introduced (see also Question 14(c)) underlining and explaining the approaches chosen. This will assist users of financial information to better understand the effect of the extension applied and sensitivity to changes in the extension methodology.

Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

61. IAIS members are divided between those who favour:
- (i) a measurement approach that includes a risk adjustment and residual margin, as proposed by the Board;
 - (ii) an approach that calibrates the risk margin initially to premium and therefore does not result in a residual margin.

62. IAIS members all agree, however, that further information would be helpful including the results of field tests to provide additional guidance on appropriate application.

Risk adjustment and residual margin

63. Those IAIS members that are supportive of the Board's proposed approach believe that it is important that the approach applied in an insurance accounting standard provides relevant information for users about the amount, timing and uncertainty of future cash flows, which they believe is best served through an explicit adjustment for risk. Measurement and remeasurement of risk remaining in the insurance contract is essential to ensure that information about the uncertainty of the cash flows is current. The risk and residual margin approach takes into account an explicit risk adjustment when measuring whether a contract is onerous and therefore whether a loss should be recognised at inception.

64. These members are also of the view that, although it requires judgement, the calculation of a risk margin is not unreasonably difficult nor an arbitrary measurement exercise, and highlight that many insurers are currently calculating such risk margins for various reporting purposes (for example in embedded value reporting) and have been doing so over a number of years. Adequate public disclosure of the basis on which the risk adjustment is calculated together with explanation of changes from one period to the next helps to establish transparency of insurer judgement in determining the risk margins. In relation to Question 14(c), this would be one aspect of additional disclosure the IAIS would recommend. This also has the advantage of allowing the 'residual margin' to be clearly identified and distinguished without compromising information on uncertainty presented in the risk adjustment.

65. These members believe the benefits of the Board's proposed approach override any concerns over the judgemental aspects of the risk adjustment, and implied scope for manipulation. Expert professional judgement is required in respect of the expected present value of future cash flows and the discount rate as well as the risk adjustment. Management have a duty to ensure the appropriate application of the principles of the standard and to provide adequate disclosure. The application would also be subject to challenge by auditors. In addition, if similar reporting is used for supervisory purposes, supervisors will have a role in challenging the assumptions applied and disclosure given.

66. These members are of the view that this approach is consistent with the principle of explicitly considering risk that is present elsewhere within IFRS where valuation approaches are prospective and include an assessment of uncertainty.

67. These members also recognise that there are elements of an insurance premium which do not represent payment to cover the cost of effecting or carrying out the contract including the elements identified in BC125(b) to (d). They believe that it is appropriate to report the profitability arising from these sources over the coverage period using a residual margin based on the passage of time or in line with a more appropriate pattern while the risk adjustment runs off over the total coverage/claims handling period.

Single Risk margin calibrated initially to premium at inception

68. The US and India support a single risk margin approach that would calibrate the risk margin to the same amount at inception as the composite margin approach. Much of the support for the one margin approach was predicated upon a lack of information to calculate and separate margin into “risk” and “residual” components reliably. Further information would be helpful including results of field tests to provide additional guidance on appropriate application. A minimum margin, by line of business, would be required for regulatory purposes.

69. As previously identified by the Board, (1) there is no active secondary market for insurance contracts, thus there is generally little market information available on the price of risk; and (2) even with the provisions to refine the determination of a risk adjustment, it is expected that there will be continued divergence in practice if the risk adjustment is not initially calibrated to premium. The US and India believe that a process that provides for a risk adjustment not so calibrated initially is subject to uncertainty and potential manipulation which would be sufficient to override the benefits of its application. This leads to the conclusion that the resultant residual margin – as it is calculated from the established risk adjustment – must be considered inherently uncertain and likely not representative of the “expected profit” from the insurance contract.

70. They believe that the alternative views provided by Mr. Engström and Mr. Smith regarding this issue deserve particular consideration. As Mr Engström and Mr Smith noted, the risk adjustment as defined in the ED is a hypothetical amount selected arbitrarily based on each insurer’s own tolerance and price for risk thereby providing considerable latitude in deciding which level of risk should be included in the risk adjustment and what price should be charged for that risk. Under the approach proposed in the ED which is not initially calibrated to premium, the risk adjustment, and therefore its complement, the residual margin, can vary significantly by insurer for the same risk thereby producing significantly different results in financial statements. As these Board members identified, it is possible for an insurer to set the quantity and price of risk to eliminate any residual margin.

71. The US and India are more supportive of the method proposed by the FASB, utilizing a single risk margin to capture both risk (uncertainty) and any expected profit from the insurance contract. Nonetheless, they regard that such a margin is better described as a risk margin calibrated to premium at inception, rather than a ‘composite’ margin. While they do not necessarily agree with the particulars of the run-off under the FASB approach, the risk margin should be run-off over the coverage period and claims handling period in a manner that may approximate the pattern of declining risk. They believe that this approach is most appropriate as

it is expected that the margin would not be fully eliminated until derecognition of the insurance liability is complete and no remaining uncertainty exists.

72. Nonetheless, they recognise that a difficult issue arises when the premium is close to the value of the first two building blocks and therefore the margin or margins are slim. There are few good answers to this problem, and the regulatory answer of a required minimum margin by line of business might not necessarily seem particularly palatable to accounting standard setters. However, they struggle to find a better one than a general comparison across the sector which regulatory databases provide. Other answers with more apparent sophistication exist, but there is little actual evidence that they provide a better answer.

73. While theoretically onerous contracts and contract portfolios are also an issue, human behaviour is such that few onerous contracts are knowingly and deliberately written at inception – which is not to say that all insurance contracts are profitable: many are written in the expectation of a profit only for the insurer to discover later that they are loss-making and should have been measured with hindsight as onerous at inception. This is simply the nature of the business.

Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)

(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?

(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?

(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?

(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

Question 5(a)

74. In dealing with the difficult issue of the Margin over Current Estimate (the IAIS terminology) the expected standard under the valuation core principle will state:

14.9 The MOCE reflects the inherent uncertainty related to all relevant future cash flows that arise in fulfilling insurance obligations over the full time horizon thereof.

Question 5(b)

75. The IAIS does not agree that only three techniques should be allowed. The IAIS believes that the characteristics of the risk adjustment set out in B72 are adequate and that any technique that provides an appropriate estimate of the risk adjustment with these characteristics should be permitted. There may be known characteristics of the cash flows and therefore the uncertainty surrounding them that would not be captured by the three stated techniques. Limitation to the three techniques available does not allow for development of new actuarial techniques and the three techniques may well be less cost effective than other techniques in certain situations. For example, while not in common use, some companies use Economic Cost of Ruin as a measure of risk. As new methods gain acceptance, or as the prescribed methods become obsolete, the Standard would need to be revised if it restricted the techniques permitted.

76. The actuarial profession has the appropriate expertise to determine acceptable risk adjustment methodologies. The IAIS suggests that an option for the Board is to consider working closely with the International Actuarial Association to develop appropriate guidance for risk adjustment methodologies.

77. The IAIS understands the Board's desire to limit the techniques emanates from a desire to ensure comparability among financial reports of insurers. The IAIS does not believe that limiting the techniques available will achieve that objective. It is possible that insurers will use different parameters and detailed methodologies even within the three techniques permitted in the ED and even for largely similar business. For example, applying the criteria in B92(a) that the technique must be implementable at reasonable cost will mean that different insurers will come to different conclusions about the most appropriate technique based on their circumstances. If the Board's intention is to provide a method to compare over time, then loss triangulations and disclosures are likely much better at achieving this aim.

