November 16, 2007

International Accounting Standards Board (IASB)
30 Canon Street
London, EC4M 6XH
United Kingdom

Re: Comments on *Preliminary Views on Insurance Contracts (Discussion Paper)*

On behalf of the American Academy of Actuaries'[1] International Financial Reporting Standards (IFRS) Task Force I offer the following comments on the IASB Discussion Paper (DP).

Overall, the Task Force appreciates the excellent work that went into preparing the Discussion Paper and believes it is a major step in establishing an internationally accepted standard for insurance accounting. We do have, however, a number of concerns about the preliminary views contained in the Discussion Paper that should be addressed in the next phase of this project.

We feel strongly that the guidance contained in the proposed standard should be, as much as possible, directed at defining the measurement attribute that is desired for insurance liabilities. This might be Current Exit Value, Current Entry Value, or some other description depending on the item being measured. The Discussion Paper, however, seems to us to contain much that we consider to be actuarial guidance and we believe this kind of guidance should be left to the actuarial profession to define.

For example, the discussion of the basic building blocks contains phrases such as "identifying each possible scenario", "incorporate all available information" and "consistent with observed market prices" that are either impossible in the real world or, if implemented, would lead to results that are not reliable or relevant and hence not useful.

Another example concerns the requirement that a probability-weighted methodology be used for current estimates. Many well-accepted techniques for insurance reserving do not explicitly utilize probability weights. We see no reason to eliminate those methods from consideration in favor of more complex and potentially more expensive methods that may not produce any meaningful improvements in estimation (and may be less transparent).

Yet another example rests in the tentative conclusions that contain several limitations on which cash flows can be considered in measuring the value of a liability. Limitations on which future year

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

1100 Seventeenth Street NW Seventh Floor Washington, DC 20036 Telephone 202 223 8196 Facsimile 202 872 1948 www.actuary.org

premiums can be considered as inflows for life products as well as limitations on which dividends or other non-guaranteed elements can be considered as outflows will not generally produce a value that has any meaning to users. The standard should accept a current estimate of all future cash flows arising from an existing policy as the basic cornerstone of the measurement.

Due to the wide diversity of products and environments that exist in the insurance industry, we propose that national actuarial organizations be given the responsibility for developing actuarial guidance. We support the objective of internationally accepted actuarial standards that will embrace the objective of avoiding, for any given situation, inconsistent treatments between countries but believe such a development is not currently an achievable objective.

Another concern we have centers around the possibility of a gain at issue. We believe that allowing a gain at issue in any but the most unusual situation would be an unacceptable outcome. Such a situation would likely lead to additional opportunities for earnings manipulation by one or more preparers and the insurance industry does not need that. While it might be that disclosure and user pressure would limit such gains, we believe the guidance should at least strongly suggest such gains are unlikely to be proper.

These are our most important issues. We address the questions contained in the paper in the remainder of our response below.

Sincerely,

Henry Siegel
Chairperson, International Financial Reporting Standards Task Force
Risk Management and Financial Reporting Council
American Academy of Actuaries

Questions From the Discussion Paper

Chapter 2

Question 1

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

IAS 39 is not a suitable model for recognition and de-recognition of many insurance contracts. While this issue has important legal and regulatory aspects, we have a few observations to offer.
First, it is important to remember that it is the insurance contract being recognized, and not the various pieces of the cash flows.

Given this understanding we note the following:

Recognition

- When an insurer becomes a party to the contract varies significantly depending on the situation and jurisdiction involved. Sometimes it is when the contract is signed or when cash has been received or even before either the contract has been signed or cash received.

- An important issue here may be the determination of when the contract has been "delivered", as per IAS 39, paragraph AG35(b). Such delivery may not occur until the actual period of risk covered by the contract has occurred.

- When an insurer becomes a party to the contract is not the same as becoming liable under the contract. A contract can be completely negotiated and money exchanged either before or after the coverage begins.

