

Sept. 25, 2007

**International Association of Insurance Supervisors  
Insurance Contracts Subcommittee**

**Presented to the  
NAIC's International Solvency and Accounting (E) Working Group**

To: International Solvency and Accounting (E) Working Group

From: Rob Esson

Re: IAIS Insurance Contracts Subcommittee Update

The Insurance Contracts Subcommittee has met three times since the June National Meeting to discuss the IAIS response to the IASB's discussion paper. The latest draft of the response is attached. At the recent Sydney meeting, a number of points from the NAIC's letter to the IAIS were incorporated, and there is a fairly good alignment between the IAIS and NAIC views. Unfortunately, the NAIC suggestion regarding rewording the market consistent and probability weighting in the building block one was not taken up. There are, however, three main issues to the IAIS response that remain outstanding and will be discussed further at the forthcoming meeting in Zurich (10/29-31) with a view to resolving the final drafting:

1. Recognition of bound but not incepted insurance contracts: While the subcommittee is tending towards the view that there is no good principles based reason not to recognize a bound but not incepted contract (especially if it is likely to be loss making), it is understood that this would result in a change of practice in the vast majority of jurisdictions. The subcommittee needs to discuss further whether any practical constraints or guidelines can be provided to prevent an inappropriate cost vs. benefit, and how such contracts should be reported on the face of the income statement.

2. Policyholder behavior: much of the subcommittee seems to be tending towards a recommendation that all cash flows that have a commercial substance should be taken into account in valuing a contract, while France has suggested extending the IASB's favored option of only cash flows that enable policyholders to retain guaranteed insurability. The subcommittee ran out of time to finalize this, but it might be that the French proposal is more of a fall-back to the higher level principles based answer.

3. Service margins: this has become a most difficult topic, with genuine debate on whether service margins exist, and if they do, whether they should be part of the liability measure. Some even argue that the service margin becomes the plug difference between premium less acquisition costs, and the exit value liability measure - i.e. the service margin will absorb any profit on inception. The discussions surrounding these issues are likely to be the most time-consuming at the Zurich meeting.

## **Executive summary**

- General points of agreement
- Key points of disagreement
- Further issues to be covered/further input

### **I. General comments**

1. The International Association of Insurance Supervisors (IAIS) has been pleased to provide input to the Board during its considerations of the Phase II Insurance Contracts Project. Two prior papers, referred to colloquially as the first and second 'Liabilities Papers',<sup>1</sup> have been provided to the Board in May 2005 and May 2006 respectively. The Board will be aware that the IAIS has an overriding principle and aim:

*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.*

2. While not commonly realised, Insurance Supervisors are one of the largest groups of users of general purpose financial statements for insurance enterprises, even in those jurisdictions where additional reporting requirements are imposed on the regulated entities. As such, the IAIS has a vital interest in the final insurance contracts standard.

3. The IASB will be aware from the prior work of the IAIS that the IAIS supports many of the Board's tentative conclusions, and many of the underlying directions of the insurance contracts project. In particular, the IAIS was and remains an early supporter of the use of some form of exit value as the measurement attribute for insurance contracts. We remain ready and willing, as we have stated in our prior commentary, to work with the Board, to enhance the dialogue between the IAIS and the IASB on these matters and work towards an objective of facilitating consistent regulatory and general purpose financial reporting

4. The IASB has been working on the insurance contracts project with little respite for ten years. If it were easy, it would have been completed eight years ago. It isn't easy, and the project spreads its tentacles into almost every difficult area with which the Board is dealing. In many areas of the project, a theoretically pure answer on one aspect may work for that aspect, but then causes problems with others. As such, we are of the opinion that there is no perfect solution to the project, merely practical solutions that may go only 50, 70, 90% towards the theoretically pure answer in various aspects, which when integrated across the whole project provide the optimal practical solution at the expense of the theoretical purity in every situation. As an analogy, we think that there are aspects of the project that are inter-related that are like a party balloon: squeeze any one part hard enough and it pokes out in another place.

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1 IAIS: *Issues arising as a result of the IASB's Insurance Contracts Project – Phase II: Initial IAIS Observations* (May 2005) and

IAIS: *Issues arising as a result of the IASB's Insurance Contracts Project – Phase II: Second set of IAIS Observations* (May 2006)

5. Our recommendations are governed by this realisation. For example, we support the use of market consistent measures to the extent possible. We also support the theoretical concept that it ought not to matter whether one measures at the individual contract level or the portfolio. We believe that similar obligations with similar risk profiles should result in similar liabilities. The problem is that these three notions – when pushed to the limit – become inconsistent with each other: individual policies can act differently dependent upon the portfolio, there are diversification effects. An inefficient company with higher expenses than the market would record market consistent liabilities (using an exit value notion) lower than its real expectations of economic outflows – an uncomfortable result, although one that we as Insurance Supervisors would certainly address were it to stand. One of the few more observable exit values – portfolio transfers of participating contracts – is causing difficulty in that the real expected outflows of policyholder dividends may in certain circumstances be difficult to reconcile with the definition of a liability. Another similar difficulty arises when the Board endeavours to unbundle aspects of the measurement model for life products resulting in discomfort that an aspect (the future premiums) may not seemingly meet the definition of an asset.

