24 March 2008

International Accounting Standards Board
30 Cannon Street
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(By email: iasb@iasb.org)

Dear Sir

RESPONSE TO DISCUSSION PAPER: *PRELIMINARY VIEWS ON INSURANCE CONTRACTS*

1. The Accounting Standards Council (ASC) appreciates the opportunity to comment on the Discussion Paper: *Preliminary Views on Insurance Contracts* issued by the International Accounting Standards Board (IASB) in May 2007. Our comments below address the specific questions set out in the Discussion Paper.

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?

The contractual rights and obligations of an insurance contract are seen to be similar to those of a financial asset and liability. Accordingly, the recognition and derecognition requirements for an insurance contract could be treated in accordance with those in IAS 39 for financial instruments.

However, insurance contract could also be viewed as a service contract in which case, the recognition and derecognition would need to be aligned with IAS 18 and IAS 37.

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

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(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?

We agree with the three building blocks used in the measurement of insurance liabilities.

We agree in principle the use of market consistent assumptions in the measurement of insurance liabilities if those are observable market data. However, those data are more often than not practically difficult to obtain in reality or even exists at all due to the absence of an active secondary market. We would urge the Board to consider permitting the use of entity specific data in the estimate of cash flow.

We also believe in most cases, the current methods employed in estimating cash flows would consider probabilities (e.g. use of mortality rates, IBNR) but perhaps not in the manner which is set out in Chapter 3. We would suggest that the guidance be more principle-base as opposed to prescriptive on the methods of arriving at the probability weightings.

In principle, we do not disagree that risk and service margins should be included in the measurement of insurance liabilities. However, in practice risk and service margins may not be easily separable and quantifiable and this may lead to the use of arbitrary basis that may result in varying insurance liabilities. Accordingly, additional disclosures around key assumptions and judgments made in estimating risk and services margins be included to enhance comparability of the financial statements between insurers.

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?

The level of detail provided in Appendix E and F is appropriate.

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 believe (c) would be appropriate. However the margin that insurers would require may present challenges for one to determine the appropriateness of the profit to be recognized at inception. More guidance is required.

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?

In practice, most of the insurance liabilities are extinguished through settlement with the insurance contract holders, and transfers of contractual rights and obligations to another entity do not occur frequently. In this regard, we believe that the use of CEV may not be appropriate basis for measuring insurance liabilities. Instead, the insurance liabilities should be measured in accordance with the three building blocks as advocated.

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

No, comment as above.

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 assets? Why or why not?

The pricing of an insurance contracts include assumptions about policyholder behaviour, therefore, any measurement model should incorporate them as well. The contract's asset and liability component are inextricably linked and it would not be practicable to view the component separately.

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

Yes, for reason stated above, and which is the current practice.

(c) Not recognize them? Why or why not?

As these are considered in the pricing of insurance contract, not recognizing the impact of beneficial policyholder behaviour would not give a faithful representation of the transactions.

Question 7

A list follows of possible criteria to determine which cash flows an insurer should recognize relating to beneficial policyholder behavior. 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.

No

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

No.

(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).

A measurement basis that considers insurance contracts as a bundle of cash flows representing a variety of interrelated rights and obligations is consistent with the pricing of contracts and would be a faithful representation of the arrangement.

We understand that this is the basis which is currently being practiced.

(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.

No

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

No

(f) Other (please specify).

Nil

Question 8

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

Acquisition costs should be expensed off when incurred. This is because the benefits of acquiring the new business has occurred and such benefits do not carry forward to subsequent periods. In the absence of future economic benefits, the acquisition costs should not be deferred and recognize as an asset in balance sheet.

Additionally, the Board should develop a consistent approach on the treatment of acquisition costs between investment and insurance contract, as under IAS 39 presently allows deferral of acquisition costs for investment contracts.

The Board may also need to consider defining what constitutes acquisition costs.

Question 9

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

The measurement treatment of insurance contracts acquired in a business combination or portfolio transfer should be the same as the direct written business. However, assuming that the

portfolio transfer constitutes a business combination within the scope of IFRS 3 Business Combination, the Board advocates any goodwill which is defined as the difference between the consideration paid and the measurement value of the underlying insurance contracts acquired, be taken to income statements is not in accordance with the principles set out in IFRS 3.

As noted in the DP, the Board needs to conclude whether CEV is the same as fair value before concluding on the treatment of insurance contract acquired in a business combination or portfolio transfer.

Question 10

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

In principle, the measurement of all assets should follow the measurement principles as advocated in the current IASs/IFRSs.

However, when the adoption of these measurement principles result in accounting mismatches with the insurance liabilities, the Board should consider transition relief to permit insurers to re-designate their assets held to back insurance liabilities to minimize the impact of the accounting mismatches on first adoption of the new standard.

Question 11

Should risk margins:

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

We agree with the proposal that risk margins should be determined on a portfolio basis. However, we believe that the Board should consider providing further guidance to what constitute a portfolio of insurance contracts in this context.

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

We believe that benefit of diversification should not be ignored in determining the risk margin as it reflects an economic reality that insurer considers the benefits of diversification in the pricing of its products and managing its portfolios. On that basis, we believe that the risk margin used in the true current exit value model should incorporate the benefits of diversification to the extent that the effectiveness of this diversification benefits in reducing the overall risks exposure can be demonstrated.