78. The IAIS stresses that meeting the criteria in B72 is the most important factor in choice of technique. However, once a technique is chosen, it is important to ensure that the technique is applied consistently by the insurer in subsequent reporting periods. It is our understanding that changing between methods would not amount to a change in accounting policy under IAS 8. The IAIS suggests that a requirement for disclosure (see also Question 14(c)) of the explanation of changing techniques would be an important addition to help ensure consistency of risk adjustment techniques across time. It should be a requirement that there has been a development of sufficient magnitude that justifies the change.

Question 5(c)

79. The IAIS is uncomfortable with the proposal that insurers should disclose a point estimate of the confidence level if either CTE or the Cost of Capital (CoC) method is used. The criteria used to estimate the risk adjustment are parameters of the technique. Not only is judgement applied in assessing the appropriateness of the technique it is also applied in assessing the modelling parameters and data used. Disclosure of the confidence level when other techniques are used creates the illusion of precision when there are intrinsic errors of estimation arising from the uncertainty of cash flows and the application of judgement. Should the Board decide to continue with this proposed requirement, the IAIS recommends that a disclosure of a range, rather than a specific point on the distribution, be allowed in order to remove the illusion of precision in the translation from one risk margin methodology to another.

80. It is therefore preferable for the insurer to disclose fully how it has established that it has estimated the risk adjustment appropriately including disclosure of the techniques, parameters and assumptions applied and not to be required to re-express the result in terms of a technique that it has not used. Moreover, translating a CTE or CoC measurement to a confidence level is probably onerous in practice, and confidence levels from different insurers may not be comparable. This may lead to convergence towards the use of the confidence level rather than application of risk adjustments that are useful for economic decision making. B92 refers to the selection of the most appropriate technique depending on the nature of the insurance contract. The IAIS recommends that estimation of the risk adjustments using appropriate techniques which give results that possess the characteristics in B72 should be the aim rather than trying to establish the **most** appropriate technique.

Question 5(d)

81. The IAIS agrees that an insurer should measure the risk adjustment at a portfolio level of aggregation (i.e. a group of contracts that are subject to similar risks and managed together as a pool), consistent with measurement of fulfilment cash flows. However, insurers should also be allowed to measure risk adjustments on an individual risk basis (mortality, lapse etc.) within each portfolio, unless a reliable basis for the relationships between risk types for the portfolio is established.

Question 5(e)

82. The IAIS does not agree with the application guidance as it is far too detailed regarding the three permitted techniques whereas in our view it should really concentrate on ensuring that whatever technique is used meets the characteristics listed in paragraph B72.

Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

(a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?

(b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?

(c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?

(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?

(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?

(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

Question 6(a)

83. Yes, insurance contracts involve uncertainty and initial gain is rarely assured.

Question 6(b)

84. Yes, however the IAIS believes that deliberately onerous contracts are a relatively rare occurrence.

Question 6(c)

85. Calculations at a portfolio level make more sense in a business that largely depends on the law of large numbers - i.e. there should be a degree of averaging between the individual contracts in a portfolio for the purposes of determining the residual margin.

86. If changes in future non-financial assumptions or risk margins are absorbed into the residual or composite margin (see paragraphs 88 to 89 following) then the need for business to be segregated by date of inception and coverage period may be unnecessary.

Question 6(d)

87. Some members are supportive of the proposal in the ED to lock-in the residual margin and amortise it over the coverage period. Accordingly, these members support the ED's proposal to take adjustments to the present value of fulfilment cash flows to profit or loss. In these members views, the proposed amortisation approach is appropriate given the nature of the residual margin and would appear to allow for the simplest and most transparent presentation of the residual margin approach proposed in the ED

88. Other members are in favour of remeasuring the residual margin. This issue is framed in the context of a question about a residual margin but is an equally valid point in relation to a composite margin. They believe, any change in expected future cash flows or a risk margin **as a result of changes in future non-financial assumptions** should be recognised in the residual margin (or composite margin). To the extent that the cash flows and risk margin are reliable at inception, an equally reliable adjustment of the cash flows and risk margin should adjust any remaining portion of the residual margin. For adverse adjustments, this should occur until the residual margin is exhausted, after which any further adverse adjustments should be recognised directly in profit or loss. Where there is no residual margin or it has been previously exhausted due to run-off and remeasurement and there is a positive adjustment to future non-financial assumptions then a residual margin should be created. The arguments for this treatment are as follows:

- It is fundamentally inconsistent not to recognise any profit at initial recognition but for any change in assumptions to go fully to profit or loss thereafter.
- To recognise any change in assumptions fully when it occurs implies that what is assumed about non-financial experience in the future is certain – there is no distinction made between what has actually happened in the past and can't be changed (which should be recognised in profit or loss), and what might happen in the future.
- That the future is inherently uncertain is implied by the use of a residual or composite margin at initial recognition.
- In particular, some might argue that to spread the change into the residual or composite margin is akin to a "shock-absorber". However, as previously stated, such an argument treats the future as being as certain as the past – which is known to be false. Actual experience in the past would still be fully recognised. It is only the uncertain future which would be spread. Hence, there is no "shock-absorber".
- If future non-financial assumptions or risk margins deteriorate then the residual value of the business to its owners might go down, but until the future is fully realised that is not known for certain, just as it was not known for certain when the business was first written. The opposite occurs if non-financial assumptions or risk margins improve.
- Under the ED proposal, profit at initial recognition is effectively locked in and any change in non-financial assumptions or risk margin needs to be recognised immediately to preserve that profit. Yet there is nothing sacrosanct about that profit at initial recognition – what is proposed is therefore effectively arbitrary.

- Allowing any changes in future non-financial assumptions or risk margin to go straight to profit or loss will produce volatility in reported profit or loss for only a small change in assumptions, particularly for life insurance where the impact over a number of years is capitalised.
- Recognition of the change in profit or loss over time as the residual or composite margin is gradually released is consistent with the fact that assumptions and risk margin themselves are spread over time.
- Booking any change in future non-financial assumptions or risk margin directly into profit or loss leaves the system open to manipulation – assumptions may be set adversely at inception and then subsequently improved, generating a capitalised profit. Even a small change in assumptions for long term insurance can have significant effects. In contrast, the proposal above limits the risk of manipulation, since any change in non-financial assumptions or risk margin will not have an immediate effect on profit or loss.

89. The adjustment of the residual margin in parallel with re-measurement of the present value of the fulfilment cash flows due to changes in non-financial assumptions should be made through profit or loss, on different line items. There are several reasons for this proposal: (1) a passage through profit or loss recognises the business related nature of such adjustments (this being a key difference with volatility resulting from changes in financial assumptions); (2) it is more transparent than a simultaneous debit/credit in the liability; (3) this removes any resemblance with a shock absorber mechanism.

90. Regarding short-duration contracts, France has some concerns with the conclusion that the residual margin should be released over the coverage period for the following reasons:

- The insurer is providing services to the policyholder over both the coverage and claims handling periods;
- The fulfilment cash flows and the risk adjustment are remeasured over both the coverage and claims handling periods.

91. Therefore, France considers that the residual margin (see paragraph 88), should be released over both the coverage and claims handling period. Where a simplified method is applied (according to paragraph 54 of the ED), the amortisation over both periods is based on the supposition that the residual margin is only partially amortised at the end of the coverage period.