6. In all these cases, we believe that there will need to be a practical solution and that the Board will need to find a way to achieve a result that really improves financial reporting in a cost effective manner. In trying to find practical solutions, an important IAIS principle in developing our comments to the discussion paper is that “similar obligations with similar risk profiles should result in similar liabilities”.<sup>2</sup>

**[To reconsider later whether we have an overriding principle.]**

7. One of our recommendations, which expands on a recommendation in the second liabilities paper, is to promulgate a common reference framework for modelling, until such time as insurance liabilities become directly observable in a deep liquid traded market. The lack of market observability for the vast majority of insurance liabilities causes many of the problems inherent in the project. If insurance liabilities were traded in a deep liquid market (leaving on one side the significant legal obstacles to enable this to happen), then the exit price would be observable and akin to level 1 fair value.

8. Clearly this is not the case, and hence the Board is recommending a proxy methodology, the three building blocks, to try to model or approximate the exit price. However, in particular, the risk margin component is particularly difficult to calibrate reliably, and there is little current guidance on how to do so in a manner that will promote consistency and comparability.

9. An example, but not necessarily the only one, would be a common reference framework of a large well diversified AA-rated insurer. Possibly, having such an entity to model to might obviate some of the inter-related problems noted above. For example, it would assume that the portfolios of similar risks within the modelled entity are large enough that increased uncertainty due to the portfolios being too small in the transferor would not be a problem – hence the ‘unit of account’ would be at the level of the large well-diversified AA-rated insurer, not the entity specific level of the transferor. The ‘well diversified’ aspect would imply that the transfer notion would take into account a market level of diversification (as opposed to the alternative, which is a clearly unrealistic zero diversification). Additionally, the transfers would be modelled to an entity with a specified credit rating and therefore standing, at a level that is likely to be practical. Some of the putative transfers under the concept of

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<sup>2</sup> See second Liabilities Paper.

similar credit standing in the discussion paper would, quite simply, be illegal in the vast majority of jurisdictions. This common reference framework would solve these problems while more clearly reflecting the intended exit value concept.

10. The other area that we feel may help the project considerably would be a removal of non-market constraints on cash flows. This is a notion with which a number of Board Members seem uncomfortable, yet we believe that done correctly would improve the project. The key, it seems to us, is the correct interpretation of the wording of building block one. The requirement in paragraph 34(c) is to “incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations.” Paragraphs 39 – 43 expand on this notion to clarify that this would require probability weighting of the cash flows under various scenarios. The IAIS agrees with these suggestions. However, there has been disquiet at the Board regarding where the contract begins and ends, and whether certain unbundled cash flows meet the definition of an asset or liability when looked at in isolation.

11. We would suggest that, while this unbundling idea appeared at first to be a promising approach, it has not met its promise and that a different way of looking at these 10-year old problems may be better. In particular, rather than trying to split up cash flows and define exactly where contracts in the abstract begin and end, we recommend looking at the difference between having a contract, and not having a contract. The things that arise in the one case that do not in the other constitute a fairly good definition of what the contract is all about. The Board seems almost to be wavering in its application of principles regarding recognition and measurement, and it seems to us, has ‘peeked ahead’ in a number of cases.

12. An example would be discretionary participation features which are an important part of the observable exit value of certain life contracts. It is as if the Board has agreed that there are contracts to be recognised, but has then peeked ahead to the measurement, and unbundled the expected cash flows, because it feels that some cash flows wouldn’t meet the definition of a liability in isolation. In order to square the circle, it has then had to go back to reconsider the recognition criteria to exclude those cash flows from recognition in the first place. In our view, the better way would be to ask the question as to whether, in totality, there is a right or obligation to be recognised as a result of the contract. If yes, then an artificial unbundling of the product into particular cash flows that is known to be inconsistent with market behaviour does not seem to us to constitute a faithful representation of the measurement of the exit value of the contract.

13. We are fully aware that some are concerned about the possibility that using unconstrained cash flows in the measurement process may give rise to abuse. We believe however that two factors should work to mitigate the potential problem. Firstly, a true probability weighting of the cash flows would adjust them for all scenarios. Secondly, market participants evaluate insurance portfolios based on those unconstrained probability weighted cash flows for building block one. However, they then adjust the result with building block three (the risk margin) for the uncertainty surrounding such things as discretionary participation features, or the level of expected future premiums (which also ought to be part of a set of consistent lapse and persistency scenarios within the probability weighted cash flows). The point here is that although certain expectations about future cash flows are built up by the market, they are also discounted within the risk and uncertainty factors. Nonetheless, adjusting these out of the measurement in the first place does not result in a faithful representation of the phenomena that the Board is purporting to measure. As with the allowance for probability, uncertainty is dealt with by refined adjustments to the measurement, not by crude, binary inclusion or exclusion of material cash flows. In the arguments for discounting, paragraph 66 (b) states, inter alia, that “If it is true that some

insurers underestimate claims liabilities, the appropriate response is to improve the methods used to make those estimates, not to compensate for those underestimates by excluding an economically relevant factor from the measurement." We agree with this, but would extend it to those areas where there is concern about unconstrained cash flows giving rise to abuse: the appropriate response is not to constrain the cash flows so as to ignore real world economic views, but to provide appropriate guidance to prevent the abuse in the first place.