If this approach is adopted, the Board may consider that the diversification benefits between portfolios as incorporated in determining the risk margins, should be separately disclosed.

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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.**

We believe that the measurement of the reinsurance assets should be based on the same principles that are applied to the measurement of the underlying insurance liabilities. The Board proposed the approach to measure the risk margin on reinsurance assets at the same amount as the risk margin for the corresponding part of the underlying insurance contract. Although we do not object to such an approach, there is seldom an observable market for reinsurance assets and therefore we have concerns about the ability to reliably measure reinsurance assets at current exit value. We prefer the measurement of the assets to take into accounts all the factors that the insurer would consider in negotiating the price of the reinsurance.

With respect to part (b) (i) of the question, we agree a risk margin will increase the measurement of a reinsurance asset, in the same way that it increases the measurement of an insurance liability.

With respect to part (b) (ii) of the question we agree that an expected loss model should be used for defaults and disputes.

With respect to part (b) (iii) of the question, we also agree that current exit value would include probability-weighted cash flows in respect of all contractual rights however we note that such rights may not be material in most circumstances.

Question 13

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

We believe that the insurance component and deposit component should be unbundled and measured separately if the components are not interdependent and can be reliably measured. If the components are interdependent but can be measured separately on a basis that is not arbitrary, then the deposit component should be unbundled.

However, the question on unbundling is also dependent on the outcome of the Board's decision on performance reporting. If different approaches are required for performance reporting of insurance contracts and other instruments, we would support unbundling because transactions should be accounted for based on their substance rather than their form and that an arbitrary definition should not result in different accounting for instruments with the same economic substance. In such circumstance, unbundling the deposit and service components would improve transparency and comparability across products and industries.

Unbundling also raises the possibility that the two components may be two separate units of account with insurance component measured as a portfolio of contracts while the deposit component measured as individual contract under IAS 39.

Question 14

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

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

We agree with the Board's preliminary view that the current exit value of a liability is the price for a transfer that neither improves nor impairs its credit characteristics. We also agree that the measurement of an insurance liability on initial recognition should reflect its credit characteristics because the risk of default by the insurer would be priced into the premium charged under the contract at that date.

However, we do not agree with the proposal that the measurement of an insurance liability should reflect changes in its credit characteristics subsequent to initial recognition. Under the current exit value model, the liability is measured based on what another 'borrower' would accept to take on the obligation under the insurance contract. In our view, changing the fair value of a liability for changes in the issuer's credit risk is a concept that is valid only from the perspective of the investor. When an investor is able to transfer the asset, the price in such a transfer should have reflected the credit risk in the issuing entity.

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?

In our view, it is not appropriate to comment on any observed inconsistencies between the Board's preliminary views on insurance contracts and the requirement of IAS 39 and IAS 18 until constituents agree on an appropriate model for measuring insurance liabilities and until the Board has made further progress in its project on financial instruments. We believe that it will be more beneficial if the Board first reviews the comments from constituents on the Insurance Discussion Paper, and then considers a project separately.

Question 16

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

We believe that the definition of legal or construction obligation should be in line with IAS 37. Exposure draft to IAS 37 deems that there is a constructive liability when there is a valid expectation that the entity will discharge its responsibilities or where other parties can reasonably expect the entity to perform those responsibilities.

The policyholders of participating insurance contracts have an expectation that the insurer will continue to declare dividends to their contracts on a yearly basis and that constructive liability exist at balance sheet date. Consequently, we felt that expected future cash flows from policyholder dividends payable should be included in the measurement.

(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?

The proposed change in definition for constructive obligation introduces terms such as "reasonably expect". We believe that such term introduces additional ambiguity instead of clarity. As such, we propose that the Board include specific examples of parameters used to determine 'reasonably' for guidance.

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

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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 amounts 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).

(a) – (c) Yes, we agree that the Board should permit insurer to measure such assets at fair value through P&L so as to reduce accounting mismatch. The importance lies in the method used to fix accounting mismatches.

(d) We do not agree that the current exit value of a unit linked liability should be adjusted primarily because if fair value model is applied consistently for (a) – (c), there should be no difference between the fair value of the assets and the book value of the corresponding assets.

Question 18

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

We would reserve our comments on this topic until the measurement model is decided and the Board has indicated what its views on this topic are. If insurance contracts are ultimately viewed as financial instruments, then premiums should be treated as deposits. If insurance contracts are viewed as service contract, then the premium should be treated as revenue that is measured on a release from risk basis in a manner consistent with revenue from other services under IAS 18.

We believe that presentation of premiums should be further considered in the Board's project on financial statement presentation and not separately in this project.

Question 19

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

We propose that the presentation of income statement for insurer should be consistent in principle with IAS 1 and show specific line items which are relevant to users in accordance with insurer's judgment. The standard should also require an analysis of the movement in liabilities in the notes.

Question 20

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

We believe that all income and expenses arising from changes in insurance liabilities should be recorded in the income statement which is in line with the matching principle and in line with the fair value model adopted on measurement of assets to the extent that accounting mismatches can be eliminated.

Question 21

Do you have other comments on this paper?

We have no further comment on this paper.

2. Should you require any further clarification, please kindly contact me. Thank you.

Yours faithfully,

Dexter Tan
Secretary, Accounting Standards Council