92. Furthermore, some jurisdictions have concerns that the two recognition methods for the residual margin provided for in paragraph 50 of the ED will result in useful information in all circumstances as they do not capture all situations – in particular for certain long-term contracts where claims and benefits may be weighted towards the end of the coverage period. For example, deferred annuities, despite the fact that the insurer is already providing services before the payment of annuities, no residual margin would apparently be recognised during this period.

93. Notwithstanding the above, the US and India would prefer a method that does not result in a residual margin.

Question 6(e)

94. Multiple methods may be more appropriate. For example, a constant yield to cash flows seems a simpler method, and since the cash flows should be updated on a current basis, this ought to reflect changes on a current basis to the risk adjustment.

Question 6(f)

95. Generally no, although there are some differences of view. Many IAIS members believe that accreting interest on a figure derived as a difference does not add significantly to its meaning. Nonetheless, if interest accretion on the residual margin is required, then the IAIS does not believe it should be accreted on the basis of the discount rate determined at inception. The interest rate used for interest accretion should be the discount rate used for the liability as a whole.

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)

(a) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

96. The IAIS supports the Board's position that acquisition costs should be treated as part of the cash outflows from a portfolio of insurance contracts. The IAIS agrees, in principle, with the view that only incremental acquisition costs should be considered as part of the fulfilment cash flows of a portfolio of insurance contracts. However, it is important that acquisition costs are evaluated as incremental at the portfolio level.

97. In identifying acquisition costs that are to be included in fulfilment cash flows, financial statements of insurers should be comparable no matter what distribution channel is used by the insurers. The current proposals would result in incremental acquisition costs from a third-party distribution channel being included in fulfilment cash flows to determine insurance contract liabilities. However, in-house distribution channels which have fixed overhead costs not directly related to successful sales would appear to need to directly expense those costs, yet the aforesaid remuneration of third-party distribution channels would likely be set at a level that would cover the third party's similar overhead costs.

98. However, some jurisdictions acknowledge that this is a difficult issue given that arriving at consistent treatment of acquisition costs across insurers could result in an approach towards capitalisation of costs that differs from other accounting standards (and thereby other industries) and could thereby reduce cross-sectoral comparability unless the effect of the different treatment is clear to users of financial statements.

99. As a result, the definition of 'incremental' acquisition costs requires development. Paragraph B61 would appear to limit incremental fulfilment cash flows to costs that "relate directly to insurance contracts or contract activities", with paragraph B61(f) and (g) seeming to exclude general overheads relating to policy issuance. In that sense, the recent FASB Accounting Standards Update 2010/26 appears to provide a good starting point for developing further guidance. It is acknowledged that the FASB guidance has been developed in the context of identifying acquisition costs to be capitalised as deferred acquisition costs which is not advocated by the IAIS. However, the definitional issues encountered in determining acquisition costs to be capitalised and incremental acquisition costs to be taken into account in fulfilment cash flows are very similar and as such the FASB guidance is highly relevant.

100. The FASB ASU 2010/26 addressing the issue is as follows:

944-30-25-1A An insurance entity shall capitalize only the following as acquisition costs related directly to the successful acquisition of new or renewal insurance contracts:

a. Incremental direct costs of contract acquisition

b. The portion of the employee's total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe

benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:

- 1. Underwriting*
- 2. Policy issuance and processing*
- 3. Medical and inspection*
- 4. Sales force contract selling.*

c. Other costs related directly to the insurer's acquisition activities in (b) that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred.

d. Advertising costs that meet the capitalization criteria in paragraph 340-20-25-4.

Question 8 – Premium allocation approach

(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?

(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

Question 8(a)

101. The IAIS believes that the premium allocation approach should be permitted but not required. Requiring the use of this simplified method for short-duration insurance contracts may enhance comparability among insurers with only short-duration insurance contracts, but may conversely reduce comparability among insurers having otherwise similar portfolios but with different durations. Within a single entity, a requirement to use the premium allocation approach may reduce consistency and add complexity in the treatment of otherwise similar contracts issued with different durations.

Question 8(b)

102. The IAIS suggests in the context of a 'permitted but not required approach' that the criteria set out in paragraph 54 be modified to be more flexible based on a principle. The Board has already stated the principle in BC 146 (see bolded text below):

The Board believes that when the pre-claims period is approximately one year or less and provided that the contract contains no significant embedded derivatives, the unearned premium **is a reasonable approximation of the present value of the fulfilment cash flows and the residual margin** (and achieves a similar result at a lower cost)[...]

103. The IAIS suggests the following changes:

54. Insurers may apply paragraphs 55–60 ~~apply~~ to portfolios of insurance contracts where that measurement approach provides a reasonable approximation of the present value of the fulfilment cash flows and any margin, and will achieve similar results over time. If the insurer meets the following criteria it is presumed that the premium allocation approach provides this reasonable approximation:

(a) (i) The coverage period of insurance contracts within the portfolio ~~extend for is~~ ~~approximately~~ one year or less,

or

(ii) the coverage period of some insurance contracts within the portfolio extends for more than one year but these contracts form either an insignificant part of the portfolio of insurance contracts or an insignificant part of the reporting entity's business that otherwise meet criterion (a)(i)

and

(b) The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives in accordance with paragraph 12.

104. These criteria would allow many non-life insurers to use the premium allocation approach. It would seem, on the face of it, appropriate to simply apply the premium allocation approach to non-life contracts only. Nevertheless, the IAIS agrees that there ought to be a conceptual basis for applying the premium allocation approach in place of the building block approach, not a simple industry basis for a distinction between the models. In fact, there is no simple basis for such a distinction and developing an internationally acceptable delineation between life and non-life insurers would prove challenging. The above drafting provides a conceptual basis for using the premium allocation approach which will have the practical effect that it will allow many non-life insurers to use the approach.

105. To explain our reasoning for criterion (a)(ii) above, there are a number of instances of contracts issued by insurers where the coverage period is longer than one year, yet the majority of their portfolio(s) is likely to have a coverage period of one year or less. It would be confusing where insurance contracts are managed as part of one portfolio but have different coverage periods to then require two different measurement approaches. It is unlikely that the additional costs incurred by insurers would be outweighed by benefits for users of financial statements, and the likely confusion created would probably be detrimental to those users.

106. The premium allocation approach is meant to be a simplified approximation of the full building blocks model for the pre-claims liabilities of some short-duration insurance contracts. The IAIS is concerned about the notion of the time value of money in paragraph 56 of the ED and the need for interest accretion on the carrying amount of the pre-claims liability in paragraph 59 of the ED. For short-duration contracts, interest accretion will be immaterial in most circumstances except perhaps in hyper-inflationary economies. In fact, this is the basis of the conceptual distinction proposed by the IAIS that would allow the use of the premium allocation approach in place of the full building blocks model for pre-claims liabilities. The IAIS is concerned that the benefit of having a simplified method of measurement will be outweighed if the complication of interest accretion is introduced. The likely value to users of financial statements of requiring interest accretion will be minimal given that in most circumstances the effect will be immaterial. This can also be linked to the principle the IAIS has suggested for paragraph 54 of the ED. If the interest rate is high and likely to remain so over the life of the contract then the premium allocation approach is not likely to provide a reasonable approximation of the present value of fulfilment cash flows.