14. Such true probability weighting of cash flows would also, we believe, help with the issue of policyholder behaviour. Insurance policies are not treated like fungible financial instruments by policyholders, whether efficient markets theory dictates they should be or not. Consequently, a real world economic view of insurance contracts should take into account reasonable expectations of policyholder behaviour. We believe that these are all part of a true probability weighted valuation of cash flows. While not necessarily harmful, we don't believe that the construct of a 'policyholder intangible asset' is necessary if the cash flows are weighted on the basis of true economic expectations. The end result, which we believe the Board supports, would be financial reporting for insurers that would reflect their true economics in a decision useful manner.

**[Possible additional general comments]**

**Question 1**

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

15. We see no good reason for the recognition and derecognition requirements for insurance contracts to be inconsistent with those for financial instruments in IAS 39, which we see as rooted in the general asset-liability model.

16. However, we believe that further awareness of the practical application of the recognition and derecognition requirements to insurance contracts is necessary. In particular there is a question of when you actually have an insurance contract, which may necessitate reconsideration of the insurance contract definition under IFRS 4.

*Recognition*

17. Paragraph 27 of the discussion paper quotes from IAS 39 (paragraph 14) as follows: "An entity shall recognise a financial asset or a financial liability when, and only when, the entity becomes a party to the contractual provisions of the instrument." In the Board's preliminary view, that requirement is also appropriate for insurance contracts. In other words, an insurer would recognise rights and obligations created by an insurance contract when it becomes a party to the contract.

18. We note that the application of these recognition criteria to insurance contracts will imply a material change to current practice. In many jurisdictions insurance liabilities are recognised from the date of contract inception, ie from the date on which the insurance cover starts. However, insurance contracts are commonly entered into before that date. For example, an insurer might enter into a contract on November 1 (the binding date), for coverage to commence on January 1 (inception date). We assume that the IAS 39 criteria imply that the rights and obligations arising from the insurance contract should be recognised

from the date that the insurer becomes bound to the contract. This should be made explicit in the paper.

19. A change to current practice will have wider consequences than just the requirement to measure the rights and obligations under the contract during the period from binding to inception. Revenue recognition and the calculation of certain performance indicators are interrelated with current practice for recognition of the liability. These will have to be reconsidered in light of the changes to current practice regarding recognition. Such changes will also have a knock-on effect on the measurement of reinsurance contracts (insurance assets), for which measurement issues do not currently generally arise until the start of the period of coverage, cf. question 12 (b) (iii).

20. In some cases, entering into a contract before inception is only binding for the insurer, while the policyholder has the option to withdraw from the contract, for example simply by not paying the premium. The existence of such cases highlights the need for including options and maybe also other derivatives on insurance contracts in the scope of the standard in order to ensure consistent measurement between such derivatives and the underlying contract.

21. Appropriate measurement as a consequence of the above recognition criteria will need to be given careful consideration.

#### *Derecognition*

22. Paragraph 39 of IAS 39 states: "An entity shall remove a financial liability (or part of a financial liability) from its balance sheet when, and only when, it is extinguished – ie when the obligation specified in the contract is discharged or cancelled or expires"

23. We agree in principle with the IAS 39 approach and also believe that current practice is largely consistent with this approach. However, we would add the following additional comments in respect of insurance contracts.

24. The period of risk exposure under insurance contracts is usually well defined, and should have a clear expiry date. However, in many cases it can be difficult to establish whether the liability in respect of the risk exposure is extinguished because valid claims can emerge long after the risk period has expired.

25. In noting the above, we do not see the issue as a matter of principle but as one of implementation.

26. We also note that it is possible for a liability to be extinguished by transfer to another insurer, but the more usual arrangement for transferring risk is reinsurance, where the original insurer retains liability.

**[For further discussion of recognition at next meeting.]**

#### **Question 2**

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

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

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

**(c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)? If not, what approach do you propose, and why?**

27. Insurance liabilities, in general, should be measured at observed market prices if they are available. Where prices can be observed in a deep, liquid market, then such inputs would achieve the measurement objective without the need to use the building block approach. However, as such prices are not available for insurance liabilities in most cases, a proxy methodology is required. The IAIS therefore believes, in principle, that the three building block approach provides an appropriate methodology for the measurement of insurance liabilities.

28. We assume that the notion of 'contractual cash flows' encompasses all cash flows stemming from the contractual relationship between the insurer and the policyholder not excluding, for example, optional or discretionary cash flows.

29. Building blocks (a) and (c) require the current estimate and the margin, respectively, to be 'explicit', and we encourage the IASB to include requirements for separate disclosure of the current estimate and the margin. As the discussion paper does not consider disclosure requirements it is unclear to us what is meant by 'explicit' within the above context, and we encourage the IASB to clarify on this. We agree that the building block approach implies that the cash flows, the discount rates and the margins are separately assessed. Furthermore, we will support that there are disclosure requirements for the present value of the cash flows, the size of the effect of discounting and the size of the margins, when disclosure issues are put on the agenda. Such separate disclosures help to promote understanding of an insurer by both (potential) policyholders and other market participants, as well as market discipline by insurers.

30. Regarding building block (a), we note (and support) the guidance in Appendix E (paragraph E21) which indicates that cash flow scenarios should be sensitive to future inflation rates.

