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19 November, 2007

Technical Director - File Reference 1540-100 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders

Dear Technical Director:

We appreciate the opportunity to comment on the Financial Accounting Standards Board's ("FASB" or "Board") Agenda Proposal on "Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts" and are pleased to see the efforts being made by the standard setters to achieve improved and consistent insurance accounting.

Overview

Fitch Ratings (Fitch) is a leading global rating agency committed to providing the world's credit markets with independent, timely and prospective credit opinions. Fitch's insurance company ratings make use of both qualitative and quantitative analyses to assess the business and financial risks of issuers for both fixed-income investors and policyholders. In this process, Fitch relies directly on the financial statements, and this reliance places us in an informed position to comment on information we believe is useful and crucial in the credit evaluation process, which is a critical component of efficient capital markets.

Fitch is very supportive of the efforts being made by the International Accounting Standards Board ("IASB") and FASB to bring greater comparability and increased disclosure to the insurance industry. Given the diversity in accounting for insurance liabilities across jurisdictions, the proposed project is sure to generate the needed debate and views on accounting for insurance contracts.

Fitch's insurance analysts in the United States do not see the same urgency for reforming insurance accounting as their European colleagues, primarily because there are consistent standards among US insurers (at least within the same parts of the industry), our analysts are familiar with these standards and US analysts also make use of extensive regulatory reporting, which is publicly available. Nevertheless, there is consensus among our analysts

that their work would benefit from a global standard for insurance contracts, applicable to all types of insurance anywhere in the world that achieved consistent reporting, with good, transparent disclosure on the main assumptions made.

Answers to specific questions asked in the Agenda Proposal

Question 1: Is there a need for the FASB to comprehensively address accounting for insurance contracts? Why or why not?

- a. What aspects of existing U.S. GAAP accounting for insurance contracts could be improved or simplified and how pervasive are these issues?
- b. How important is the development of a common, high-quality standard used in both the U.S. and IFRS jurisdictions?

Fitch believes that there is a general need for the FASB to comprehensively address accounting for insurance contracts. Insurance accounting is widely characterized by a lack of consistency and disclosures are sometimes inadequate. However, as noted above, our US analysts do no see the urgent need for change primarily because information obtained from the financial statements is often supplemented by information from statistical supplements and regulatory filings.

The Current Exit Value ("CEV") method of valuing insurance contracts is largely unprecedented in practice and may prove challenging to implement. We suggest that alternative valuation methods such as "current entry value" and "settlement value" should be considered. We support the principle that all insurance contracts should have the same accounting and we cannot see any strong argument why good accounting would distinguish between life and non-life insurance contracts particularly in respect of the application of discounting.

Developing one set of high quality standards applicable in the United States and for IFRS reporters is important to Fitch. We rate large insurers whose operations and financial reporting cut across national borders. Over the years, some of these insurers have accounted for similar contracts in a variety of ways due to jurisdictional differences. Clearly, this trend has contributed to the perceived lack of transparency accorded to the financial reporting of insurers. We believe our analysts, the market and the insurance industry will benefit from a set of high quality standards which improves transparency and reduces the perceived complexity associated with insurers. We also want to emphasize the need for relevant information which will provide the necessary insight into the economic fundamentals and drivers of value of an insurer.

Question 2: Are the preliminary views expressed in the IASB's Discussion Paper a suitable starting point for a project to improve, simplify, and converge U.S. financial reporting for insurance contracts? If not, why not?

- a. Do you believe the preliminary views would be feasible to implement? If not, what aspects of the preliminary views do you believe could be difficult to apply and why?
- b. Are there other alternatives to improve or simplify U.S. financial reporting for insurance contracts that you would recommend? What would be the benefits of those alternatives to users of financial statements?

Fitch believes that the preliminary views expressed in the IASB's Discussion Paper are a suitable starting point in the overall convergence of US insurance accounting and IFRS.

We expect the implementation of some key issues expressed in the preliminary views to be challenging. The concept of the three building blocks underpinning the DP is largely unprecedented in the United States and various concerns expressed by the user community underscore the need to carry both preparers and users along on the project.