107. If the above recommendations are not implemented, as previously stated, the US and India strongly prefer a two-model approach whereby life insurance contract accounting is separate and distinct from non-life insurance contracts with the delineation determined by national insurance supervisors. The US notes that such an approach has been continuously successful during recent and historical periods of economic stress. Such a model for non-life contracts would share characteristics of, but would not necessarily be identical to, the premium allocation approach proposed in this letter.

Question 9 – Contract boundary principle

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

108. The IAIS agrees with the basic boundary principle but some supervisors have identified an issue relating to regulatory restrictions and are concerned with the definition of contract boundaries in paragraph 27 of the ED. For instance, the proposed language may treat many one-year health insurance contracts as extending beyond the next policy anniversary date. This is due to the fact that some individual contracts cannot be re-rated commensurate with their risk in light of regulatory restrictions, even though it may be possible for the portfolio of contracts as a whole to be re-rated commensurate with its risk. The IAIS believes that this interrelationship needs to be acknowledged and therefore recommends revising the language in 27 (b) as follows:

27 The boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance contract from those that relate to future insurance contracts. The boundary of an insurance contract is the point at which an insurer either:

- a. is no longer required to provide coverage, or
- b. has the right or the practical ability **to set a price for that contract that either (1) fully reflects the risk of the particular policyholder; (2) or may not fully reflect the risk of each particular policyholder in light of regulatory restrictions but can within the same portfolio fully reflect the risk of that portfolio.** In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance (i.e., no discernible effect on the economics of the contract).

109. The position of voluntary contributions needs to be clarified in the ED. At this stage, it is not clear if voluntary contributions would be included within the contract boundary.

Question 10 – Participating features

(a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?

(b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?

(c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?

(d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

Question 10(a)

110. The IAIS agrees with the position taken by the Board that payments arising from a participating feature should be included in the measurement of insurance contracts in the same way as any other contractual cash flows. The IAIS has long held the position that amounts relating to future policyholder distributions in respect of both the guaranteed and discretionary elements of participating contracts should be treated as liabilities based upon the probability-weighted expected future cash flows.

Question 10(b)

111. The IAIS agrees that financial instruments with discretionary participation features should be within the scope of the IFRS on insurance contracts as they are within the scope of the current IFRS 4 and that does not appear to have caused any issues in practice.

Question 10(d)

112. The key issue for the Board to consider given the inclusion of financial instruments with discretionary participation features is to ensure that they are treated consistently with insurance contracts with discretionary participation features. A concern has been raised by France, the United Kingdom, Belgium, Germany, Denmark, the Netherlands and Italy that there is potential for inconsistency (see Appendix 3).

Question 11 – Definition and scope

(a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?

(b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?

(c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

Question 11(a)

113. The IAIS believes there is an opportunity to both clarify and streamline the drafting of paragraphs 2 to 6 on the scope of the standard and paragraphs B2 to B33 on the definition of an insurance contract. It is suggested that the definition of an insurance contract should be mentioned up-front in the standard. The suggested wording for paragraph 7 is:

7. An insurance contract is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder where:

- (a) an uncertain future event refers to uncertainty as to:
 - i whether an insured event will occur;
 - ii when it will occur; or
 - iii how much the insurer will need to pay if it occurs.
- (b) compensation may be in cash or in kind.
- (c) insurance risk is defined as a pre-existing risk (arising from a possible adverse event impacting on the policyholder), other than financial risk, transferred from the holder of a contract to the issuer, and
- (d) significant insurance risk is deemed to be present if situations of commercial substance exist in which the present value of compensation significantly exceeds the present value of amounts that would be payable if no insured event occurred, even where the probability of those situations is extremely low.

Appendix B provides guidance on the definition of an insurance contract

Question 11(c)

114. Most jurisdictions agree that financial guarantee contracts where payment is dependent on the policyholder having suffered a loss (thereby meeting the definition of an insurance contract) should be included within the scope of the insurance contracts IFRS.

Question 12 – Unbundling

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

115. The IAIS believes that it is appropriate to unbundle an insurance contract where practicable if the component is not closely related to the insurance coverage specified in the contract. If part of an insurance contract that can practically be unbundled (e.g. by a valuation with no rider benefits) meets the definition of, say, a financial instrument then it should be accounted for as such. Otherwise, the result may be accounting arbitrage and there will be less transparency.

116. Regarding unbundling of investment linked business, some benefits are of the 'greater of' variety – e.g. the benefit on death over the coming month is the greater of the account balance or some fixed sum insured. Such benefits can be easily and practicably unbundled and insurers should do so to ensure consistency.

117. The IAIS believes clarification of the unbundling requirements is necessary for consistency. Under the current guidance it is uncertain, when comparing the principles within the ED and the basis of conclusions, whether the cash surrender value of a life contract should be unbundled. The issue relates to the use of the words 'often' and 'may' in BC 224.

118. US regulators believe the unbundling criteria are likely not functionally different from the existing guidance in US GAAP but are seeking clarification on that point from the FASB.

Question 13 – Presentation

(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?

(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

Question 13(a)

119. Subject to the comments made in the next section regarding Question 13(b) the IAIS believes the summarised margin approach is useful for portfolios that are not measured using the premium allocation approach. Members also agree that both the summarised margin approach and premium approaches are useful. However, IAIS members are split regarding whether such presentation should be on the face of the statement of comprehensive income or in the notes to the financial statements, with strong but differing preferences expressed.

120. Most IAIS members, however, would not regard the summarised margin presentation as useful, even in the notes, for portfolios measured under the premium allocation approach. These members believe that the measurement approach and presentation are inextricably linked, and believe that the presentation method outlined in paragraph 75 should be the primary form of presentation in the statement of comprehensive income under the premium allocation approach.

121. The IAIS Standard on Disclosures Concerning Technical Risks and Performance for Life Insurers¹ requires that an “insurer should disclose a quantitative source of earnings analysis at a sufficiently segmented level”, and provides an example table of how such a disclosure might be provided.

122. Any summarised margin presentation would be different from most existing practices in public reporting by insurers through their primary financial statement. Should the Board require this presentation in the final standard, the IAIS would recommend that the Board also require additional transitional disclosure in the notes. The objective of these disclosures would be to explain the transition from the old performance statements to the new one (as well as how equity is affected by the change).

123. Mixing margin and volume information in the statement of comprehensive income may not be impossible, but it would need further guidance and disclosures addressing conceptual and practical questions such as the definition of premiums, claims or expenses (or part thereof) that would have to be presented in the statement of comprehensive income. Another issue would be to know how these items connect with the changes in the liabilities presented as part of the margin approach. In this analysis, it is important that the Board consider the understandability of performance by all users, not merely by specialised professional analysts.

¹ http://www.iaisweb.org/temp/Disclosures_concerning_technical_risks_and_performance_for_life_insurers.pdf

124. As stated in the general comments section, the IAIS recommends consideration of the appropriate performance metrics for insurers by a Technical Advisory Group. This consideration will be vital to determine how presentation should be developed. The Board may need to revisit paragraph 73 after discussion with the proposed Technical Advisory Group of the appropriate performance metrics for insurers.

Question 13(b)

125. Our response to questions 3(c) and 6(d) indicate that many IAIS members would not agree with presenting all income and expense arising from insurance contracts in profit or loss.

