



Lynda Sullivan CA, CPA
Executive Vice President & Controller

December 15, 2010

Ms. Leslie F. Seidman
Acting Chair, Financial Accounting Standards Board
401 Merrit 7
Norwalk, CT 06856-5116

Re: Preliminary Views on Insurance Contracts

Dear Ms. Seidman,

This letter is Manulife Financial's response to the Financial Accounting Standards Board's Discussion Paper "Preliminary View on Insurance Contracts" dated September 17, 2010 ("the DP").

In brief, we are very supportive of adopting a high quality global standard for insurance contracts and accordingly welcome this opportunity to submit our comments on the DP.

Manulife is a leading international financial services company providing insurance, financial protection, wealth and asset management solutions for our clients' most significant financial decisions. We operate in 22 countries and territories. Manulife has a large U.S. investor base and several of our subsidiaries currently report under U.S. GAAP in the U.S. As a Canadian company, we will be adopting IFRS in 2011. Manulife takes pride in providing leadership in our industry on many fronts, including our involvement in the development of the international insurance contracts accounting standard. Our FASB and IFRS related activities include field testing submissions to the IASB, membership on the Insurance Advisory Working Group as well as participation in many industry and professional association forums including; the Canadian Life and Health Insurance Association ("CLHIA"), the Group of North American Insurance Enterprises ("GNAIE"), the American Council of Life Insurers, the Canadian Accounting Standards Board's Insurance Task Force ("AcSB"), and the Canadian Institute of Actuaries ("CIA").

The insurance products we offer vary by geography and range from participating to non-participating policies, from group life and health products to individual life and long term care insurance, and include structured settlements and life contingent and variable annuities. We provide financial security to our customers and it is therefore vital that the accounting standards we adopt appropriately reflect the economics of our business including the strength of our balance sheet.

As a company that is domiciled in North America, with material businesses in both Canada and the U.S., we urge the IASB and FASB to work together to achieve one high quality global insurance standard. We believe that both Canada and the U.S. are following standards that work today, but the insurance industry in both countries will benefit from a single high quality global standard.

Canadian insurance companies already mark-to-market their assets and liabilities and our overall insurance contract measurement model is not that dissimilar to that proposed in the DP. We therefore agree with many of the concepts and recommendations in the DP however, we remain extremely concerned with the discount rate proposal. Our discussion below on both the discount rate issue and alternative proposals is consistent with the views expressed in our IFRS 4 ED

200 Bloor Street East, Toronto, ON M4W 1E5

Tel: 416 415-3993 Fax: 416 926-6285 E-mail: Lynda_sullivan@manulife.com

manulife.com

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response letter. We also believe that the same concerns are reflected by GNAIE, the NAIC, the CLHIA, the AcSB, the CIA, and both buy and sell-side analysts.

Discount rate issue:

We are in favour of using realistic and attainable, transparent, objective and comparable yields in discounting our liabilities. But the proposal to use a single vector of discount rates, whether it be risk free rate plus a liquidity premium, or a high quality corporate bond rate such as a double A rate, does not help the reader of financial statements for the simple reason that spread changes or “basis risk” between the reference discount rate and the investable universe is too great. This is magnified by discounting long term obligations (10, 20 years or more) and creates volatility that is not in keeping with the change in economic circumstances that it attempts to measure. The extreme volatility throws up false positives and false negatives, both of which do not serve the needs of investors in understanding the financial statements, assessing risk, allocating capital or assessing performance. You can be assured that preparers, investors and analysts would likely resort to the use of non-GAAP measures to explain and/or interpret results in these circumstances, the proliferation of which would be a de facto repudiation of the proposed accounting standard.

We believe the discount rate approach used in the DP may be a carryover from the exit principle, rather than the fulfillment concept.

In our view the essence of the fulfillment concept is that the measurement of insurance contract liabilities should take account of all risks that the insurer needs to provide for in order to be able to fulfill its obligations under the contract. The ability to do so is inextricably linked to the cash flows that the insurer expects to collect from its assets. It is therefore imperative that the measurement of insurance contracts, and the assets that are counted on to fulfill the obligations, be consistent. By proposing to measure the non-participating insurance contract liabilities using a single market yield rate (or yield curve), whether it be risk-free rates, risk-free rates plus liquidity adjustment or other, users of financial statements are left unable to judge whether the insurer will be in a position to fulfill its in force contracts. The longer the term of the contract, the more critical this issue becomes. Most of the non-participating insurance contracts of Canadian insurers are long-term.