#### *Discount rate*

31. Regarding the discount rate, in the IAIS's first Liabilities Paper paragraph 47 reads as follows:

*The IAIS believes that, when a deep liquid market of appropriate term exists, a risk free rate is appropriate, except where benefits are dependent on the performance of the underlying assets, and that discounting should utilise the entire yield curve, rather than an average rate. When a deep liquid risk free market of appropriate term does not exist, reference should be made to the highest quality and deep liquid markets that do exist such as swap or other*

*derivatives markets, markets for long term utility debt, markets for high quality long term corporate debt etc.*

32. In short, the IAIS believes that estimated cash flows should, in principle, be discounted by risk free rates corresponding to maturities of the cash flows in the measurement of insurance liabilities.

33. The IAIS fully supports the Board's preliminary view that all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations should be reflected in insurance liabilities. Under the three building blocks approach, the IAIS understands that the cash flows are estimated in first building block, uncertainty of the estimated cash flow is considered in the third building block, and only the factor of the time value of money is in the second building block. In other words, the estimated cash flow should, in principle, be discounted by the risk free rates in the second block.

34. Consequently, the IAIS does not believe that asset earning rates should be used for discounting (except implicitly for unit linked and certain elements of participating contracts). Additionally, while paragraph 69 of the discussion paper suggests that the discount rate should be adjusted for liquidity, we are concerned that the practical implementation of this may be difficult and that it may be better that considerations regarding liquidity be a part of the risk margin.

*Service margin – **for further discussion at Zurich meeting***

35. IAIS members – as well as other commentators – are unsure of what is intended by the 'service margin' referred to in block (c). IAIS members are concerned over the prominence given to the service margin; we are confused by what it is meant to represent conceptually, and have concerns over whether the risk margin and service margin need to be or are split in practice. We understand that the intention may be to ensure that all relevant components of the margin are taken into account in its calculation, and not just insurance risk, bearing in mind that investment management type products will need to be accommodated within the model. We urge the Board to clarify its intention regarding the service margin in subsequent drafting.

### **Question 3**

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

36. The Board has indicated its intention to develop a principles-based standard. There are also several areas in the Discussion Paper where the Board indicates that it does not intend to provide detailed guidance (eg approaches to determining risk margins and discount rates). Factors such as the discount rate, risk margin and service margin may have a significant impact on the balance sheet. Small changes in such factors may have a large impact upon the measurement.

37. An appropriate level of guidance will help to promote comparability in the application of the Phase II standards worldwide. At the same time, products vary from jurisdiction to jurisdiction (due to differences in legal environment, markets etc.) which may give rise to a

need for additional guidance at the national or local level. This may be the case particularly in emerging markets.

38. The IAIS believes that significant guidance will be required on both estimates of future cash flows and risk margins. Neither Appendix E nor Appendix F provide the level of guidance that will be necessary for consistent worldwide implementation and application. However, it might not be practical or necessarily appropriate for the full extent of the guidance to be provided as part of the Phase II standard; detailed guidance in the standard would not be consistent with a principles-based approach (which the IAIS supports). The subjects of insurance cash flow estimation and risk margins are also highly technical and an area of ongoing study and practice development by the actuarial profession.

39. For this reason the IAIS believes that the actuarial profession has a significant part to play in developing implementation and application guidance in measuring insurance liabilities. The IAIS has encouraged the International Actuarial Association (IAA) to continue its work this area, and we anticipate that the output will provide an important contribution to the development of the necessary guidance. Such guidance at the international level would help to promote worldwide consistency in application. Local features may require that national actuarial standards provide more specific guidance.

40. We understand that if application guidance involves the removal of options within IFRS, provided there is appropriate disclosure, this does not create non-compliance with IFRS. It would be helpful if this were acknowledged in the Phase II standard.

**Question 4**

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

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

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

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

**(d) Other (please specify).**

41. In the context of determining an exit value which incorporates an appropriate risk margin, the IAIS believes that (c) is the correct principle.

42. The IAIS's second Liabilities Paper included the following principle: "An exit model is preferable but profit on inception should be recognised only where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities." We suggest that the idea of an 'appropriate and sufficiently reliable risk margin' provides a principles-based safeguard against the inappropriate recognition of gains on inception, and that the risk margin should exhibit these qualities. We recommend that similar wording be used explicitly in describing the expected characteristics of the risk margin.

43. We would be interested in receiving further information on the costs contemplated within "relevant acquisition costs" and the rationale for deducting these. [Could be moved pending discussion of Q15]

**Question 5**

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

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

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

44. (a) The IAIS believes that the measurement attribute described is an appropriate measurement attribute for insurance liabilities. The attribute is based on the notion of transfer. The IAIS believes that the notion of transfer would be strongly influenced by the settlement obligations that the transferee would undertake. In other words, any transfer would need to be made to an entity capable of accepting the transfer, which, in the case of a regulated industry like insurance, implies that the transferee would also need to be regulated and capable of settling its obligation to the claimant/beneficiary in accordance with the original insurance contracts. This implies that the exit value would, in any case, be the expected present value (ie appropriately adjusted for the time value of money) of the ultimate settlement cash flows, including the appropriate margin for uncertainty. We also refer to our comments to question 4 above proposing that the risk margin should be sufficiently robust.