In our view, on initial adoption there will be only limited expertise in deriving reported numbers by the preparers and in understanding these on the part of the auditors and analysts/investors. However, we think that these skills and the precision of calculations will develop over time, and that back-testing will provide additional and helpful information into the process.

Fitch considers that there are inherent difficulties in making use of market prices as a basis for determining the expected price of a liability where little or no market actually exists (e.g. insurance liabilities). In order for market prices to be reliable and up to date, a liquid market in such transactions is usually required. Applying prices derived from liquid assets (or liabilities) directly to illiquid assets/liabilities may result in a consistent over-estimation of the value of these assets and underestimation of the value of these liabilities. The agency would welcome further discussion on the extent to which market illiquidity should be incorporated into the valuation of insurance liabilities.

Although we agree with the principle in theory that entity-specific cash flows should be excluded, we question what this would actually mean in practice. In effect, companies will base their estimates of future cash flows from their insurance contract portfolios on their own entity-specific experience and make some adjustment to this, because market information for companies holding identical or even similar portfolios is generally not available.

Question 3: Is there a need to address accounting by policyholders in an insurance contracts project? Why? If yes, should accounting by policyholders be addressed at the same time as the accounting by insurers? Can or should that wait until after the accounting by insurers is completed?

Given the complexity associated with accounting for insurance contracts and the vast disparity in the accounting of some insurance contracts, we believe that the FASB should address the accounting for policyholders in a different project after the accounting by

insurers is complete. This is consistent with the IASB's stated approach and it should give the accounting for insurance contracts the attention that it needs.

Question 4: How would you address the interaction between the accounting for insurance contracts and the FASB's other projects on the conceptual framework, revenue recognition, liabilities and equity, financial instruments, and financial statement presentation? Are certain projects precedential?

Fitch believes there is a vital link between the accounting for insurance contracts and the FASB's other projects outlined above. We expect the main principles of insurance contracts to be consistent with principles used elsewhere in US GAAP. We think the conceptual framework project and the revenue recognition project should be precedential to the accounting for insurance contracts. However, we acknowledge the timing challenges that the completion of these projects will pose to the insurance project.

We suggest that the conclusion of the insurance project should not be seen as a closed door but should be subject to review three or four years after adoption to resolve inconsistencies that emerge as the rest of accounting develops. This would also ensure that decisions made about which way to go on controversial accounting issues, such as revenue recognition, for the purposes of getting the insurance standard out of the door do not establish a principle that has to be applied elsewhere.

Fitch would be happy to participate in the insurance working group's round-table meetings, and we would be pleased to answer any questions on our comments either as part of or outside this forum. We also attach our response to the IASB's Discussion Paper on its preliminary views on insurance contracts.

Yours sincerely,

Julie Burke Managing Director Insurance Group Fitch Ratings Chicago Olu Sonola Associate Director Credit Policy Group Fitch Ratings New York



15 November 2007

Peter Clark International Accounting Standards Board 30 Cannon Street London EC4M 6XH

Discussion Paper: Preliminary Views on Insurance Contracts

Dear Mr. Clark.

We appreciate the opportunity to comment on the International Accounting Standards Board's (IASB or Board) Discussion Paper on its preliminary views on insurance contracts and are pleased to see the efforts being made by the IASB to achieve improved and consistent insurance accounting.

Overview

Fitch Ratings (Fitch) is a leading global rating agency committed to providing the world's credit markets with independent, timely and prospective credit opinions. Fitch's insurance company ratings make use of both qualitative and quantitative analyses to assess the business and financial risks of issuers for both fixed-income investors and policyholders. In this process, Fitch relies directly on the financial statements, and this reliance places us in an informed position to comment on information we believe is useful and crucial in the credit evaluation process, which is a critical component of efficient capital markets.