- It may not be clear at a point in time as to whether or not an insurer is liable to pay to or on behalf of certain people under some insurance contracts (e.g., who is a named insured under a commercial liability policy, given various corporate restructurings, name changes, mergers/acquisitions/divestitures, etc., between the time the contract was signed, the coverage period occurred and the claims were filed). Accordingly, it is not always easy to determine whether a liability for payment to a particular claimant will be required.

- We need to consider if there are recognition issues when there are changes (or potential future changes) to an existing contract such as in the treatment of exposure changes under existing group contracts.

De-recognition

- De-recognition is often not a concept that applies to many insurance contracts since technically you may never be "off the hook." Claims may not be reported until many years after coverage has expired.

- A liability based on the present value of expected future cash flows will properly reflect expiration of liabilities without a formal de-recognition of a policy itself.

- On claim settlements, de-recognition should be consistent between assets and liabilities, particularly with regard to complex settlements of major litigation.

In summary, this is a subject that requires more discussion with the industry as a whole.

Chapter 3

Question 2

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

The Task Force's basic position is that the measurement of all insurance liabilities should reflect a current estimate of all future cash flows for a portfolio of insurance liabilities, appropriately discounted and with a risk margin if the time value of money is to be reflected. This is generally in accord with the three building blocks. However, we have three major concerns about this section of the Discussion Paper that we want to emphasize.

First, we believe that much of the language in the Discussion Paper is actually actuarial guidance that should be reviewed, discussed and promulgated by the profession in order to assure that it is based on "appropriate practices," properly understood, and properly implemented. We would look to the accounting standard setters to state the measurement and recognition principles and objectives, but they should allow actuaries, in concert with other interested professions, to write the detailed measurement guidance.

Second, financial inputs that are level 1 or level 2 under FAS 157 can only be separated into the three parts in an arbitrary manner since margins are not explicitly stated for them. Thus all three components may not be available for each item in the calculation.

Finally, the concept of "market consistent" needs clarification. We believe those words should apply to inputs that a knowledgeable buyer would use in valuing a liability. Most often, such inputs would be what are referred to in the paper as "entity" level or sometimes "portfolio" level. Our experience is that there are very few "entity level" inputs that would not be reflected in determining the value of the liability in the actual market.

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

In general, we are concerned that some of the wording contained in this section is based on theoretical considerations that are not truly reflective of appropriate practice. We recommend, for reasons discussed below, that the words "market-consistent" and "probability-weighted" either be removed from this definition or the guidance in the document state clearly that there are situations in which precise adherence to those requirements is not possible or necessary.

For property/casualty insurers, the most common current practice for claim liabilities is to use estimators of the mean, rather than to attempt estimation of all possible scenarios and assign probability-weights to each such scenario. The methodology that the document appears to prescribe is impossible to implement in many claim situations, where the possible scenarios are not limited by contract to a small number of scenarios. The proposed methodology would require omniscience with regard to the possible outcome of uncertain events, including possible future human behaviors (such as those of courts and/or juries). As such, it is not practical to implement. We support the conceptual goal of a mean estimate, but not the methodology to produce such an estimate that the Discussion Paper appears to prescribe. The IASB should not replace methodologies that work well today.

We also note that some companies purport to meet the requirements of the prescribed methodology through the use of stochastic models. But such models only assign probability weights to the scenarios that are modeled. This is very different from modeling "all possible scenarios," as models are only an approximation of reality and cannot encompass the entire range of possible outcomes for most real-life insurance situations. For example, we are not aware of any stochastic model for life insurance that included the scenario of the September 11th terrorist attacks on the World Trade Center in New York, despite the fact that it may have been a source of concentrated mortality risk for one or more life insurers. Hence, we reiterate that the methodology prescribed in the DP for measuring the expected cash flows is not practical to implement.

Also, the Discussion Paper discusses using "all currently available information" in making such estimates. A literal interpretation of this objective is impossible to achieve for many insurance liabilities, due to the inherent lags in evaluating and analyzing information. In short, estimates cannot be done in "real time." Data must be evaluated for accuracy and completeness before use, and then it must be analyzed to determine its possible effect on the estimation process. In most cases, the data is only an indirect indicator of ultimate future cash flows, not a direct indicator. For example, a certain outcome for a recently closed claim may allow one to infer an implication for future claim settlements, but typically will not dictate a specific outcome for such future settlements. Hence, analysis and judgment must be applied to most insurance liability estimates, delaying the incorporation of "all currently available information" into the estimate.