126. The presentation requirements for the statement of financial position, which call for reporting either a net asset or net liability for each insurance portfolio, will not provide useful information on the face of the financial statements particularly for short duration contracts. Many insurance supervisors require, and the IAIS believes financial statement users would benefit from, separate reporting of unearned premium reserves and claim reserves as well as, where material, uncollected premium balances. There generally would not be a right of offset between assets receivable from one policyholder with a claim obligation owed to or on behalf of another policyholder. For non-life insurance contracts, loss reserves and unearned premium reserves convey important information to users. A net presentation of such items would result in a significant reduction of decision useful information on the face of the balance sheet.

127. It is unclear whether some unit-linked contracts may need to be unbundled in accordance with paragraph 8 and therefore whether in such circumstances paragraph 78 would result in effectively two pieces of presentation for the overall unit-linked contract.

Question 14 – Disclosures

(a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?

(b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?

(c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

Question 14(a)

128. The IAIS agrees with the overall disclosure principle provided in paragraph 79 of the ED as it supports transparency objectives.

Question 14(b)

129. Although the IAIS agrees with the overall disclosure principle, it understands that industry is concerned with the specific, voluminous disclosures considered necessary – presented in paragraphs 85-97 (six pages) of the ED – to achieve compliance with the disclosure principle. Compliance with these extensive disclosure requirements may be costly, and the IAIS encourages the Board to conduct extensive outreach on this issue to determine any cost/benefit issues.

130. For example, with regards to the risks arising from insurance contracts other than insurance risks, the guidelines in the ED specifically indicate that the disclosure of summary qualitative information regarding exposure to risk shall be based on information provided internally to key management personnel of the insurer and provide information about the risk management techniques and methodologies applied by the insurer. Some jurisdictions are concerned that these requirements may be crossing the line between pertinent information necessary to assess the insurer and confidential information regarding the insurer's operating assessments.

Question 14(c)

131. As previously stated, the IAIS is concerned with the overall presentation of information in the statement of comprehensive income for insurance contracts. It is our assessment that the determination of what is necessary to be disclosed may be significantly impacted if the statement of comprehensive income is modified in accordance with our recommendations. Such a determination should be informed by the Technical Advisory Group that the IAIS has recommended be set up.

132. As stated in paragraph 59, the IAIS notes that additional disclosure may need to be developed to address volatility in the profit or loss of insurers due to changes in discount rates. However, the nature of that disclosure will depend on the Board's conclusions as to the appropriate presentation of the performance of an insurer in a reporting period.

133. The IAIS also notes that disclosure requirements should be introduced (see paragraph 60) underlining and explaining the approaches chosen on the extension of discount rates beyond an observable yield curve. This will help users of financial information to better understand the effect of the extension applied and sensitivity to changes in the extension methodology.

134. In paragraph 64, some IAIS jurisdictions supporting a risk and residual margin have suggested that disclosure about the basis for risk adjustment is a necessary public disclosure by an insurer. To the extent that this is not already covered in paragraph 90 (a), the IAIS suggests that where an insurer changes the risk adjustment technique used from one reporting period to another, disclosure of an explanation for changing techniques would be necessary (see paragraph 78).

135. The IAIS believes it is essential that differences between regulatory reporting requirements and general purpose reporting are reconcilable and that these differences are publicly disclosed and explained (see paragraph 161). The IAIS therefore recommends that the Board add a requirement that insurers disclose in their financial statements a reconciliation between their regulatory reporting and general purpose reporting.

Question 15 – Unit-linked contracts

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

136. The IAIS agrees with the proposals to require assets held for unit-linked contracts to be carried at fair value and the presentation requirements for unit-linked contracts and related assets set out in the ED except to the extent of the clarification requested on unbundling (paragraph 127).

Question 16 – Reinsurance

(a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?

(b) Do you have any other comments on the reinsurance proposals?

Question 16(a)

137. Yes. An insurer is exposed to the credit risk of a reinsurer so the valuation of its reinsurance assets should take this risk into account.

Question 16(b)

138. Yes. There are two issues about the reinsurance proposals that require greater clarity in the drafting of the final standard and one issue of significance to the industry where a modification would not create any issues for insurance supervisors:

- i It needs to be made clear that the measurement of reinsurance assets should be on the same basis as used for underlying direct insurance contracts (see paragraph 139)
- ii If the underlying direct insurance contracts are capable of being measured under the premium allocation approach then a reinsurance asset should be capable of being measured in the same manner. This would apply even if the reinsurance contract standing on its own would not meet the criteria for use of the premium allocation approach (see paragraph 140)
- iii In order not to disturb established performance metrics, reinsurance commissions should not be netted against premiums (see paragraph 143)

139. With regard to paragraph 138 i above, the current drafting in paragraph 43 of the ED needs to be clarified to create a link between the measurement for a cedent's reinsurance contract to the measurement of the underlying insurance contracts issued by the cedent. Said in another way, for a proportional reinsurance contract, the reinsurance asset should be measured as a mirror image of the underlying direct insurance contracts issued by the cedent which are covered by the reinsurance contract except to the extent an allowance for the credit risk of the reinsurer. For non-proportional contracts the mirror image analogy does not work as well, however the determination of the fulfilment cash flows should be based on the fulfilment cash flows of the underlying direct insurance contracts covered by the non-proportional treaty. These concepts were well explained in slides 8 and 9 of the slides supporting the 25 October 2010 webcast of the IASB. Therefore, the IAIS believes the Board's intention is correct but paragraphs 43 to 45 do not clearly state that intention although paragraph 44 does make the link for the purposes of remeasurement.

140. With regard to paragraph 138 ii above, another issue in relation to reinsurance assets that is related to the issue in paragraph 139 is that the choice of measurement approach - the full

building block approach or the premium allocation approach - should be based on the measurement approach for the underlying insurance contracts appropriately adjusted for the credit risk of the reinsurer. Therefore, if the underlying insurance contracts are measured using the premium allocation approach it should be clear that the related reinsurance asset must be measured on the same basis.

141. In the 25 October 2010 webcast, the first question posed on slide 13 was about whether the premium allocation approach should apply to the measurement of a cedent's reinsurance contracts which cover 12 month primary contracts even though the reinsurer is thereby providing coverage to the cedent for 24 months in effect. The IAIS would answer yes to this first question.

142. A further question was asked as to whether the premium allocation approach should be capable of applying if the coverage period of a cedent's reinsurance contracts was for 2 or 3 years but covering primary contracts that are 12 month in duration and measured using the premium allocation approach. The IAIS would answer yes to this question.

143. With regard to paragraph 138 iii above, there are well established performance metrics used in the industry which rely on the reporting of reinsurance premiums that are not subject to the netting of reinsurance commissions. In effect, reinsurance premiums and commissions are used on a gross basis. While this is principally an issue for the industry, the IAIS has been informed by its observers that this is an issue that is significant to them. The IAIS sees no particular benefit in netting the reinsurance commissions and reinsurance premium and therefore it suggests that the Board remove paragraph 46 of the ED.

Question 17 – Transition and effective date

(a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?

(b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?

(c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?

(d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

Question 17(a) and 17(b)

144. The IAIS does not agree with the Board's proposal which would result in a zero residual margin at transition. The IAIS is concerned that the entire residual margin will be reflected in equity on transition and that insurers will not be able to record profits on this business in force at transition as they emerge: the release of profits will be disturbed. This is an issue for users of insurers' financial statements generally but is a substantive issue for those insurers that have issued participating contracts and their policyholders.