45. (b) Regarding the best label for the measurement attribute, we are unable to answer this question pending the outcome of the work on fair value measurements. SFAS 157 defines fair value in terms of a current exit value model. The Board will be aware from the IAIS's comments to the recent discussion paper on Fair Value Measurements that there are certain aspects of this model that we believe are inappropriate for the measurement of liabilities in level 3 of the hierarchy. If these aspects are not addressed in the work on fair value measurements and yet the two terms remain similar, then the IAIS would urge the IASB to use a different label for insurance contracts.

#### **Question 6**

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

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

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

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

46. The IAIS supports the approach of alternative (b). Future premiums do not exist in isolation, but only exist in conjunction with the obligations under the rest of the contract. Moreover, the separate identification and measurement of beneficial policyholder behaviour is often arbitrary. Therefore, we believe that cash flows arising from beneficial (as well as

unfavourable) policyholder behaviour should be included in the liability measurement as mentioned in our introduction.

47. Regarding alternative (a), in our view estimating all the cash flows stemming from the contractual relationship is solely a practical step in the measurement process when trying to assess a current exit value of the contract, when its value can not be observed directly in a market. It is confusing to look at different parts of the cash flows as constituting different types of assets or liabilities such as a 'customer relationship asset'. The objective is to measure the contract as a whole and not a group of separate assets and liabilities artificially extracted from the contract. However, if the Board is unable to live with the consequences of an exit value that represents a true probability weighting of all cash flows, the recognition of a customer relationship asset that is not artificially constrained may be necessary.

**Question 7**

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

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

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

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

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

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

**(f) Other (please specify).**

48. The IAIS believes that future cash inflows under a contract should be allowed for in the measurement of the insurance liability, to the extent that they are integral to the fulfilment of the obligations under that contract.

49. We refer to our introductory comments in which we argue that an insurance contract should be considered as a whole, rather than unbundled into separate components which are then assessed individually against specific recognition criteria. Paragraphs 81-82 of the IAIS's second Liabilities Paper discuss this issue as follows:

*81. The problem appears to arise from the view that, because of the insurer's inability to enforce payment of future premiums under a long term contract, such premiums must be treated separately and differently. The practical reality is that future premiums are part of a single common contract, and are integral to the fulfilment of the obligations under that contract. Neither the company nor the policyholder is able to deal with one without simultaneously dealing with the other. To recognise one, the other must also be recognised.*

*82. If it is accepted that the obligation as a whole should be recognised, measurement of the obligation then requires consideration of all of the associated cash flows, including the contractual, long term premium inflows. To the extent that there is any uncertainty surrounding those cash flows it should be reflected through the application of an appropriate probability assumption, consistent with the probability assumptions applying to other cash flows. This is consistent with the measurement of financial instruments involving cash inflows as well as cash outflows.*

We continue to support the above comments.

50. The IAIS understands the concept of 'guaranteed insurability' as an attempt to differentiate future premiums under an existing contract from future premiums in respect of new contracts with similar characteristics. It distinguishes cash flows which are part of the contractual obligations from those which – looked at in isolation – would represent intangible assets and hence fail to meet the definition of an asset. However, building block A refers to 'explicit, unbiased, market-consistent, probability-weighted and current estimate of the contractual cash flows'. We are concerned that the concept of guaranteed insurability both introduces an unnecessary constraint on the recognition of cash flows, and is inconsistent with the proposed measurement attribute.

51. Restricting the future premiums that are to be taken into account in the measurement by means other than the probability that they will occur (ie through the concept of 'guaranteed insurability') seems to be in conflict with economic reality and the current exit value attribute. Market participants would take all cash flows stemming from the contractual relationship into account on a probability-weighted basis when assessing the transfer value. Furthermore, we believe that the concept of 'guaranteed insurability' is not sufficiently clear and without further clarification is likely to produce differences in application, potentially unnecessarily restricting the recognition of future cash flows in some circumstances and allowing the recognition of future cash flows that are not part of the contract in others.

52. To answer the question, we believe that option (c) may be closest to the IAIS position. More importantly however, returning to comments from our second Liabilities Paper, "the IAIS believes that the principle of allowing for probability in the measurement of insurance liabilities is fundamental to achieving sensible and meaningful financial reporting for insurance contracts." We feel that the notion of 'beneficial policyholder behaviour' used in

the question is wrong-headed, and that the focus should be on appropriate probability-weighting of the cash flows. We recommend that measurement model set out in the discussion paper is applied consistently, including to insurance contracts whose measurement depends upon expected policyholder behaviour. The issue then becomes one of ensuring that assumptions used in the probability weighting are appropriate.

**Question 8**

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

53. The IAIS believes that acquisition costs should be recognised as an expense when incurred. This is consistent with a prospective approach to valuation (which would apply under both a 'current exit' and 'current entry' model) in which the recovery of acquisition expenses is implicit within the allowance for future revenue in the liability measurement.<sup>3</sup>

**Question 9**

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

54. The measurement of insurance contracts will generally require modelling. However, where they are acquired in a business combination or portfolio transfer they will have an observable value at the point of transaction. We anticipate that there may be differences between the consideration upon transfer and the liability measure adopted for insurance obligations. The balancing item, being goodwill, may include such items as the transferee's (different) expectation of policy renewals based upon anticipated policyholder behaviour. Where such goodwill arises, this would represent a difference between 'fair value' and the Phase II measurement attribute of 'current exit value'.