While we understand that the Discussion Paper intentionally did not address most practical issues, it is not practically possible to redo all assumptions at every measurement period. Clearly there will be periods when assumptions don't change because there simply isn't time to evaluate the available data until the next quarter or possibly later. We would suggest this be clarified to avoid disputes with auditors over the requirement for "current" assumptions.

Furthermore, we anticipate that in many situations actuaries will need to be able to use approximations rather than full-scale stochastic analyses for every assumption. In today's computing environment, running such a model might take several days and would make meeting the filing deadlines of most financial reporting requirements problematic, especially if the models had to incorporate "all available information" up to the model run date.

For all liabilities, the use of "market-consistent" assumptions requires further clarification in view of the current exit value measurement objective contained in the Discussion Paper. In most transactions, the estimate of future cash flows used by both buyer and seller is based on the company's own past experience. In the United States, Actuarial Standard of Practice (ASOP) #23, Data Quality, states that the actuary should give "due consideration" to "appropriateness for the intended purpose of the analysis". If the task at hand was to estimate the value of a company's business, the data pertaining to

the business would generally be most appropriate. It would be unusual to set a price based solely on efficiencies that only the purchaser might be able to implement.

It is also questionable whether using market average assumptions different from a company's own anticipated experience is appropriate. We think the text of the Discussion Paper should be made very clear as to whether the meaning is: (a) the liability should be evaluated using values of assumptions found commonly in the marketplace or (b) using values of assumptions the market would utilize for measuring the liability of a particular company. The two answers can be quite different. Under interpretation (a), depending on whether the company is efficient or not relative to the market, such assumptions would create an artificial gain or loss at issue that has no real economic meaning.
Due to the similarities in insurance products, the demand for insurance coverage is relatively fixed. To distinguish themselves in the market insurers have developed market positions and capabilities through "creating special, beneficial attributes of their individual products." Such product attributes include: "the extent to which coverage will be extended by the claims department for marginal claims; the extent to which the insurer offers coverage extensions in the policy that other companies do not; the financial strength of the insurer; the insurer's flexibility in customizing insurance programs to meet individual customer's needs; the ability of the insurer to successfully fight third-party claims; the accessibility of the insurer's claims department, and the quality of the loss control offered by the insurer."

Any exit value measurement in the market would recognize the impact of an insurer's market position and capabilities on its unpaid contract obligations. Thus the value of a company's contractual obligations in the market is unique to the company. Any estimate of the future cash flows would be produced using assumptions derived from the following data sources stated in order of preference; the portfolio of contracts being evaluated, other insurance data, non-insurance data.

We conclude that the observable market value for insurance contract obligations, if they're to be consistent with current market values, would have to be estimated using primarily a company's own experience. Therefore, the requirement to remove entity specific cash flows from the estimate is contrary to the reality in the market.

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

We are in general agreement with this requirement for both life and non-life liabilities, if the time value of money is to be reflected[2], but would note that there are several technical issues that need to be addressed.

Definition of "current market discount rates":

We assume that these returns are often risk-free rates with an adjustment for required liquidity. This is consistent with our response to Question 14 below. Thus, in the US, government bonds of the appropriate duration would be the starting point with an adjustment to reflect that liabilities are not totally liquid and that therefore assets don't need to be either. Some additional return is possible to reflect this. For other jurisdictions, either a government bond rate or a forward rate would be the starting point for discounting.

[2] There is a clear consensus for the reflection of the time value of money for life contract insurance liabilities, but not for property/casualty claim liabilities. Therefore, we take no position with regard to the reflection of the time value of money for property/casualty claim liabilities, other than commenting on the suggested guidance for how to do so if it would be so required.