Fitch is generally very supportive of the efforts being made by the IASB to bring greater comparability and increased disclosure to the insurance industry. Our insurance analysts find the differences that emerge in the accounting for insurance contracts, and especially from the reporting of life assurance companies under current IFRS 4, unhelpful. Fitch would, therefore, welcome a standard that improved consistency, disclosure and the measurement of insurance liabilities. In the case of life assurance, we find the Embedded Value and European Embedded Value initiatives helpful in our analytical work, but we would hope that these initiatives will be surpassed by a standard that brings consistent and comparable reporting with good, transparent disclosure of some of the multitude of assumptions made when reporting insurance contract risks and performance.

Balancing relevance and reliability

Given the degree of assumptions that have to be made in measuring insurance assets and liabilities, we recognize that it will be very difficult to come up with something that is both highly reliable and highly relevant. We suggest that the balance sways towards relevance, as the Discussion Paper is suggesting, but that disclosure requirements strive to fill the reliability gap that then emerges. If this is not done, it will be difficult to gain analysts'/investors' confidence in the numbers provided.

In our view, on initial adoption there will be only limited expertise in deriving reported numbers by the preparers and in understanding these on the part of the auditors and analysts/investors. However, we think that these skills and the precision of calculations will develop over time, and that back-testing will provide additional and helpful information into the process.

Timing

We understand that financial reporting of insurance contracts is more riddled with estimates and assumptions than is common in the reporting of most other transactions. Partly for this reason, any new accounting standard will have to address just about all of the most complex accounting issues currently under debate. However, as users, we see some urgency in amending IFRS 4 and do not think the project is worth slowing down to wait to see how all of the other issues are resolved. We do, however, think that the IASB should strive to make sure that the main principles of insurance accounting are in line with principles used elsewhere in IFRS and in particular in line with the conceptual framework. We, therefore, suggest that the conclusion of Phase II should not be seen as a closed door but should be subject to review three or four years after adoption to resolve inconsistencies that emerge as the rest of accounting develops. This would also ensure that decisions made about which way to go on controversial accounting issues, such as revenue recognition, for the purposes of getting the insurance standard out of the door do not establish a principle that has to be applied elsewhere in IFRS.

Still on the subject of achieving an expeditious conclusion to Phase II, we note that the Financial Accounting Standards Board (FASB) has also published the Discussion Paper for comment. Although Fitch welcomes this initiative as part of the commendable efforts being made by the IASB and the FASB to achieve general convergence of accounting standards, we would not like to see the IASB revision of IFRS 4 slowed down because the Board was waiting to achieve consensus on this with the US accounting community. From our own perspective, Fitch's insurance analysts in the United States do not see the same urgency in reforming insurance accounting as their European colleagues, primarily because they are used to the standards they have and make use of extensive regulatory reporting, which is publicly available. Nevertheless, there is consensus among our analysts that their work would benefit from a global standard for insurance contracts, applicable to all types of insurance anywhere in the world that achieved consistent reporting, with good, transparent disclosure on the main assumptions made. As an interim step, we suggest the IASB persevere with developing IFRS 4 as a sound financial standard. The best way to persuade the US insurance community to change its accounting may be to demonstrate to users how well the alternative can work in practice.

Answers to specific questions asked in the Discussion Paper

Q1. Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

Yes. In our view insurance contracts are financial contracts and the Board should work with the principle that accounting recognition should be consistent with IAS 39. It makes sense to us that the main determining feature for recognising an insurance liability or asset is when the insurer "becomes a party to the contractual provisions" of an insurance agreement.

With regard to de-recognition of insurance liabilities, it makes sense to us to continue with the

current IFRS 4 requirement – i.e. when, and only when, it is extinguished (discharged, cancelled or expires). Assets stemming from the same contractual obligations should be de-recognised at the same time. We understand that the de-recognition of financial assets is complex and part of another project, and suggest that the best time to review how this should be best applied to insurance contracts is once a conclusion is reached on de-recognising financial assets in general.

- Q2. Should an insurer measure all its insurance liabilities using the following three building blocks:
- (a) Explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,
- (b) Current market discount rates that adjust the estimated future cash flows for the time value of money, and
- (c) An explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)? If not, what approach do you propose, and why?