**Question 10**

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

55. In this regard the IAIS recognises, in principle, the need to assess the overall financial position of an insurer based on consistent measurement of assets and liabilities. (This would include, in the event of such designation, assets held for the purpose of backing insurance liabilities. However, this is not an insurance-specific issue.) The IAIS generally supports a market-consistent approach to valuation. We believe that such valuation of assets, obligations (liabilities) and risk exposures is necessary in order to provide sufficiently relevant and reliable information concerning the financial position of an insurer.

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<sup>3</sup> See paragraphs 87-89 of second Liabilities Paper.

56. Just as it should be helpful for the market to have insurance liabilities presented using an exit value, it would also appear to be helpful for the market to have other financial information presented in a manner that reduces accounting mismatch. We believe that if the current exit value is determined by the board to be the same as fair value, the corresponding value of assets that support these liabilities should be capable of being measured at fair value. If this is adopted, a one time redesignation provision should be allowed. We note the transitional provisions included in paragraph 45 of IFRS 4 regarding the redesignation to fair value of assets held to back insurance liabilities, and recommend that a similar transitional provision should be made available. A full fair value approach would reduce accounting mismatch, and would reduce the possibility of inconsistent reporting that can occur through the use of the fair value option. However, we believe such an approach should not be specific to insurance, and instead strong consideration should be given to reducing existing accounting mismatches that result from applying different methods of valuation, to the extent possible.

**Question 11**

**Should risk margins:**

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

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

57. (a) In the First Liabilities Paper the IAIS argued that “the Board should consider measurement criteria that can result in answers at the individual contract level that are consistent with those obtained when those contracts are measured at the portfolio level.” We agree that, in principle, 'the expected (probability-weighted) cash flows from a portfolio equal the sum of the expected cash flows of the individual contracts' and that therefore 'the unit of account does not affect the present value of the future cash flows.'<sup>4</sup>

58. Whilst the measurement criteria are theoretically applied to the individual contract, we agree that in practice the risk margin will be determined for a portfolio of contracts and believe that the definition of portfolio in IFRS 4 seems to be appropriate for this purpose.

59. (b) The Second Liabilities Paper includes the principle that 'similar obligations with similar risk profiles should result in similar obligations.' At first glance this might be taken to imply that benefits from inter-portfolio diversification or negative correlation between portfolios would not be included in the liability measurement. However, this question is closely related to the concept of the reference market – the market participant to whom the business might be transferred in determining an exit value. In theory valuation should be based upon the assumptions about the level of diversification of the market participant. If the market participant is considered to be well diversified, perhaps inter-portfolio diversification benefits should indeed be taken into account in the liability measurement, consistent with the

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<sup>4</sup> Discussion paper, paragraph 186.

assumptions about the market participant. This then raises the question of the treatment of an insurer's relative diversification compared with the market participant. Where the effects of relative diversification are included in the liability measurement, then the above principle no longer applies.

60. Paragraphs 51-52 of the second Liabilities Paper discuss the issue as follows:

*51. Inter-portfolio offsetting effects can arise where different portfolios of risk can offset each other. An example of offsetting portfolios might be a portfolio of whole of life or term policies and a portfolio of immediate annuities: it would be expected that the inherent trend in mortality would tend to offset between such portfolios. Even where portfolios are merely poorly correlated there can be a diversification benefit as adverse experience is less likely to occur in both portfolios simultaneously.*

*52. Pooling and inter-portfolio offsetting across risk types can give rise to a benefit to be reflected in the measurement of the liabilities, only to the extent that they are recognised in market transactions. To the extent that the market does not reflect such benefits, or to the extent that the insurer achieves greater or smaller pooling or offsetting benefit than the market, the effect is company specific, and the IAIS believes this should be included in the solvency capital requirement rather than in the insurance liabilities.*

61. If diversification at the level of a typical market participant is not included in the liability measurement, this may have reporting consequences. For instance, a large diversified insurer may decide to pass some or all of the benefits of diversification on to its customers through its pricing. However, because of the inability to reflect sufficient diversification in the liability measurement, it would potentially report a loss at inception on the business. It would subsequently release profits equivalent to other less diversified insurers. But because of its capital efficiencies those profits would represent a higher return on capital than the market would ordinarily require for the risk.

**Question 12**

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

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

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

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

**(iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has**

**not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.**

62. (a) Yes. The IAIS believes that the measurement of reinsurance assets should be consistent with the measurement of the corresponding liabilities in the cedant's books ie current exit value.

63. (b) (i) – (ii) Yes. These logically follow on from (a) above. However, we note that the expected loss model for reinsurer defaults will include impairment, which is not symmetrical with the liability measurement by the reinsurer.

64. (b) (iii) We agree that application of the recognition criteria of IAS 39 (see our response to question 1) implies that a contractual right to obtain reinsurance for contracts that have not yet been issued should be recognised from the date such contractual rights are obtained. We tend to agree that the current exit value of such rights is not likely to be material, but believe that this is a matter for measurement rather than principle.

### **Question 13**

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

65. We agree with the Board's view, as set out in paragraph 228 (a), that if the components are not interdependent, then the Phase II standard should apply to the insurance component, and IAS 39 to the deposit component. We also agree with the Board's view (228 (b)) that if the components are so interdependent that they cannot be split other than on an arbitrary basis, then the Phase II standard should apply to the whole contract.