Important exceptions to this basic definition are given below.

Discount Rates for Scenarios:

Proper integration of building blocks (a) and (b) is necessary to produce the correct result in a stochastic valuation.

For instance, each separate scenario is typically associated with a unique interest rate path representing the financial conditions of that scenario. It is therefore important that the cash flows of a scenario be discounted using discount rates from the yield curve associated with that scenario.

The fact that the DP treats the single probability-weighted cash flow vector and the discount rate as separate building blocks leaves open the possibility that the DP means that one discount rate vector (or even a single discount rate) should be applied to the single probability weighted cash flow vector.

The use of a single (set of) discount rate(s) would clearly generate liabilities that don't correlate to an exit value. For instance, cash flows in low interest scenarios would need to be discounted at the appropriate low interest rate to produce proper liability values. Otherwise, the value of option-like features, such as minimum interest guarantees, would not be measured consistently with observable market values of corresponding exchange-traded options.

We recommend that the standard be clarified to explicitly permit the use of multiple discount rates that correspond to the interest and economic scenario of each series of cash flow calculations.

Liabilities Dependent on Investment Return:

We would also note that for many liabilities, the value of the benefits paid depends directly on the investment return earned on the assets supporting the liability. In those situations, which include most life and annuity products currently being sold, other than strictly non-participating guaranteed benefit coverages, the discount rate should be consistent with the estimates of future investment returns used to project the liability for each scenario. Otherwise, non-economic gains or losses will be created.

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)?

With regard to the "service margin" discussion, we believe that any separation of margins into separate pieces would not be a meaningful distinction and would often be arbitrary.

For both Life and non-Life liabilities, determining the proper margin will be quite subjective. It is necessary, in our view, to calibrate the risk margin in some manner to avoid having it be an arbitrary and unreliable value. We discuss this issue further under Question 4.

For non-life claim liabilities, we believe that a risk margin needs to be included if the liabilities are to reflect the time value of money, but are concerned that such margins cannot be calibrated to the market, as such a market does not exist (and face significant legal and other obstacles to ever being created). We also believe that the measurement objective for such risk margins should be value-in-

use rather than value-in-transfer, since there is a lack of secondary transfer markets and insurance companies generally do not intend to transfer liabilities in any event.

We point out that commonly used "market consistent" valuation techniques for non-insurance financial risks (for which markets do exist) do not provide for separation of the risk margin from the discounted, probability weighted cash flows. Such valuation techniques include a risk margin through the use of biased rather than unbiased probability weights. The weights are biased through calibration to market prices. The unbiased probability weights are not determined. Without them, the market-consistent value cannot be (and need not be) split into an unbiased estimate and a risk margin.

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

As noted above, we are in favor of a liability that reflects all future expected cash flows arising under a policy that is in force, that is discounted appropriately (or possibly not at all for P&C claim reserves) and includes an appropriate margin. It may be that such a definition is sufficient for the accounting standard and that the professional organizations should be allowed to develop detailed guidance around this requirement.

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?

Overall, we believe that much of this guidance is too prescriptive, includes items that are more actuarial guidance than accounting guidance, and in several places proposes or requires approaches that are inferior to other alternatives for the production of decision-useful estimates. We believe that the IASB should focus on defining the desired measurement attribute and then allow the actuarial profession to define how the calculations should be done.

We believe that the requirement to be “as consistent as possible with observable market prices” is currently subject to multiple interpretations, and such ambiguity should be removed. We believe that the primary intent of this statement is that the valuation should be consistent with prices in robust financial markets for financial market variables, but the current guidance does not appear to limit the discussion to “financial” markets only. Therefore, there is the danger that an auditor may require an insurer to incorporate such things as public inflation indices and the prices from disclosed merger/acquisition/divestiture activities, despite the lack of reliably measurable comparability to the reporting entity’s insurance liabilities.