The three building blocks make sense to us. However, we think more clarity would be helpful on what the Board expects to see.

- (a)We think there will always be some bias in an insurer's calculation of liabilities, for example in the weighting of recent historic versus average loss data, data sources and the degree of conservatism used in the formulation of best estimate assumptions. For example, the agency would highlight the importance of assumptions concerning inflation (whether general or loss cost inflation specific to business lines) in the estimates of cash flows, especially given the discounting of reserves. Good, transparent disclosure of the main assumptions behind the cash flow estimates would help the user understand what the bias is and adjust for it, and would also steer companies to establishing and adopting market-consistent assumptions. We think that achieving market-consistent assumptions for measurement is something that evolves as market disclosure evolves.
- (b)We would encourage a clearer definition of what the Board means by "market discount" rates, particularly whether these should be risk-free rates, as currently applied to pension liabilities under IAS 19, or the company's own borrowing rate, as per IAS 39. We would strongly favour the former, and paragraph 70 of the Paper implies to us that this is also the IASB's favoured approach, although we do not think this is very clear. We do not consider the company's own creditworthiness to be appropriate in measuring the value of a portfolio of insurance risk. Where expected cash flows have been calculated as the probability weighted average of a number of possible scenarios, additional clarity would also be helpful as to whether the appropriate discount rate used should be that applicable in each scenario considered (as implied by paragraph 39, "the best estimate is the probability weighted average of the present value of cashflows") or whether to apply a single discount rate to the best estimate of cash flows (as seems to be implied by paragraph 69, "the discount rate should be consistent with observable current market prices").

We know that there is some resistance, particularly in the US non-life insurer community, to discounting reserves for non-life insurance contracts, and indeed from a credit analyst and investor's perspective discounting would result in a lower reserve buffer. However, we would expect this buffer to be at least partly replaced by an alternative form of buffer which more closely relates to actual risk (i.e. the risk margin), and if necessary, this buffer may need to be

supplemented by a higher level of equity to maintain a given level of financial security. Fitch considers that this will better reflect actual risk, increase transparency and maintain consistency in accounting. We cannot see any strong argument why good accounting would distinguish between life and non-life reserves in respect of the application of discounting. Discounted reserves by both types of insurer would provide us with more comparable information when analysing companies, especially bearing in mind that many of the insurance groups that we rate are conglomerates of life and non-life companies.

(c)We think a risk margin is an appropriate way to account for the uncertainties that arise from estimating future cash flows based on a variety of assumptions. We also support the idea of having companies disclose information about how they derive their risk margins on various portfolios. We would welcome substantial disclosure about the methodology behind and assumptions made in deriving this number and think that numeric information about its sensitivity to changes in key assumptions would provide us with valuable information over time that would help us to understand the risks the company is taking, how these are developing and how the company compares with its peers. We find it difficult to envisage how a preparer will be able to derive risk margins without entity-bias, although we note that in some cases there may be some degree of regulatory oversight over the models used to determine risk. However, with adequate disclosure around the assumptions made, the impact of this on users should be minimised.

We also think that any service margin will be entity-biased. Which services are determined to be provided and the way in which these are provided will inevitably differ from one company to the next. We would like the Board to be more precise on where it thinks companies should draw the line between direct and indirect service costs in an insurance contract.

Q3. 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 guidance on cash flows is comprehensive, but we question the emphasis placed on market "prices" in this. E2(b) says that future cash flow estimates should be "as consistent as possible with observable market prices", and this view is expanded in E7-E9. E11 then says that "Market prices overrule all other forms of evidence." We question whether this guidance might lead to inappropriate measurement of cash flows where market prices are available but include a substantial degree of "noise" that should be eliminated from the cash flows the insurer is trying to measure. For example, mortality bond prices include information about mortality rates but pricing often reflects the sentiment and limited liquidity of the market at any point in time, while the mortality data behind them is available from other market sources. We, therefore, think it would be more appropriate to replace "prices" with "data" in E2(b) and E11. We are also concerned with using market prices taken from an illiquid market as inputs to long-term cash flow calculations and suggest that these should not necessarily overrule all other forms of evidence.

