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Sir David Tweedie Chairman International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom Robert H Herz Chairman Financial Accounting Standards Board 401 Merritt 7, PO Box 5116 Norwalk CT 06856-5116 USA

Dear Sir David & Chairman Herz

The International Association of Insurance Supervisors (IAIS) is strongly interested in the IASB & FASB's development of an Insurance Contracts accounting standard. We would like to thank both Boards for your responses at the Financial Stability Board Steering Committee meeting on 8 March 2010 confirming your commitment to complete the Insurance Contracts project by June 2011.

We acknowledge that this project is not easy. We stand ready to provide input to assist board members' deliberations regarding the complex issues in this project. While it is more important that there be a high quality global accounting standard for insurance than it is to meet any particular deadline, we nonetheless encourage the Boards to use every endeavour to complete a high quality standard within this project timeline. The issues raised in the attachment are intended as a useful input into these deliberations. In addition, we intend to send a letter prior to your April meeting about residual margins, adjustments after initial recognition and acquisition costs which we hope will assist the board in their deliberations leading up to the publication of the exposure draft. We realise that the Boards have committed many hours of meeting time to the project over the coming weeks. We would be pleased to assist board members in any way we can.

It may be valuable to both IASB and FASB board members as well as the IAIS to engage in bilateral dialogue over the coming months. As such we believe it would be appropriate to arrange at least one meeting with IAIS representatives where as many board members as possible could be present. We will be as flexible as possible with the meeting arrangements. If we need to make ourselves available for more than one meeting in order to discuss issues with as many board members as possible, then that should be feasible. We acknowledge that the members of both Boards are extremely busy at the moment, not only with the Insurance Contracts project, but with all the other MoU projects as well as their usual business.

Please contact Rob Esson, Chair of the IAIS Insurance Contracts Subcommittee (tel: +1 816 7838 131; email: Resson@naic.org) or Peter Windsor at the IAIS Secretariat (tel: +41 61 280 9196; email: peter.windsor@bis.org) to make arrangements for any meetings or other input that the IAIS can provide.

Yours faithfully

Peter Braumüller Chairman, Executive Committee

Alfred Gross Chairman, Technical Committee

Attachment 1 - Concerns with the Insurance Contracts project

Background

In light of the Boards' commitment to finalise the Insurance Contracts project by June 2011 and the need to finalise a number of issues prior to the publication of an exposure draft in the second quarter of this year, we offer the following thoughts for the benefit of the Boards. To begin with, we attempt to go back to first principles to look holistically at the project and what all stakeholders may wish to achieve; we then look at some specific issues where those principles can be put into practice.

In your joint project to develop a Conceptual Framework, you have enunciated the qualitative characteristics that distinguish useful financial reporting information from information that is not useful or is misleading. You stated that the two qualitative characteristics are relevance and faithful representation. In S4 of the Exposure Draft for *An Improved Conceptual Framework for Financial Reporting*, the IASB stated that:

Financial reporting information is a faithful representation if it depicts the substance of an economic phenomenon completely, neutrally and without material error.

The important point here is depicting the substance of an economic phenomenon. One crucial economic phenomenon in insurance is essentially the inverted production cycle. By this we mean that the revenue is received in relation to future performance rather than revenue being received in the usual manner at the end of a production cycle. This causes issues in measuring economic performance where cash is received for a promise to perform an uncertain obligation at an uncertain future date.

There are some key issues that we believe would undermine faithful representation of the economics of an insurer's business:

- Showing losses for contracts that are expected to be profitable and the obvious corollary of not recognising losses on loss-making contracts
- Separating components of contracts which are practically inseparable due to interdependence
- Putting in place any rule or requirement which results in biasing the probabilityweighting of future cash flows of an insurer (e.g. recognising any kind of deposit floor).

Where accounting is not reflective of the business of insurance, it creates the opportunity for inappropriate incentives for management. This is a key concern for supervisors. We are not only looking at this project from the perspective of endeavouring to use general purpose financial reporting for supervisory purposes to the extent possible, we are also concerned about governance issues created from the incentives derived from general purpose financial reporting.

Asset/Liability matching is key part of the economics of an insurer. This is because of the inverted production cycle. An insurer needs to invest premiums received in order to be able to honour its future, uncertain obligations.

Market related volatility can affect both the assets of an insurer and the liabilities of an insurer. For example, when market interest rates change, the value of an insurer's assets change but in most cases so should the value of the insurer's liabilities as one of the building blocks for valuing liabilities is the effect of the time value on money. To the extent that there

is not a matching of assets and liabilities that should clearly be represented in an insurer's performance.

Unbundling & Embedded derivatives

We understand that some members of both Boards are concerned that there might be potential mismeasurement of insurance contracts if components of those contracts are not considered separately.