66. However, we do not agree with the Board's view regarding interdependent but measurable contract components where the entire contract would be measured in accordance with the Phase II standard, but with the IAS 39 amount split out. This approach would lead to inconsistencies where, for example:

- it may not be mandatory to measure the deposit component at fair value under IAS 39
- the measurement of the deposit component under IAS 39 might be affected by the surrender value floor
- the measurement of the deposit component might imply a different treatment or quantum of acquisition costs than under Phase II (IAS 39 only allows incremental costs to be deferred).

67. As a result, if the whole contract were measured in accordance with the Phase II standard and the deposit component then unbundled under a different measurement attribute

under IAS 39, then what remained would no longer be measured in accordance with the Phase II standard and would not provide meaningful information.<sup>5</sup>

68. To address this issue, we believe that a more principles-based approach to unbundling contracts in the circumstances described in paragraph 228 (c) would be firstly to measure the entire contract using the Phase II model, then to measure the deposit/service components using the Phase II model and deduct these from the total. The deposit/service components would then be measured in accordance with IAS 39 and IAS 18 as appropriate.

69. However, we emphasise that there are cost/benefit considerations to be taken into account.

**Question 14**

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

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

70. (a) No. The IAIS believes that credit characteristics are generally irrelevant to the measurement of insurance liabilities and most other liabilities.

71. (b) (i) & (ii) No.

72. The Board will be aware from the first and second Liabilities Papers that the IAIS considers that allowing for own credit worthiness in the measurement of insurance liabilities would be inconsistent with the valuation of insurance liabilities in a going concern. The IAIS considers this unacceptable not only for prudential purposes but also for general purpose financial statements, as we believe this will result in information which is not useful and could be misleading.

73. The IAIS provided substantive comments on this issue to the Board in its response to the Fair Value Measurement discussion paper, and will not reiterate all the arguments. Nonetheless, we note that the only justification in FAS 157 for considering an entity's credit risk in the measurement of a liability is that the holder of the obligation as an asset would consider it in determining the amount that they would be prepared to pay. This justification is

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<sup>5</sup> As an example let us consider an accident insurance policy with accumulation. Such a product would fall into the "interdependent but can be measured separately" category. For such products, an insurer pays (i) insurance claims (not death benefit) where a policyholder is injured during the period of insurance cover, and (ii) proceeds at maturity. In this case, in general, the premium corresponding to maturity proceeds could be regarded as a deposit component and it would seem appropriate to apply IAS 39 to this component. However, were the policyholder to die during the period only death benefits would be paid and maturity proceeds not. This means that the value of the deposit component, measured separately in accordance with IAS 39, is effective only where the policyholder does not die during the period of insurance cover. In other words, the deposit component does not exist independently of the insurance component and neither component can be measured separately where both components are interdependent. (This would be consistent with paragraph 11 of IAS 39 (measurement of embedded derivatives).) Therefore, it would not be appropriate to measure both components separately in cases where both components are interdependent.

based upon a symmetry of assets and liabilities which is breached in many places in current IFRSs and the current discussion paper.

74. The IAIS is aware of the research by Board member Professor Barth on this issue, and would note that it does not disagree that – to the extent that credit standing may be inferred in a level 1 price – such effects may be presumed to occur in level 1 of the fair value hierarchy. We do, however, disagree most strongly with such effects being an explicit part of the measurement attribute in level 3 of the hierarchy.

75. The reason it works in level 1 is because you don't actually trade the liability. Rather, what is traded is the corresponding asset which is then able to cancel out the liability.

76. Other than recapture of reinsurance arrangements, that doesn't happen in insurance. Rather, portfolios of liabilities are actually traded (along with a corresponding portfolio of assets). This is then where the reference entity comes in, consistent with all other exit value considerations. It is the credit characteristics of the reference entity which determines the value under the trade, since they are the ones whose credit standing is ultimately relevant to fulfilment of the obligations.

#### **Question 15**

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

77. The IAIS believes that inconsistencies between IAS 39 and the accounting model for insurance contracts should be eliminated to the extent possible. We understand that the longer-term intention of both the IASB and the FASB to move towards 'fair value through profit and loss' for all financial instruments, and believe that this will help to address the issue in the future. However, we would also note that there are differences between insurance contracts and financial instruments which mean that full consistency in the treatment may not be appropriate in all circumstances. See also question 21 for our comments on surrender values.

#### **Question 16**

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

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

**to pay policyholder dividends?**

78. (a) As stated in the second Liabilities Paper, “the IAIS believes 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 expected future cash flows. To treat them as equity would misrepresent the financial position of the company.”

79. The IAIS believes that the accounting model for insurance contracts, including participating contracts, should reflect their economic substance. As indicated in our comments above, we support the measurement attribute described as 'current exit value' (question 5) and the building block approach to achieving this (question 3). Discretionary benefits under participating contracts do have an observable exit value – in a portfolio transfer of participating contracts – and hence economic substance as part of the liability measurement. In the case of participating contracts, it is the contract as a whole that creates an obligation to pay dividends to policyholders. The issue is one of measurement of the liabilities under the contract rather than recognition. We believe that the building block approach set out in the discussion paper addresses the measurement.