More generally, the agency notes that market prices can be separated into the present value of expected cash flows and an additional component which incorporates other factors such as risk and uncertainty. If market prices are used as an input to valuation models (e.g. to calculate expected cash flows), it may be necessary to exclude the component of the price that relates to risk and uncertainty. A failure to make this adjustment is liable to lead to a double-counting of the adjustment for risk if a risk margin is subsequently added to the valuation of liabilities. We note that the Paper identifies this point in paragraph F7 but think it is worth emphasising.

Related to this, Fitch considers that there are inherent difficulties in making use of market prices as a basis for determining the expected price of a liability where little or no market actually exists (e.g. insurance liabilities). In order for market prices to be reliable and up to date, a liquid market in such transactions is usually required. Applying prices derived from liquid assets (or liabilities) directly to illiquid assets/liabilities may result in a consistent over-estimation of the value of these assets and underestimation of the value of these liabilities. The agency would welcome further discussion on the extent to which market illiquidity should be incorporated into the valuation of insurance liabilities.

Re E2(e), although we agree with the principle in theory that entity-specific cash flows should be excluded, we question what this would actually mean in practice. In effect, companies will base their estimates of future cash flows from their insurance contract portfolios on their own entity-specific experience and make some adjustment to this, because market information for companies holding identical or even similar portfolios is generally not available. We made a similar comment in our May 2007 letter to the IASB on its Discussion Paper: Fair Value Measurements, where we said that Level 3 valuations would often be based on the specific experiences and requirements of the company concerned and effectively be "value in use" estimates, perhaps with some prudent adjustments to satisfy the auditors.

We find the guidance on risk margins in Appendix F somewhat vague. Although we understand that the IASB wants standards based on principles rather than rules, we are concerned that this will result in inconsistent methodologies between companies and even allow for some profit smoothing. We think it would be helpful in achieving comparable reporting if the Board specified preferences on how risk margins should be measured.

Disclosure would be very important concerning the methodologies being used for both cash flow estimations and risk margins, along with sensitivity analysis of some of the main assumptions made (e.g. interest rates, lapse rates, mortality rates). Ideally there would be disclosure that would allow us to standardise firms, although this would require being prescriptive to some degree, so is something the IASB may want to leave to the industry to develop. It would be very helpful for disclosure requirements to include comparative analysis of past estimates with actual performance (back-testing), for example comparing lapse rates used versus actual surrenders, with explanations of significant differences that arise.

Q4. What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the ... alternatives you support.

We do not agree with alternative (a) that the margin should be calibrated directly to the premium (less relevant acquisition costs), subject only to a liability adequacy test. Although this may well be closest to current practice for many insurers, we think that insurance premium pricing incorporates an element of profit and loss depending on market conditions and a company's franchise.

In our view, alternative (c) is the most appropriate in theory, although it could be cumbersome to apply in practice. 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. Under this formulation, information about the extent of profitability on new business

adds transparency and provides valuable information to the users of the accounts. This contrasts with option b.) where there is a rebuttable presumption that the actual premium (less relevant acquisition costs) is consistent with the margin a market participant would require. Option (b) would be likely to result in a higher risk margin being applied when pricing conditions are good with a much lower risk margin usually being applicable under softer market conditions, and in our view, this would provide less helpful information for users of the accounts.

In favour of option (c), the agency also notes that just as day one profits may be permitted in accounting, it is also possible that day one losses would be recognised (e.g. in a soft market where an insurer is maintaining customer relationships in the expectation of improved pricing in future). Where there is a rebuttable presumption that the risk margin is equal to the difference between the expected present value of cash flows and the price charged, we think that day one losses would in practice be less likely to be recognised. That said, we think that option (b) does represent a simpler alternative that may be worth considering whilst insurers are still developing and improving their pricing models and eash flow projections.

- Q5. 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 agree that deriving the value of insurance contracts by the three building blocks discussed in chapter 3 of the Paper is appropriate, and we think that conceptually this should amount to something very close to an amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. As long as there is no unexplained gap between the two values, we agree that the measurement attribute is appropriate. However, we sense that there may be an unexplained gap and think that this "missing link" is something worth exploring.