145. If insurers have the ability to go back and calculate the building blocks accurately then they should be allowed to do so. The next best option would be to look for a suitable proxy for the calculation with full disclosure of the methodology used, such as treating the transition like a business acquisition. If none of this is possible then the original IASB staff proposal set out in paragraph BC 249 in the Basis of Conclusions would be more appropriate than the Board's current proposal. The IAIS believes that the concern of the Board about comparability of initial residual margins on transition does not outweigh the benefits of determining such an amount.

146. The IAIS disagrees with the one-way transition provision in paragraph 102 allowing redesignation of "a financial asset as measured at fair value through profit or loss if doing so would eliminate or significantly reduce an inconsistency in measurement or recognition." The reasoning in BC253 concentrates entirely on the measurement attribute for insurance liabilities which it asserts will be a current value with all re-measurements recognised in profit or loss. However, the unbundling provisions in the ED create the possibility that items previously recognised as insurance contracts under IFRS4 Phase 1 may be unbundled into insurance contracts and financial instrument liabilities. In order to achieve the best matching insurers may have previously elected the Fair Value Option for the assets matching those Phase 1 insurance contract liabilities. Once unbundled, however, the default attribute under IFRS 9 for financial liabilities that are neither held for trading nor derivatives is amortised cost and insurers should have the ability to redesignate financial assets that match these financial liabilities at amortized cost if they meet the requirements of IFRS 9, without being forced to utilize the Fair Value Option on both sides of the transaction. A forced Fair Value Option would create a bias on the part of the Board regarding what would otherwise be an acceptable way of matching assets and liabilities.

147. It is also notable that if the Board accepts the need to address non-economic volatility concerns raised by many members of the IAIS in the general comments section of this letter, then one approach would be the option of matching of liabilities with a locked-in discount rate with assets held at amortised cost. If the Board accepts that proposal then it is vital that the Board allow for redesignation of financial assets to amortised cost.

148. Accordingly, the IAIS recommends that the Board allow a two way redesignation of financial assets at transition and alter the wording in paragraph 102 of the ED to state: "... it is permitted, but not required, to redesignate a financial asset as measured at fair value through profit or loss **or at amortised cost** if doing so would eliminate or significantly reduce an inconsistency in measurement or recognition **arising from transition to this standard and that in doing so the financial asset is not recorded in a manner inconsistent with classification requirements of financial instrument accounting standards.**" [Emphasis added] The requirement that the redesignation only occur if it eliminates or reduces a mismatch should prevent abuse.

Question 17(c)

149. The IAIS has made it clear in its submissions about the Financial Instruments Project that the effective date for IFRS 9 and for insurance contracts must be aligned for insurers. The likely different adoption dates could lead to accounting mismatch issues or the need to change accounting methodologies in close succession unless a practical transition is granted to insurers.

Question 17(d)

150. Supervisors and the industry will need time to adapt to the new standard which is likely result in significantly different accounting for many jurisdictions. The IAIS believes that the Board should provide for a carefully considered implementation period for the insurance contracts standard. The IAIS will consider a fuller response in accordance with the Board's Request for Views on Effective Dates and Transition Methods at a later date.

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

151. Some IAIS member jurisdictions have a comment about recognition of insurance contracts in the period between the date that the insurer is bound to accept risk under the contract and the date that the contract begins or ‘incepts’. They believe that the Board is conceptually correct to require recognition at the bound date. However, they believe that it would be pragmatic to allow a ‘net nil’ measurement approach for contracts in the period between the bound date and the inception date of the contract. This would mean that premium received or receivable would be offset against the liability recognised for the contract in the period between the bound date and the inception date of the contract unless the contract is onerous.

152. Conceptually, if an insurer is aware that it is contractually bound to an onerous insurance contract then it should recognise that contract on a gross basis and the resulting loss should be recognised immediately. However, onerous contracts must be considered in the context of a portfolio of similar contracts and those jurisdictions would recommend that a pragmatic, cost-effective approach should be taken. The measurement approach in the ED requires measurement at the portfolio level for the fulfilment cash flows and risk adjustment (see paragraph 23 and 36). The portfolio may well still be profitable even though there are some onerous contracts. The contracts which are not onerous should not be subject to remeasurement until the inception date of the contract.

153. These members understand that recognition of insurance contracts at the bound date may lead to significant costs for insurers to put in place systems to capture enough data at this date. This is also an issue for subsequent remeasurement before the inception date. Most insurers are set up to capture data as at the inception date of contracts. They are concerned that requiring insurers to significantly re-engineer existing data capture systems to allow gross recognition at the bound date might not be offset by benefits to users of financial statements from this additional information. They believe that insurers should have the means to identify onerous contracts when written on an exception basis but do not expect that this would necessarily mean that significant systems change should be required in relation to all contracts.

154. They therefore recommend that paragraph 21 of the ED should be modified in the following way based on the commentary above.

21. An insurer can become a party to an insurance contract before the coverage period starts. In many cases, the measurement of insurance contracts does not change materially after initial recognition before the start of the coverage period. During that time, **the measurement of the insurance contract should be carried out on a net basis with the amount of premium received or receivable netted against the liability recognised in relation to the insurance contract. ~~the measurement of the insurance contract is updated only for cash received or paid, the accretion of interest, and changes in estimates of cash flows and discount rates.~~** An insurer shall start recognising the residual margin in profit or loss only once the coverage period begins (see paragraph 50).

155. Some IAIS members agree with the Board's proposal and are concerned about the appropriateness of a simplified measurement approach for the period between the recognition of a contract and the start of the coverage. For those members, there is no clear evidence that the simplified approach will bring benefits for the following reasons:

- a. insurers will in any case have to apply the building blocks when the coverage period starts; applying the building blocks earlier because the contract incepts earlier does not induce material additional cost;
- b. Insurers will in any case have to set up an internal control procedure for identifying all the contracts issued and for assessing whether they are onerous or not; this means setting up a complementary internal process and controls next to the usual one followed for other contracts. If they do not do so, questions could be raised regarding the robustness and relevance of the insurer's internal onerous contracts test. So, either this test is equivalent to the building blocks and therefore brings no benefits; or the test is less robust than the building blocks and therefore brings important concerns regarding the quality of the information provided to users (as well as questions about the quality of the internal control).
- c. The fact that the contract value would be nil is only true at the inception date. If the financial year ends between the inception of the contract and the start of the coverage, and if premiums are paid before the closing date, the value will not be nil even if the date of the beginning of the coverage period is later.
- d. The insurer will also have to provide disclosure regarding the reconciliation between opening balance and closing balance (new contracts, premiums paid, net exchange from foreign currency, break down of the value between expected cash flows, risk margin and residual margin and so on) and also the disclosure regarding risks (sensitivity, concentration, and so on).
- e. Moreover, in several jurisdictions supervisory provisions would constrain insurers to apply strict procedures relative to the inventory of all the insurer's obligations, recognition of these obligations and assessment of the risks linked for the capital requirement.
- f. Finally, considering that the simplified approach implies that the contract is not recognised on the balance sheet, this may have unintended negative consequences in terms of organization of the internal control and of audit.

Question 19 – Benefits and costs

Do you agree with the Board’s assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

156. The IAIS would expect the Board to learn more about the actual costs and benefits of the proposals during its proposed continuation of field testing.