For property/casualty claim liability estimation, it is generally accepted by property/casualty actuaries that external data should only be used to the extent that entity-specific data is not sufficiently credible, and even then only with great caution. The potential (and commonly observed) variation between various claim department settlement strategies, processing systems, claim estimation approaches, claim incurral dating practices, underwriting criteria, markets, etc., makes the use of industry and/or external data typically suboptimal. In contrast, the current IASB guidance for level three fair value estimates and for other similar “market consistent” valuations incorporates a bias for market-based information over entity-specific information for the production of estimates. Hence, we believe that the requirement to be “as consistent as

possible with observable market prices" should be limited to robust financial market prices for financial market variables.

The requirement to incorporate "all available information" is problematic, and sets up an impossible standard that will be used against the reporting entity in litigious environments. This is discussed earlier in the response to question 2, and is also repeated here:

> A literal interpretation of this requirement is impossible to achieve for many insurance liabilities, due to the inherent lags in evaluating and analyzing information. In short, estimates cannot be done in "real time". Data must be evaluated for accuracy and completeness before use, and then it must be analyzed to determine its possible effect on the estimation process. In most cases, the data is only an indirect indicator of ultimate future cash flows, not a direct indicator. For example, a certain outcome for a recently closed claim may allow one to infer an implication for future claim settlements, but typically will not dictate a specific outcome for such future settlements. Hence, analysis and judgment must be applied to most insurance liability estimates, delaying the incorporation of "all currently available information" into the estimate.

The prohibition on using entity-specific cash flows is of questionable value, as it could lead to information that is not decision-useful for potential investors, capital providers or management of the reporting entity. Users of a reporting entity's financial statements usually are interested in projected future cash flows for that entity. The ability of a different entity to obtain operating efficiencies (or lose such currently existing efficiencies) if it took over the liability may be useful information, but such estimates are probably more hypothetical and particular to a specific user, and do not represent estimates of future cash flows for the particular reporting entity being evaluated. We recommend that the IASB reconsider their approach in this matter.

The discussions in paragraph E15 (in particular, E15(c)), E18 and F3(j)) appear to us to include more actuarial guidance than accounting guidance. As such, we recommend that they be rewritten and refocused solely on clarifying the accounting principle(s) and objectives that the actuarial estimates must address.

The assignment of a probability estimate to each possible scenario is often impossible to accomplish, and as such is completely impractical. It should be largely deleted from future documents. It is impossible, even with stochastic models, to enumerate all possible scenarios for a portfolio dealing with real-life dynamics of human behavior. Complicating factors include the open-ended nature of potential court and jury rulings, the absence of firm limits on the timing of the same (or of many settlement negotiations), and the inherent nature of surprises in real life (e.g., the World Trade Center attacks, the tsunami of December 2004, the various court rulings in the U.S. regarding asbestos liabilities, the pandemic of 1918). (Note that paragraph E26 acknowledges such phenomena, despite the absence of such acknowledgement in earlier paragraphs, such as E20.)

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).

We prefer alternative (b) but we believe the evidence needed to recognize a gain at issue should be overwhelming. We would expect that under this alternative, gains at issue would be limited to very rare niche situations. One example we identified would be when a regulator set a minimum premium in excess of what the insurer would otherwise demand. Losses at issue should also be relatively rare, occurring only when an insurer knowingly prices a product to produce a loss over the long term.

We find the possibility of a gain at issue under normal situations potentially misleading and believe that earnings should, instead, emerge as the insurer is released from risk under the policy. Some argue that when the pricing cycle for non-life products is either at its top or bottom, gains or losses at issue should emerge. Our experience, however, is that companies rarely know whether the cycle has reached the top or bottom until several years after a policy is issued and therefore can't reliably predict whether a portfolio of policies has a gain or loss at issue. For this reason, we recommend that earnings should properly emerge only as coverage is provided.

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?

(a) We believe that the measurement attribute should be the present value of future expected cash flows using appropriate discounting and risk margins as described above. We are unable to define this in terms of transfer values or economic values or similar language. Such language does not apply in situations where there is no deep, liquid market.