We also think that whatever measurement attribute IFRS 4 (revised) uses should be consistent with how fair value is to be measured under IAS 39, once a conclusion on this is reached.

- b) The label for the measurement attribute should be whatever is consistent with the conclusions of the general IASB fair value measurement discussion. Current exit value corresponds with SFAS 157, but we question whether it is appropriate here, when exit is most likely going to be by settlement with the policyholder. Furthermore "current exit value" is not a known term outside technical accounting circles other than for fire sales. We would like to see further investigation of whether settlement value may be a more appropriate measurement here.
- Q6. 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?
- (b) Incorporate them, as a reduction, in the current exit value of insurance liabilities?

(c) Not recognise them?

Alternative (a) would arguably be the most transparent for the user and would be consistent with other IFRS, but we think this would be costly to implement and would not reflect the way the business is managed, so may not add much value from our perspective as users. Alternative (b) is the most pragmatic approach in our view. Alternative (c) is prudent and may be the best approach for solvency measurement, but not for accounting. Not recognising beneficial customer behaviour would hold back some potentially helpful information from users. We would, however, encourage plenty of disclosure around assumptions made and conclusions reached in deriving these values.

Q7. 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?

On balance, we think the Board should adopt its favoured criterion (a) of 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). "Guaranteed insurability" is defined as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained, but we think more guidance will be needed to be clear about what this actually means in practice, probably with some further examples.

We foresee an issue here with the legal versus the constructive/effective position. In our view this is a wider issue that the IASB still needs to address. For example, we know it is being explored in the discussion around IAS 37 and constructive contracts and think it may also be applicable to long-term lease arrangements.

Q8. Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

Yes. Acquisition costs for insurance contracts are an expense and should be recognised when incurred. This is consistent with the way we consider acquisition costs in accounting generally, although we are aware that IAS 39 generally rolls acquisition costs of investment management contracts into the asset. We think that accounting for acquisition costs upfront would be consistent with the proposed "exit value" approach and with the three building blocks. Permitting recognition of profit on Day One and as it is earned should offset at least some of the concerns with the impact of upfront acquisition costs distorting profit when new business is being put onto the books. We think that deferred acquisition costs can be an appropriate way of matching expense and revenue for accounting for insurance contracts when premiums are recognised on an accruals basis over a period of time but this is not the approach being put forward in the Paper.

Q9. Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

We would like to see transparent, numeric disclosure concerning the insurance contracts acquired. It would be particularly helpful to show us the impact of changes made to valuation methodology and assumptions.

In principle, the accounting should be neutral between acquiring books of business individually rather than through a business combination. If this is not the case then insurers may be able to structure transactions to take advantage of this differential and it may lead to a lack of consistency between firms.

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

We think the IASB's main aim in dealing with this should be consistency. If reserves are to be measured as proposed and changes are taken through profit or loss, the fair value option in IAS 39 should enable measurement of assets held to back these liabilities to pass through the income statement as well.

Q11. 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) In our view risk margins should be measured on a portfolio basis, and we agree that the IFRS 4 definition of portfolio is appropriate.
- b) We do not think that the accounting measurement should reflect the benefits of diversification between portfolios. The aim of accounting should be to measure transactions or groups of assets or liabilities and not to value the company as a whole. Diversification benefits between portfolios are entity-specific and generally involve a high degree of subjectivity. Fitch takes these into account in its analysis, and we welcome management's opinion either in notes to accounts or management commentary on diversification benefits, but we do not expect accounting to measure these on the face of the financial statements.
- Q12. (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?