157. The IAIS understands that insurers, especially small insurers, are concerned that they will be burdened with significant fixed costs for systems changes needed to implement the ED proposals. In the case of the insurance industry, the IAIS disagrees with the Board’s assertion that investors will bear the costs of implementation as stated in BC 258. Such additional costs would ultimately be borne by policyholders, and could tilt the competitive balance towards larger insurers – both which are matters of significant concern to insurance regulators. Additional costs borne by policyholders may affect ‘the efficient allocation of resources in the economy’ [BC 258]. See also the general comments at the beginning of this submission outlining the important role of insurance in the economy.

158. Small insurers make up the majority of insurance companies operating in most jurisdictions. Many small companies serve niche markets. Pricing may be established relative to competitive benchmarks. The selling feature of their products may emphasize the service offered with an acknowledgement of cost volatility from year to year due to their low volume and limited diversification. These provide a valuable social service and the IAIS would be concerned if the proposals were to impose an excessive additional burden on these insurers.

159. As stated previously, the IAIS is concerned both with general purpose accounting and with solvency issues. The IAIS believes that it is most desirable that the methodologies for calculating items in general purpose financial reports can be used for, or are substantially consistent with, the methodologies used for regulatory reporting purposes, with as few changes as possible to satisfy regulatory reporting requirements. Indeed many, but not all, IAIS jurisdictions currently base their regulatory reporting requirements on general purpose financial statements, or at least on equivalent quantities determined using the same methodologies as for those financial statements.

160. There is widespread support for an effort to achieve a single set of accounts that could be utilised for both general purpose financial reporting and regulatory reporting, notwithstanding the potentially differing purposes of such reports. Achievement of this aim is likely to reduce costs for regulated insurance entities and thereby policyholders.

161. Although it is clearly preferable for the insurance contracts measurement model for regulatory reporting to be consistent with that used for general purpose financial reporting, this may not be possible or appropriate in all cases. However, the IAIS believes that it is essential that differences between regulatory reporting requirements and general purpose reporting are reconcilable and that these differences are publicly explained (this has also been raised in relation to Question 14(c)). Otherwise there is a risk that public confusion will call into question the credibility of both reporting regimes.

Appendix 1: Views regarding discount rate families:

162. The IAIS has identified four families of solutions regarding choice of a discount rate which are explained further below. These are:

- a. Risk-free discount rate
- b. Risk-free discount rate with liquidity adjustment
- c. Yield on high quality corporate bonds (or where there is no deep market in such bonds, the yield on government bonds) consistent with IAS 19 requirements
- d. Economic default adjusted rate

163. As mentioned in paragraph 50, there may be some flexibility in jurisdictions' stated views regarding use of a different rate in the balance sheet and the profit or loss, with differences recorded in OCI. The views noted below are predominantly related to the balance sheet rate.

NOTE THERE ARE ASSERTIONS MADE AND STRONGLY HELD VIEWS IN EACH FAMILY OF SOLUTION THAT, NONETHELESS, ARE NOT UNIVERSALLY AGREED BY IAIS JURISDICTIONS.

Risk-free discount rate

164. Supporting jurisdictions: France, Belgium, Denmark, Germany, the Netherlands, Italy, Norway and Switzerland

165. They disagree with the inclusion of an illiquidity premium in the discount rate. In the ED context, they believe that the Board's proposal for the introduction of an "illiquidity premium" is not based on sound conceptual and practical accounting reasoning:

- i. The introduction of an illiquidity premium is inconsistent with the concept of fulfilment value. Policyholders' greater or lower ability to liquidate insurance contracts has no demonstrated impact on the insurer's liability towards these policyholders. The value of an insurance liability - which has the same illiquidity feature at any point in time since its origin – is usually not influenced when markets' perception of liquidity of financial instruments change.
- ii. In the present value of the fulfilment cash flows, all future cash flows must be taken into account on a probability weighted basis, which means that the liquidity features of these cash flows are already taken into account. Hence, introducing illiquidity features into the discount rate would lead to double counting of the liquidity element.
- iii. The Board has stated as a principle that the valuation of a liability should be independent of the asset mix of the reporting entity (see BC95 to BC97 of the ED) and therefore an illiquidity premium reflecting varying degrees of liquidity in the asset markets would not be appropriate.
- iv. The illiquidity premium as it currently stands in the ED, i.e. without convincing conceptual background and guidance for application, is likely to result in IFRS financial statements

that are not reliable, comparable nor transparent. Serious doubts can indeed be raised about the possibility to find a reliable, unbiased and justified method to assess this “illiquidity premium” on an ongoing basis. The wide range of current practices in the discounting applied to Embedded Value reports as published by many insurance groups, is a good illustration of the potential divergence that can appear with the implementation of the ED’s illiquidity premium.

166. They suggest that the reference in paragraph 30 for the determination of the discount rate should be to the risk free rate term structure.

167. They believe that the requirements in paragraph 32 need further clarification, including the criteria mentioned (i.e. “depend wholly or partly”) as this might produce arbitrary and incomparable results. If paragraph 32 means that an allowance for using discount rates which reflect the performance of associated assets, then they would disagree with the Board's proposal as they would assert that there is no reason to use a different discount rate to that set out in paragraph 30. They believe that determination of cash flows based on relevant assets and the time value of money are not interdependent.

168. The major criterion for application of the replicating portfolio technique, being an “exact match of cash flows”, should be explicitly stated within this paragraph in order to prevent abuse or inconsistent application of such an approach. The absence of a clear and rigorous framework regarding the use of replicating portfolio techniques may fail to meet the requirements of users of the financial statements if it leads to less transparency, particularly since this approach does not provide users with information on the risk margin and the discount rate that is otherwise required for the valuation of insurance contracts. In fact, replicating portfolio techniques should be used only when the amount, timing, or uncertainty of cash flows from an insurance contract depends on the performance of specific assets (e.g. unit-linked contracts) and there is an exact match of cash flows.

Risk-free discount rate with liquidity adjustment

169. Supporting jurisdictions: UK, Australia and the European Commission

170. They agree with paragraph 31 as currently drafted as insurance contract cash outflows represent economic obligations that present no or negligible credit risk to the recipient. The risk of not receiving cash inflows from policyholders is allowed for in the explicit risk adjustment.

171. They are of the view that, as explained in paragraph 34 of the proposed IFRS, the value of an instrument is affected by its liquidity. They agree that liquidity of the insurance contract is a relevant characteristic that should be reflected in its value. Where rates observed in respect of liquid instruments are lower because of the instruments’ higher liquidity, those rates should be increased by a liquidity adjustment. This adjustment would determine the discount rate that should be applied to discount cash flows that are projected to arise at a specific time and for which the possibility of corresponding cash flows arising at another time is reflected in the risk adjustment.

172. As is acknowledged in the basis for conclusions, there is not yet a consensus on how such an adjustment should be measured and, as such, in their view the liquidity adjustment requirement should be principles-based and with sufficient scope to enable a range of appropriate approaches towards the determination of liquidity adjustments to be applied. If any

specificity is required this should be left up to each jurisdiction to determine. Moreover, the liquidity adjustment requirement should be accompanied by clear disclosure in order to facilitate user analysis and comparison of methods used by firms. This should aid comparability and facilitate convergence. Such an approach is consistent with the determination of other aspects of the valuation of insurance contracts which require expert professional judgement.