At the joint meeting of the Boards on 18 February 2010 there was an extensive discussion about unbundling of contracts for the purposes of measurement and the treatment of embedded derivatives. We provide the following analysis, including a reminder about previous board decisions to assist with debate about this extremely complex issue.

First, to reiterate, the IAIS position has consistently been that unbundling should occur if the components are independent. We realise that the boards are concerned with a threshold issue here and have asked the staff to attempt to define the opposite of independent – interdependent. We are prepared to provide technical input into the discussion of that issue if it continues to be a vexed issue.

There are only two possibilities regarding the value of embedded derivatives or investments within an insurance contract: they either have an observable market value (level 1 of the fair value hierarchy) or they don't and therefore have elements of non-observability (levels 2 and 3).

The Boards have already decided that level 1 inputs should be used in building block one (probability weighted expected cash flows), and would not require an additional margin as level 1 is assumed to include a market level of risk - so presumably this would not lead to any valuation difference.

For level 2 or 3 inputs, modelling would presumably be required. We do not believe that such modelling would necessarily provide a different outcome from probability weighted expected cash flows adjusted for the time value of money and a measure for risk. Indeed, for embedded derivatives, the non-level 1 modelling might use a Black-Scholes or a Monte Carlo type model. Fundamentally, both of these types of method ultimately use probability weighted expected cash flows adjusted for time value of money and a measure of risk: in other words, the same as the insurance model. We are prepared to provide constructive input to assist the board members to compare the two outcomes.

We have endeavoured to identify possible areas where there may be a difference between a bundled and an unbundled product. We believe that there are potentially six areas where a difference might arise as follows:

- An unbundled product may be mismeasured in two pieces because the policyholder behaviour would be different in the bundle and therefore the economically appropriate cash flows for the bundled product would not equal the addition of the unbundled pieces.
- 2. If there is significant inter-dependency, the split of unbundled products may depend on the order of the calculation. This is an issue that has been extensively discussed at the Financial Instruments Working Group. The IAIS has made it clear that it does not believe that it is appropriate to unbundle in situations of significant interdependency.

- 3. It is conceivable that a properly measured bundled product might result in a small difference in diversification credit within a bundle of risks, if such a credit is allowed in the first place. If so, the unbundled product may be mismeasured.
- 4. In some cases, due to materiality, approximations may be made, especially in the components -- but we assume that, if the approximations are acceptable in the first place, then the difference is unlikely to be material.
- 5. An unbundled product may be measured under different standards resulting in e.g. the application of a deposit floor to one piece or measurement at amortised cost that might not be required in the bundled insurance product. The IAIS has already made it clear to the Boards that a surrender value per se is not a deposit floor.
- 6. The application of the residual margin may generate a difference in that it is effectively a deferred profit: if the unbundled pieces allow profit on inception to be recognised, the bundled product may be measured differently to the extent of the residual margin. Additionally, the run off of the residual margin might be different even if the unbundled pieces do not allow profit on inception.

The first three are examples where we believe that unbundling would mismeasure the economics of the product. The fourth should be immaterial. There needs to be careful consideration of whether the fifth and sixth areas would produce the outcome that the Boards desire. We believe these outcomes would not be desirable where components are interdependent and we are prepared to provide input into the Boards' deliberations. If the components are interdependent then unbundling is unlikely to be beneficial and measurement should be based on unbiased, probability-weighted expected cash flows. This is not the same as netting. Recognising separate obligations that are inherently interdependent would not provide useful information for users.

Scope and definition of project

The above discussion is critically dependent upon the scope and definition of the insurance contracts project. If the current definition of insurance in IFRS4 remains unchanged, then products without significant insurance risk would not be measured under the insurance contracts standard. While IAIS jurisdictions may adopt differing approaches to regulation of contracts without 'significant' insurance risk, we do not argue with the proposition that such products should be measured under appropriate other standards. Nonetheless, much of the discussion at the Boards' February 18 meeting seemed to surround products that may well not be within the scope of the insurance contracts standard in the first place. We are prepared to assist the Boards with consideration of the type of products within the scope of IFRS 4. Below is our initial input into the issue.

There are two particular situations that may be useful to consider: firstly, a whole life policy for a very elderly person might have very insignificant insurance risk in its last few years even though few would deny that through much of its policy period it was an insurance contract; secondly, deferred annuities that were presumed to be almost entirely investment products with no significant insurance element demonstrated during the financial crisis that secondary guarantees that had been out of the money can suddenly come into the money, and the products can act like insurance contracts. In both situations, there is the difficulty of how and when a product can switch between qualifying as an insurance contract and not qualifying. One possibility would be to decide at issue and freeze that decision: in the case of the whole life contract we believe that this is certainly the correct approach.