We think that in the interests of consistency a cedant should measure reinsurance assets at current exit value if insurance liabilities are being measured this way by the insurer and the cedant. If not, there would be accounting arbitrage risk, which is unhelpful to users. There could even be the risk of reinsurance companies being established simply to achieve potential accounting benefits from measuring assets in a different way from liabilities. In response to the specific queries raised:

- i.) We agree that a risk margin relating to the underlying contract typically increases the measurement of the reinsurance asset and equals the risk margin for the corresponding part of the underlying insurance contract. That said, Fitch expects that calculating the appropriate risk margin for reinsurance assets may be complex in some cases, especially where the insurance is non-proportional and covers a variety of business lines.
- ii.) We agree that an expected loss model should be used for defaults and disputes rather than the incurred loss model used by IFRS 4 and IAS 39.
- iii.) The agency considers that in principle the current exit value of the cedant's reinsurance asset does include the current exit value of that right although we would not expect this to

be material in the majority of cases. That said, if reinsurance prices were to increase substantially shortly after the cedant has secured reinsurance protection at an agreed price for a set period of time (e.g. a year) then this right to future coverage at a favourable price would be considered beneficial and might potentially be an asset to the firm. Fitch also questions whether reinstatements to reinsurance protection may in some cases be treated as a material asset using a similar logic.

Q13. If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?

The deposit and/or service components of contracts should be isolated for accounting measurement and presentation in cases where this can be achieved relatively easily. However, insurance products are increasing in complexity, and unbundling generally makes accounting more difficult and costly for preparers, without adding much value in terms of helpful information for users, particularly if the economic substance of the transactions is lost in the process. We think that requiring unbundling of all contracts would result in inconsistent application when determining measurement of the greyer areas. Note disclosure may be a better way to help us understand the dynamics of more complex insurance contracts. Fitch provided further details on its view of the unbundling of contracts in its response to the Financial Accounting Standards Board's (FASB) Invitation to Comment: Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting, which you can download from their website or we could forward to you directly.

- Q14. (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?
- a) Firstly we want to make clear that in our view the measurement of a liability arising from a portfolio should be separate from the credit risk of the company managing that portfolio. The credit characteristics of the insurer are irrelevant for measuring its individual risk portfolios and, in the agency's view, allowing for such company characteristics would result in an 'entity specific' valuation for portfolio liabilities rather than a 'non-entity specific' value. Therefore, the value of an insurance liability (be it exit, entry or some other value) should be the price for a transfer that neither improves nor impairs its credit characteristics.
- b) The credit characteristics of a portfolio would be taken into account as part of the three building blocks approach in the estimation of future cash flows and the risk margin added for the uncertainty of these. These should be measured independently from the credit risk of the insurer as a whole.

Consistent with our view that it is the credit characteristics of the portfolio that are relevant rather than those of the insurer, Fitch does not agree with adjusting financial liabilities for changes in a company's own credit risk. This is especially true given that in most cases financial liabilities are settled at the price agreed to at inception and it is not helpful – particularly for credit analysts - to measure them differently because of changes in the issuer's credit quality in the periods leading up to settlement. If the credit risk is to be factored into measurement beyond the risk taken into account in pricing at inception, Fitch would like to see the effects disclosed transparently so that

we can adjust for these. However, the issuer's own credit risk is a separate consideration from measuring each of the portfolios of insurance risk it includes in its books.

Q15. 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?

Many of the inconsistencies listed in Appendix B relate to aspects of IAS 39 that are likely to be covered as part of the Board's current project on fair value measurement. We do not think the Board should be changing the treatment of financial liabilities solely to be consistent with the conclusions of Phase II of the insurance contract project. There may well be aspects of measurement that will be very relevant for insurance liabilities but not a priority when considering other financial liabilities. We would, therefore, consider a review of revised IFRS 4 a few years after implementation to be the most effective way to deal with the potential inconsistencies that may arise with other standards, particularly as many closely related standards are likely to be revised during the next few years.

Q16. (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...). 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?

Q17. 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?

We would like to see some worked-through examples for questions 16 and 17 in order to evaluate the consequences properly. These questions address complicated aspects of insurance accounting that will be difficult to deal with in practice. Whatever the Board's decision, we would urge transparent disclosure of the decisions the insurer has taken and assumptions made, showing the quantitative impact.

Q18. Should an insurer present premiums as revenue or as deposits? Why?