(b) The label "current exit value" is not a useful label as stated above. The term "current exit value" can lead users to expect a liquidation value rather than a going-concern value, which we don't think should be the intent. Even if "current exit value" were the adopted language, restricting which cash

flows can be included will produce a value that is not “exit value” as any market would understand it.

Chapter 4

Question 6

In this paper, beneficial policyholder behaviour refers to a policyholder’s exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:
(a) incorporate them in the current exit value of a separately recognized customer relationship asset? Why or why not?
(b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?
(c) not recognise them? Why or why not?

Alternative (b) is preferable; the beneficial flows should be netted into the liability rather than shown as a separate asset. This recognizes that the individual cash flow measurements are not, in themselves, a separate asset or liability. Rather, issuing the policy creates the liability and the cash flow measurements are simply for the purpose of measuring the value of that liability.

Alternative (c) is not an acceptable alternative since it would not recognize all expected future cash flows.

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).

We support Option (b) (above). We believe the liability measurement should recognize all expected future cash flows, beneficial or not, that arise from existing contracts. This is consistent with the way products are priced and the way an acquirer would value the business in the market, and is consistent with our choice of Question 4's option (b).

Option (a) is unnecessarily restrictive. Payment of premiums to the company may benefit both the policyholder and the insurer since the insurer is often able to invest money more efficiently than an individual because of its access to the capital markets and favorable tax position. Thus, the payment of life insurance premiums greater than the minimum necessary to retain insurability may actually reduce the ultimate cost of the insurance to the insurer.

Furthermore, Option (a) would create significantly different results for Whole Life Insurance and Universal Life contracts in the US although the marketing and pricing of the two alternatives is very similar. In this situation the proposed accounting would produce differences that don't reflect the true market.

Cash flows arising from contracts that have not yet been written would be excluded unless those policies would be burdensome to the insurer. Cash flows from future contracts should not be recognized where (i) the pricing of the new contract is not a function of the current contract, and (ii) neither party is obligated to participate in the new contract. Where (i) and (ii) exist, the new contracts represent franchise value and the value of customer relationships, not the value of current contracts.

The Board's difficulty in accepting this for premiums, policyholder dividends and other non-guaranteed elements, points to a problem with the Framework that should be corrected: Failure to incorporate all expected future cash flows in the liability measurement will have the effect of generating a gain or loss at issue that does not reflect economic reality, and will provide information to users of the financial statements that will be misleading.

There is also a special situation that applies to Individual Medical Insurance in the US and other products where pricing is dependent on the ability to obtain future premium rate increases from regulatory authorities and the insurer can't unilaterally cancel the contract. In those situations, future cash flows must anticipate future rate increases sufficient to offset future benefit increases or the liability calculation becomes meaningless. If those rate increases are not realized, then the assumed future premiums would be reduced and a loss recognized at that time.

Question 8

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

This question is related to how premiums after the first year are recognized for life contracts and how the pre-claims liability is established for non-life contracts.

For Life Contracts, if all expected future premiums are utilized in calculating the policy reserve, then expensing the acquisition expense is consistent with the reserve measurement. If premium recognition is limited, however, some recognition of deferred acquisition costs will be necessary in order to avoid a loss at issue since those future premiums include provision for recovery of those acquisition costs.

With regard to property/casualty insurance contracts, the approach to the recording of such costs is less important than the consistency with the recording of the unearned premium liability or "stand-ready obligation." If the unearned premium liability or stand-ready obligation is established gross of such expenses, then such acquisition expenses should be an allowed pre-paid asset in order to avoid a non-economic loss at issue. If such pre-paid expenses are not allowed to be reflected as an asset, then the related unearned premium liability or stand-ready obligation should be established net of such expenses. Note that for many property/casualty contracts, the commissions and premium taxes are recoverable on a pro rata basis upon cancellation of the contract. As such, they are a recoverable "asset," convertible to cash upon mid-term cancellation of the contract. Hence, such costs are of a different nature than many up-front commissions for long-duration life contracts.