Disclosure

The discussions at the IASB and FASB quite correctly centre around providing users with the information they need to make economic decisions. We do not believe this useful information can always be revealed only through the measurement attributes applied. Often the choice of one measurement attribute does not rule out disclosure of information not included or not explicitly disclosed in the value assigned to a liability or asset.

An example of this is the residual margin issue detailed in our letter of 9 February. The approach to measurement suggested where the residual margin would be adjusted for changes in some estimates would require adequate explanation through disclosures in the notes to the financial statements of an insurer. Clearly, users of financial statements would be interested in how any residual margins are determined including a reconciliation of movements in those margins.

Contract Boundaries

From discussions that the IASB and FASB have had recently we understand that the general direction of the Boards' thinking is in line with IAIS positions but some of the discussion on unbundling does potentially bring up issues with contract boundaries, for example if some contract features are to be considered as options. The IAIS position on contract boundaries was based on the consideration of interdependent cash flows as part of one set of cash flows rather than unbundled contractual components. The IAIS position has not changed since March 2009 when we made the statements which are set out again in Attachment 2.

Discretionary Participation Features

The IAIS believes that this is another issue which conceptually can be dealt with through the principle of using unbiased, probability-weighted cash flows to determine the expected value and risk margin of insurance contracts with discretionary participation features. The key point here is considering probability but not constraining that probability to only cash flows that the insurer is contractually compelled to make. Constraining probability-weighting by giving consideration only to legal obligations as opposed to the full range of probable outcomes would create misleading information. In fact, it is likely to lead to large residual margins at inception equal to the expected bonuses and then result in the recognition of losses as expected bonuses are paid. It is understandable that users of financial statements would want to know about obligations and discretionary payments and the extent to which discretionary participation is included in insurance liability valuation. However, this can be achieved through supplementary disclosures rather than an alteration of the underlying value of the contract or indeed some form of unbundling of the contract into insurance and investment components.

Attachment 2 - Contract boundaries from 31 March 2009

Proposal on Contract Boundaries

We refer to paragraph 93 of our response to the IASB Discussion Paper: Preliminary View on Insurance Contracts, in which we promised to provide the IASB with additional input on criteria for determining cash flows under a contract. We set out below our thoughts on this issue.

- 1. The IAIS believes that a principles-based solution is needed to resolve the issue. Whilst addressing an insurance issue, it is preferable that a solution should be applicable more generally than just to insurance contracts.
- 2. The accounting view (for contracts in general) is that what is considered to be part of a contract can be recognised, while what is a customer relationship can not. In the Discussion Paper, the Board has proposed an approach for insurance contracts which narrowly defines the contract, and the cash flows thereunder, but then has a device (guaranteed insurability) to also recognise part of the customer relationship. Our intention, which we believe the Board supports, is to achieve financial reporting of insurance contracts that reflects the true economics. The principles we propose, as elaborated in this note, define the contract boundary in a way that achieves this, but avoids the necessity of recognising a customer relationship intangible in order to achieve an economically sensible result. These principles are therefore an alternative to the concept of guaranteed insurability.

Recognition vs measurement

- 3. We believe that a clear distinction needs to be made between recognition and measurement. For recognition purposes, the IAIS believes that the fundamental component of the unit of account for insurance contracts should be an individual contract or policy. The interrelated rights and obligations of a contract give rise to an asset or liability potentially qualifying to be recognized and accounted for as a package.
- 4. Accordingly, the first question would be: 'is there a contract to be recognised?' In considering this we have previously recommended looking at the difference between having a contract, and not having a contract. We understand that the Board might prefer a separate examination of the rights and obligations that are bundled into a contract: however, the separability of those rights and obligations from individual contracts would inevitably be arbitrary, and indeed the very name of the project, the "insurance contracts" project might almost amount to an implicit recognition of this issue.
- 5. Once an insurance contract has been identified for recognition, then it becomes a question of measurement (and not appropriate to consider recognition further). Consistent with the building block approach as set out in the discussion paper *Preliminary View on Insurance Contracts*, measurement will require estimating the future cash flows.
- 6. The issue is thus one of determining firstly which are the contractual cash flows (recognition), and secondly how to measure those cash flows (measurement). We believe that clear principles will help to achieve this, whilst avoiding the possibility of abuse (which may occur by taking cash flows without appropriate constraint into the measurement process).

Initial recognition and derecognition

Initial recognition

- 7. As we noted in commenting on the discussion paper *Preliminary Views on Insurance Contracts*, we see no good reason in theory for the recognition and derecognition requirements for insurance contracts to be inconsistent with those for financial instruments in the current version of IAS 39, which we see as rooted in the general asset-liability model.
- 8. However, as we pointed out, application of the IAS 39 criteria to insurance contracts would 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, which can differ significantly from the date on which contracts are agreed to. We note that there are strong parallels between this existing practice and the provisions of paragraph AG35B of IAS 39 where assets and liabilities are generally not recognised until at least one of the parties under a firm commitment to purchase or sell services has performed under the agreement.
- 9. In practice, therefore, *absent an onerous contract* we question whether the costs and practical issues associated with a significant change to current practice on initial recognition would outweigh the benefits.