Within Fitch we get different answers to this question from insurance and bank analysts, which illustrates the problem and is particularly relevant when looking at banks that own insurance companies or insurance companies that own banks. While a bank or investment company would most likely consider the nature of premiums as deposits, companies in most other types of industry we can think of would consider them as revenue. As premiums for insurance companies are currently thought of as revenue and analysed as such, we see no compelling argument to change this convention. This is especially the case for short-term contracts, which generally have a much smaller deposit component. For longer term contracts, the question of revenue or deposit comes back to one of whether contracts should be unbundled, and Fitch does not support this approach for the reasons already outlined. We would encourage the Board to investigate where accounting for premiums as either revenue or deposits would make a difference (other than comparing between insurance companies) and why.

Q19. Which items of income and expense should an insurer present separately on the face of its income statement? Why?

We attach a proposed income statement presentation the IASC Steering Committee put together that we would find helpful. We would like to see these items distinguished between life and non-life in the income statement and would like the breakdown to be mirrored in the segment reporting. We would encourage the board to further investigate ways to separate changes in liability valuations due to changes in expected cash flows from changes in the value of these liabilities due to changes in the market's valuation of these cash flows. Such a separation would be helpful for identifying those changes that are within management's control (e.g. expenses) or relate to the performance relative to management expectations (e.g. mortality experience, changes to expected loss cost trends) and those that are subject to market forces and are, therefore, subject to market volatility and outside of management's control.

Q20. Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

Showing all changes in insurance liabilities as income and expenses would probably be the most transparent approach, although this would introduce more volatility into income statements than we have seen in the past. Users will need to be able to distinguish between these movements – at least in terms of cash/accruals versus fair value. In this respect the direction that is currently being taken by the joint IASB/FASB project on presentation of financial statements should be helpful. The impacts of changes in the reporting company's various assumptions should certainly be shown in the notes to the accounts.

We also think that if all changes in liabilities are taken through the income statement, then insurance companies should then be encouraged to show all movements in securities held to back their liabilities through the income statement in order to match accounting treatment.

Q21. Do you have other comments on this paper?

We have made our main comments on the first two pages of this response, but would emphasise again that transparent and numeric disclosure is important to us, whichever direction the Board goes in with measurement. We would particularly like to see the Board explore the potential use of sensitivity analysis of assumptions and back-testing (i.e. a comparison of actual experience against historic expectations).

One question this paper does not ask that the IASB's Discussion Paper: Fair Value Measurements asked was how the proposed guidance would work in emerging markets. Given the lack of historic data collected in many markets, lack of experience in projecting cash flows (e.g. through stochastic monte-carlo simulation) or calculating risk margins as well as the potentially high volatility of some of the main inputs to calculations (such as interest rates and mortality rates), we think that some tricky issues may well arise that it would be helpful to consider in the process of drafting the standard. For our part, extensive disclosures would be helpful, as we would most likely want to be making adjustments to reflect more conservative assumptions in our rating analysis and to gain greater insight into the sensitivity of the valuation of liabilities to changes in assumptions.

Fitch would be happy to participate in the insurance working group's round-table meetings, and we would be pleased to answer any questions on our comments either as part of or outside this forum.

Yours sincerely,

Bridget Gandy Managing Director Credit Policy Group Fitch Ratings London

Andrew Murray Senior Director Insurance Group Fitch Ratings London

Attachment: Steering Committee Proposed Income Statement

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New business-new policyholders:	
EPV of premiums	xxx
EPV of claims	(xxx)
Provision for risk and uncertainty	xxx
EPV of maintenance costs	(xxx)
Acquisition costs	(xxx)
Profit (loss) - new business	xxx
Previous years' business:	
Changes in estimates/assumptions	xxx
Release of risk	xxx
Change in adjustment for risk and uncertainty	xxx
Profit (loss) - insurance business	xxx
Investing and financing activities:	
Unwinding of discount - insurance provisions	(xxx)
Effect of changes in discount rate	xxx
Return on investments	xxx
Profit (loss) - investing and financing activities	xxx
Net profit (loss)	xxx