Question 9

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

Our principal concern is that the final standard allow for consistent treatment between insurance liabilities on acquired versus pre-existing business. One reason for this view is the desire to retain comparability in the valuation of the two groups of liabilities. Another reason is that the runoff of the two categories of liabilities can become inseparable after the business combination (due to joint settlements and/or joint assessments on the combined entity or portfolio). A third reason is that maintenance of the runoff liabilities in separate categories and separate accounts, even when separable in a non-arbitrary way, can become problematic given a potential lack of incentive under the new business combination for the operating areas handling the combined runoffs to maintain and manage such separate valuations.

Chapter 5

Question 10

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

- No.

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?

(a) Risk margins and all assumptions should be determined at a portfolio level. The definition of portfolio in IFRS 4 is acceptable for pre-claim liabilities for both life and non-life policies.

It is not acceptable for claim liabilities. The focus for claim liabilities is the characteristics of the claims, not the characteristics of the contract exposures. As such, the "portfolio" definition most conducive to reliable claim liability estimates can cut across contract groupings, and can vary by type of claim or insurance versus ceded or assumed reinsurance. For example, an insurer may manage its personal homeowners policies separately from its commercial liability policies, but it may manage its leaking underground storage tank claims as a group, regardless of whether the claims are from a personal residence's oil tank or a small business' oil tank.

In short, the reference to "contracts" in the definition of portfolio should be changed to "coverages" with regard to claim liabilities.

(b) If risk margins are calibrated to premium in most cases, as we suggest, the margins will reflect whatever assumptions are incorporated into the price. If the company prices taking such diversification benefits into account, the margins will by default reflect them. We do not, however, expect that this will generally be the case.

Question 12

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

We believe the reinsurance asset should be measured on the same basis as the underlying liability.

(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.

In theory yes. In practice, this is generally true. However, in certain non-proportional reinsurance situations the second phrase may not be a meaningful statement since it may not be possible to determine 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.

We agree with the expected loss model for defaults and disputes, with the understanding that it would be applied on a portfolio basis.

(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.

We agree with the statement. Unless future contracts must be written at a burdensome rate, there should be no affect on the current liability since the present value of future premiums will be greater than the present value of future benefits and expenses plus risk margins. We also note that this presupposes "no gain at issue," which is the focus of Question 4.

Question 13

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

In most situations the Discussion Paper's proposal is not a useful or meaningful measurement. Unbundling contract features that are interrelated do not provide meaningful decision-useful information and do so at a cost. Where the pricing and negotiation of a final contract is on a combined basis for the entire contract, as is generally the case, any split of the contract into components is arbitrary and may not be auditable. Where the cash flows of the components are interrelated, the application of different accounting models for different components would seem to provide less comparable information about the contracts.

In any case, for an insurance contract that contains deposit components, a requirement for bifurcation is not necessary to reduce any inconsistencies in the accounting model. After all, the IASB has not identified any significant differences between current exit value as described in the Discussion Paper and fair value, and IAS 39 allows for a fair value option for financial instruments. Thus, if the insurance contract (including the deposit component) is accounted for at current exit value, the resulting valuation should be consistent with accounting for the bifurcated insurance component under current exit value and the bifurcated deposit component under the fair value option.

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?

In general, reflection of credit standing in measurement of most types of liabilities does not provide useful information to investors.

- *(*a) No. The proposed Framework for IFRS states that "The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions." The regulation of insurance companies prohibits the transfer of insurance liabilities in many countries, except for special circumstances that require the permission of the regulators. The most common situation whereby a regulator will accept such a transfer is where the transferor is in danger of going insolvent. In such a situation (and for all other approved transfers of insurance liabilities) the regulators will insist that the transferee be a clearly solvent company with a solid credit standing. Hence, the regulator will prohibit the transfer of insurance liabilities to any company for whom a credit standing adjustment would be material. For a company for whom a credit standing adjustment would be material, transfer to a company with an equivalent credit standing would be prohibited. A valuation based on such a prohibited

transaction would be irrelevant to a user desiring to make capital and other resource allocation decisions, and hence in violation of the proposed Framework.