Derecognition

- 10. Reiterating comments we made in responding to the discussion paper *Preliminary Views* on *Insurance Contracts*, we agree with the IAS 39 approach that "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". We also believe that current practice is largely consistent with this approach. However, we would add the following in respect of insurance contracts.
- 11. In many cases, particularly in life insurance, it will be evident when a liability is extinguished. This might occur, for example, upon policy surrender, lapse, maturity, or payment upon death.
- 12. For other insurance policies, particularly long-tail, non-life contracts, there is greater difficulty in determining that no further claims can be made against a policy. In some cases, commutation, agreement with beneficiaries, or statute may sufficiently remove uncertainty. However, where uncertainty remains that future or increased claims could be asserted, there is the possibility that a liability may never actually be definitively extinguished, although the measurement may tend asymptotically to zero.
- 13. We have also noted that it is possible for a liability to be extinguished by transfer to another insurer. However, the more usual arrangement for transferring risk is reinsurance, in which the liability is not extinguished but is retained by the original insurer.
- 14. In summary, we agree with applying the derecognition principle of IAS 39 to insurance contracts but point out that for some insurance contracts there could be a considerable period before the liability can be treated as extinguished.

Contractual cash flows: criteria for recognition and measurement

15. Our comments consider both the determination of the contractual cash flows to be measured and, once determined, how these should be measured.

A principle to determine the contractual cash flows

16. We would like to suggest the following principle to determine which cash flows should be taken into account in measuring an **insurance contract**:

The relevant cash flows are bounded by the earlier of the following, if they exist:1

- the contractual termination date as extended by any unilateral option available to the policyholder (see paragraph 18), or
- the insurer having a unilateral right to cancel or freely re-underwrite the policy, or
- both the insurer and policyholder being jointly involved in making a bilateral decision regarding continuation of the policy.
- 17. The cash flows will then be measured in accordance with paragraph 21.
- 18. Contractual cash flows arising from policyholders' unilateral in-the-money options to extend the contractual termination date must be recognized. Some members believe that such options must be accounted for in full, while others may allow the possibility that the accounting be through probability weighting where the weight for such options might not necessarily always be 100%.
- 19. We also considered the much-cited example of a 10 year long term insurance contract and a one-year contract renewed for nine years, and whether the two can be economically distinguished. We believe that at minimum the following conditions would need to apply for the contract with nine renewals to be equivalent to the 10 year policy:
 - The original policy, and eight renewal policies, would need to contain an explicit option to renew with the policyholder
 - Such renewals would need to be at a premium which is guaranteed to be the same as under the long term contract
 - No re-underwriting would be contractually allowed by the insurer, and
 - Only nine renewals would be available.
- 20. Effectively, these additional requirements are so onerous and artificial that they would not occur in reality, and consequently, we believe that there are significant differences between the examples. Nonetheless, we think that it is instructive to think in this way so as to differentiate the situations.

Measurement of applicable cash flows

21. Once the contractual cash flows have been identified on the basis of the above principle, then measurement becomes a matter of estimating the future cash flows² on the basis of

¹ For certain types of long-duration life policy with an indefinite term, these would be evaluated through the potential life of the policyholder, allowing for lapse or surrender in the probabilities attached to each cash flow.

- a probability weighting of the different possible outcomes. While we do not underestimate the practical difficulties of this estimation process, especially in a business with as much intrinsic uncertainty as insurance, we do not believe that this estimation process brings with itself any particularly difficult or unique principles (as opposed to application).
- 22. There are insurance contracts with variable premiums (such as universal life contracts). For such contracts, the expected cash-flows may include additional cash flows other than the minimum required, due to voluntary additional contributions. To the extent that this is the case, the second view set out in paragraph 18 would imply that, based on the first building block, those cash-flows may be measured using probability weights reflecting historical experience adjusted for known differences and with consideration of the policy guarantees, including secondary or no-lapse guarantees. Additionally, the margin over current estimate for such policies should be larger than for more conventional policies due to the greater uncertainty about such expected cash flows.
- 23. All members are concerned with the situation where estimates of future additional voluntary premiums from policyholders lead to the immediate recognition of profits in advance of such voluntary contributions being made. Some members would prefer that no recognition be given to such cases in advance of the exercise by the policyholder of the option to pay additional premiums, while others may allow the possibility of such premiums within the probability weighting but with an appropriate and additional margin.

² Including non-guaranteed contractual cash flows.