80. Building block (a) describes the current estimate as an 'explicit, unbiased, market-consistent, probability-weighted and current estimate of the contractual cash flows.' We believe that this principle should be applied in measuring the full liability in respect of a participating contract. We believe that the approach to the measurement of the liabilities arising from the obligations under participating contracts should be consistent with the overall measurement objective, and that separate consideration of different components of the contract is an artificial unbundling which may result in liabilities which do not reflect the economic substance. Constraining cash flows in this way is also not consistent with the measurement attribute. We therefore urge the Board to adopt an approach for participating contracts which is fully consistent with the current exit value as the measurement, without artificial constraints on the cash flows, and believe that this approach would enhance financial reporting of the economic substance of the liabilities under participating contracts.

81. (b) We understand that at its July 2007 meeting the Board decided not to go beyond the scope of IAS 37 in defining constructive obligations, and therefore we would not necessarily expect the definition within IAS 37 to be extended to participating insurance contracts. We also prefer not to respond to this question in view of the fact that the IAS 37 reconsiderations are still ongoing.

**Question 17**

**Should the Board do some or all of the following to eliminate accounting mismatches**

**that could arise for unit-linked contracts? Why or why not?**

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

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

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

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

82. We refer to our comments to question 10 which support the elimination of accounting mismatches to the extent possible. We would also note that the above types of issue apply more broadly than just to unit linked contracts (for example, index linked and participating contracts), and we believe that the solution should be compatible with the overall model.

**Question 18**

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

83. We believe that the presentation of premiums as revenue or deposit should be consistent with the unbundling of components of the contract for liability measurement (see our response to question 13). To the extent that unbundling is possible, and subject to cost/benefit considerations, this should result in insurance premiums being treated as revenue.

**Question 19**

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

84. The IAIS believes that consideration should be given to aligning the presentation in the income statement according to the quality of the inputs used in the measurement, for example distinguishing information which is directly observable in the financial markets from the inputs which are derived from modelling. The IAIS also believes that in many cases the

current national reporting practices for non-life insurance provide useful information to users of the financial statements, for calculating key performance indicators (eg loss, expense and combined ratios). The IAIS believes that meaningful information of this nature should continue to be reported on the face of an insurer's income statement.

85. We note that work is ongoing at the IASB on Phase B of the Financial Statement Presentation project. Developments on that project will interrelate strongly with the above question and the consideration of presentational issues within Phase II. In that context we urge the Board to ensure that adequate input is obtained from the financial services sector (through the Financial Institutions Advisory Group), and that this occurs at a sufficiently early stage in the project.

**Question 20**

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

86. Yes. The IAIS believes that all changes in the value of insurance liabilities should be included in the income statement when they occur.

**Question 21**

**Do you have any other comments on this paper?**

*Surrender values vs demand deposits*

87. We wish to make it clear that if an insurance contract grants the policyholder the right to surrender it for a cash payment, the surrender value, even if guaranteed in the contract, is not a deposit component. The payment of the surrender cash value is a compensation by the insurer to the policyholder for the release of the risks and obligations which the insurer had undertaken, and which is extinguished upon surrender. On surrendering an insurance contract, the policyholder forgoes insurance coverage for the remainder of the policy term as well as, for some contracts, the right to renew the contract on terms which are beneficial to the policyholder and may be unfavourable to the insurer. As such, the surrender value is the transaction value of the whole contract and not of a distinct part of it. The surrender value cannot be measured separately from the rest of the contract as payment of this value results in the whole contract becoming void.

88. The second Liabilities Paper includes the following principle: "The IAIS believes that there is no necessity for the application of a surrender value floor to the measurement of insurance contract liabilities for general purpose financial reporting." We reiterate below the paper's discussion of this issue (paragraphs 73-78):

*73. Some see the surrender value under an insurance contract as bearing some relationship to the deposit value under a financial instrument. They might therefore be inclined to advocate the application of a surrender value floor on the*

*measurement of an insurance contract liability, similar to the application of the deposit floor under IAS 39.*

*74. [However], the issue should not be confused with the application of a surrender value floor in setting total financial resource requirements for prudential purposes. In that context it remains the case that some form of surrender value minimum is appropriate, to provide protection in the event of a high level of surrenders.*

*75. The IAIS is considering whether, in the interest of market transparency, insurers should be required to disclose aggregate surrender values. Certain jurisdictions may require such a disclosure.*

*76. It is helpful to consider the multiplicity of obligations that may exist under an insurance contract, and the effects of policyholder behaviour, when considering the application of surrender value floors to insurance contract liabilities for general purpose financial reporting.*

*77. The approach of examining each component separately highlights the inappropriate consequences of a surrender value minimum applied in aggregate. However, there remains the practical measurement difficulty of consistently reflecting policyholder behaviour across all components at the one time. [...] applying a surrender value floor on one component may be inconsistent with prudent policyholder behaviour on another component.*

*78. The practical solution to this issue, as reflected in traditional actuarial valuation approaches, is to apply lapse assumptions consistently across all components of an insurance contract – valuing the contract as a whole, with the lapse assumptions chosen attempting to balance the competing influences on policyholder behaviour – e.g. by increasing lapse assumptions around points where guarantees are likely to apply. More recently, stochastic approaches and option pricing overlays have been applied to deal with the derivative aspects of some contract features, but the concept of a common underlying lapse assumption for the whole contract still applies, albeit that it might be stochastically varied depending on other influences, such as the extent to which a guarantee is in or out of the money.*