(b) The measurement of an insurance liability should not include a reflection of its credit characteristics, either at inception or otherwise. Insurance entails the receipt of premium in advance in exchange for a promise to perform at a later date. The faith of its current and potential future customers that these promises will be fulfilled is part of its franchise value. If a company attempts to realize a material reduction in its liabilities due to a questionable future ability to pay, it is destroying its franchise. Attempts to do so may also be illegal in many jurisdictions. Hence, such a reduction is generally not realizable as a viable going concern. If a transaction is not realizable by a going concern, then such a valuation is not useful and relevant information to current and potential investors. It would not be helpful in assessing the entity's future cash flow prospects.

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?

It would be preferable if there were no material advantage to be had based on which accounting basis is adopted. It is not clear that the current proposals create any such advantage. However, as mentioned above in the question 4 response, we believe that at least one of these inconsistencies (i.e., that allowing for gains at issue) should be addressed by changing the proposed insurance accounting standard and not by changing IAS 39.

Chapter 6

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?

As we stated above in response to Question 7 we favor using all expected cash flows in the determination of the liability value. We would therefore not limit the dividends to those for which a legal or constructive liability exists at the point of valuation. Furthermore, this position also applies to non-guaranteed elements in Universal Life-type contracts.

This may be an area where local guidance will be the best solution with each country deciding if future dividends should be recognized based on its own legal system.

We are unable to comment on the June 2005 proposals with regard to amending IAS37 since we believe those discussions are ongoing and the result is currently unknown.

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).

- Yes, so long as the shares are part of an outside/managed fund such as an index fund or mutual fund managed by a third party.

(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).

- No comment.

(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).

Yes to both.

Chapter 7

Question 18

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

For a policy that qualifies as insurance under the definition in IFRS 4, premiums should be revenues once they are earned for non-life insurance and as they are incurred for life insurance. Under this treatment, incurred premium is paid premium plus the change in due and unpaid premium less the change in premiums paid in advance of their due date. This treatment provides more consistent and useful information than trying to split the premiums between a deposit and an insurance element.

Question 19

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

We don't view this as primarily an actuarial issue. We are concerned, however, that whatever format is chosen that actuaries be able to calculate the actuarial components on a non-arbitrary basis.

For this reason, actuarial input into the Financial Statement Presentation project is essential as a proposal is being developed.

Question 20

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

We don't consider this an actuarial issue although, as stated above, we are concerned that actuaries be able to calculate the actuarial items on a non-arbitrary basis.

Other matters

Question 21

Do you have other comments on this paper?

Implementation Concerns

It is obvious that the accounting structure proposed in this paper is a radical departure from existing guidance. As such, there will be significant implementation challenges for insurers both to do the liability calculations as well as for the required disclosures. The cost of this implementation will not be small. Accordingly, as much implementation time should be allowed as reasonably possible.

Claim Portfolios

While it may not impact the outcome of the standard, the discussion concerning "unit of account" has some conceptual and practical problems when applied to claim liabilities. These problems center around the incorrect assumption that the expected value of a portfolio of claims is equal to the sum of the expected values of the individual claims valued independently. There are three reasons why this is an invalid assumption.

1. There are times when the outcome of one claim will affect the outcome of another claim. In that environment, the claim department's objective is to manage the portfolio for an optimum result, not each individual claim. This is most relevant for liability insurance, where precedents set in one claim will impact the value of another.

2. Economies of Scale

The valuation of a single claim in isolation may not justify the application of resources that are justified for the portfolio. If a company instead has a portfolio of claims involving that special expertise, it is more cost effective to obtain the specialized resources and expertise (either in-house or through contracted services), resulting in lower claim values and/or claim expense values.

3. Estimation methodology and estimation objective

The methodologies applicable to deriving an estimate for a portfolio frequently differ from those used in estimating an individual contract or claim value. The result is not an estimate of the value of an individual contract, as detailed analysis of the individual contract would probably conclude with a

different result. As long as the policyholder or competitors cannot cost-effectively determine whether the more refined value should be higher or lower than the allocation of the portfolio average value, adverse selection is not a concern.