173. It may therefore be appropriate to generalise the paragraphs 30-34 so that the proposed IFRS does not depend solely on observed rates. It may, for example, also be appropriate to allow a suitable long term discount based on macro-economic principles to be applied. Correspondingly, they consider that where there is an unavoidable mismatch of assets to liabilities, allowance should be made in the risk adjustment for the market risk that arises.

174. They particularly agree with paragraph 30 (a). Using discount rates based on observable current market prices for instruments held by the insurer may lead to inconsistencies if the insurer does not or is unable fully to match its portfolio of financial instruments to its insurance contract liabilities. For example, if the durations of the instruments and insurance contracts differ, the values of insurance contracts using such discount rates may move more in line with the instruments held as market prices change, but not move in line with the price of a replicating portfolio. In neither case would the measurement faithfully reflect the economic match or mismatch.

Yield on high quality corporate bonds (or where there is no deep market in such bonds, the yield on government bonds) consistent with IAS 19 requirements

175. One family discussed by the IAIS was using the yield on high quality corporate bonds consistent with IAS 19 requirements. However, while there was some sympathy for the ideas therein, it is not fully supported by any member jurisdiction.

176. Such an approach would maintain relevant consistency within the general IFRS accounting framework and across various standards. Industry specific concerns with capturing business strategies and objectives within the IFRS accounting would best be addressed in the determination of profit or loss and OCI presentation considerations.

177. An IASB acceptance of the IAIS recommendation that the Board undertake a project to consider the appropriate discount rate for long-term liabilities that are not actively traded on a cross-standard basis should, using this approach, strengthen the need for current consistency between discounting under the insurance contracts standard and IAS 19, as any other approach would seem to prejudge the outcome of that project.

178. A discount rate approach consistent with the contractual basis for valuing other assets and liabilities, and a performance reporting framework that better considers insurer assessments of the 'economic' earnings associated with such fulfilment contracts, particularly very long duration guaranteed contracts, would provide financial statement users with significant additional transparency and decision-useful information. Additionally, this approach could also reduce the extent of non-GAAP earnings measures that might otherwise be developed by various life insurers to better communicate what they consider to be the 'economic' earnings from their long-duration guaranteed contracts.

Economic Default Adjusted Rate (EDAR)

179. Supporting jurisdictions: US

180. The US is considering an Economic Default Adjusted Rate (EDAR) which would remove the default risk from the average portfolio of assets backing a portfolio of insurance liabilities.

181. Although the US understands the theory surrounding the Board's arguments regarding liquidity, the lack of any widely agreed methodology to calculate the liquidity adjustment has resulted in the consideration of an alternative methodology to calculate a discount rate. Using EDAR, insurance liabilities would be discounted at an average asset portfolio book yield less a prescribed provision for defaults (the risk adjustment). The prescribed provision is most strongly informed by real-world historical distributions of default losses but also contains a limited recognition of the current market view of risk through two elements that rely on current market spreads. In this way the default spread will not necessarily move in lockstep with changes in market interest rates but will be heavily informed by them, in much the same way as the example described in appendix B paragraphs 55 and 56 regarding mortality experience.

182. The US has significant concerns regarding long duration contracts. A risk free rate, or a risk free rate with a small liquidity adjustment would likely result in significant losses on inception for long-term guarantee business. As a result, this business will likely either not be offered or will be offered to the public at a considerable price increase in order to offset the loss on inception. Nonetheless this type of business has shown itself to be profitable over the long term and supervisors are comfortable with its overall pricing. As such, the Board proposals risk significant and damaging market disruption absent an agreed methodology for calculating a liquidity premium that would be more in line with the real-world economics used by companies to price their long-duration guarantee business. It is for these reasons that the EDAR methodology has been proposed to better reflect the economics of these contracts.

Appendix 2: Current IAIS proposed guidance on discounting for solvency purposes

183. The IAIS current draft guidance on discounting (not yet adopted, and subject to further modification) is as follows:

14.10.1 The solvency regime should require the time value of money to be recognised in the determination of technical provisions and should establish criteria for the determination of appropriate interest rates to be used in the discounting of technical provisions (discount rates). In developing these criteria, the supervisor should consider the following:

- the economics of the insurance obligations in its jurisdiction including the nature, structure and term,
- the extent (if any) to which benefits are dependent on underlying assets

14.10.2 The criteria for determining appropriate interest rates to be used in the discounting of technical provisions should recognise that the appropriate interest rates may not be directly observable and apply adjustments to observable economic and market data of a general nature as appropriate.

14.10.3 To the extent that a risk is provided for elsewhere, there should be no allowance for that risk in the chosen discount rates.

14.10.4 As the discount rates should reflect the economics of the insurance obligations, any observed yield curve should be adjusted to account for differences between the economics of the observed instrument with those of the insurance obligations.

14.10.5 To provide for consistent, reliable, economic values, the criteria for discount rates should utilise the entire interest rate term structure.

14.10.6 In principle, if an investment has a reliable market value and fully replicates or hedges an element of the insurance obligations or risks then using this value for the corresponding part of the technical provisions is equivalent to using discount rates that equate the current estimate and margin over current estimate to the market value of the investment.

Appendix 3 Concern about potential inconsistency between financial instruments with discretionary participation features and insurance contracts with discretionary participation features

184. France, the United Kingdom, Belgium, Germany, Denmark, the Netherlands and Italy are concerned that the ED creates an inconsistency regarding the treatment of the future premiums resulting from insurance contracts with discretionary participation features and those resulting from investment contracts with discretionary participation features. For insurance contracts, the future premiums can be taken into account only insofar as their pricing is determined in advance, providing a valuable advantage to the policyholder. For investment contracts, the future premiums are taken into account without the guarantee of any similar advantage to the policyholder.

185. In fact, paragraph 64 defines a boundary criterion that is based only on the right to receive discretionary participation resulting from the investment contracts with discretionary participation features. This principle, being relatively vague, raises the following concerns:

- The future premiums (voluntary premiums) of these contracts should be taken into account without other limits or conditions even if their characteristics would not be different from premiums received in the context of new contracts and
- Contractual provisions of certain contracts can provide for:
 - Allocation of some dividends to all policyholders
 - Allocation of some dividends to a specified class of policyholders whose contracts are in force.

In those cases, part of the profit generated by one generation of policyholders is distributed to future generations of policyholders. Because of this pooling of generations of contracts, the provisions of paragraph 64 based only on the right to receive discretionary participation could be seen as allowing insurers to take into account the premiums of the future contracts which could be impacted by this pooling.

186. This would not only necessitate complex estimations but may also result in significant volatility in the profit or loss due to the reassessment of these estimations

187. Thus, these jurisdictions recommend that the Board reconsider the proposed definition of the boundary of investment participating contracts. In this respect, France proposes to include voluntary premiums only if they provide a significant advantage to the current policyholder compared to a new policyholder, consistent with the proposals made by the ED in respect of insurance contracts and in the ED “revenue recognition” for the measurement of renewal options. For these reasons these jurisdictions propose to define a boundary principle for investment contracts with discretionary participation features according the following:

“Regarding investment contracts with discretionary participation features, premiums are part of the contract and should be included in the measurement if they provide the policyholder with a financial advantage or guarantee promised explicitly in the contract with a commercial substance (i.e. have a discernible effect on the economics of the

transaction) that the policyholder would not have received without paying the new premiums.”