The business model of life insurance companies involves meticulous matching of assets and liabilities, by duration and cash flow. This asset liability matching process reduces the entity's overall reinvestment risk. Given liabilities of various durations and nature, a wide variety of assets, supplemented by derivatives such as swaps, are needed in order to produce the most effective cash flow match. The measurement of accounting results should reflect the change in economic circumstance – change in the outlook for reinvestment of future cash flows, the outlook for defaults, or other forms of economic loss.

The accounting mismatch that would arise from using a single discount rate could also result in macroeconomic consequences. If the impact of income and / or capital volatility associated with the basis risk was more volatile than shareholders would be willing to bear, life insurers may gravitate towards investment portfolios which mirror the reference rate used to discount the liabilities. For example, if the reference rate was a double A, the tendency could be for insurance companies to hold double A bonds. The result would be portfolios with higher concentration in a narrower bond universe, weighted to specific rating grades of fixed-income securities instead of a highly diversified portfolio.

Needless to say, this concentration will occur not just within a specific company's portfolio, but amongst various life insurers' portfolios. Additionally, it will create unnatural demand for assets which offer yields at, or highly correlated with, the reference rate, a demand significant enough to create pricing distortions totally out of keeping with the fundamental economics and risk. A key learning from the recent financial crisis is that concentration is not a good thing.

Insurance companies like Manulife are also large investors in the economy. Insurance companies' investments in the turbulent capital markets of 2008 and 2009 were a stabilizing influence. The proposed changes would be procyclical and add volatility and therefore reduce our ability to provide long-term financing for industry, governments, infrastructure and other forms of investments essential to our economies.

Finally it could impair the ability of life insurers to offer long-term guaranteed financial products that are critical for retirement security. This, in turn, would increase pressure on governments that can ill afford the additional fiscal strain.

Alternative discount rate proposals:

In Canada our financial reporting system for life insurers, while not perfect and somewhat complex, is regarded as a success by most users. It is essentially what many refer to as the "own assets" approach. We use a current measurement model for both our invested assets and insurance contract liabilities, with the changes in current values flowing through the income statement. It incorporates dynamic assumptions related to credit defaults and a cost for uncertainty related to future investment returns. Deterioration in credit quality or insufficient return relative to assumptions is reflected immediately in the quarter, and is analyzed in our Source of Earnings Analysis. Similarly, Asset / Liability mismatch, or the cost of uncertainty in reinvestment, is reflected in the quarter.

Currently, we are aware of four different alternatives being mooted as improvements to the DP proposal. Given the significance of this effort, we urge the FASB and the IASB to fully assess and test the merits and weaknesses of each of the different alternatives currently being recommended, namely:

1. Use of "Own Assets" to derive a discount rate, together with significantly heightened disclosure;
2. Use of a "Reference Portfolio" i.e. use a number of discount rates linked to realistically investable assets representing a typical portfolio, with appropriate deductions for default and risk;
3. Use of "Amortized Cost" for both invested assets and insurance contract liabilities and,
4. The use of an "Available-for-sale" classification.

We strongly endorse the first alternative. A methodology based on multiple discount rates reflective of a company's own investment strategy is consistent with the business model, and therefore, would provide the most relevant information. The rates would include dynamic assumptions related to credit defaults and a cost for uncertainty related to future investment returns. Transparency is achieved through disclosure of the rates used, and the reduction for default risk and uncertainty. The goal of comparability could be achieved by disclosing, in the notes to the financial statements, the amount of the liability calculated using a single vector of reference rates by duration.

With these modifications, the "Own Assets" approach can be made more transparent, objective, comparable and realistic.

Failing that, we would ask you to consider the use of a "Reference Portfolio". Such a portfolio would consist of a range of asset classes and quality that would be appropriate, and are currently being used, to support the fulfillment of the policy liabilities. For argument's sake, between 8 and 12. This permits intelligent portfolio construction, cash flow matching, diversification of asset classes both within a given company, and diversification of asset classes amongst different companies. It also minimizes basis risk, by creating a portfolio that mimics the investible universe.

In reaching its recommendations we noted two reasons why the FASB and IASB did not consider it appropriate to consider the linkage to assets in the determination of a discount rate. As input to

further discussion on an appropriate discount rate for insurance contracts, we would like to address each of these points:

- The first point relates to comparability. In joint FASB and IASB deliberations, the Committee has expressed that it does not believe that identical liabilities should be measured at different amounts simply because two obligors decide to hold different assets. While we agree with the concept of comparability, we submit that it is more important that the measurement model meet the fundamental principle of faithfully representing an entity's financial position and performance. To achieve this, the measurement of a company's asset liability matching performance, which is a material and quantifiable component of an insurer's business, needs to be included in the measurement of the liability. The objective of comparability of two insurers' insurance contracts liabilities can be achieved through comprehensive disclosures in the notes to the financial statements.
- The second point relates to the fact that insurers who invest in junk bonds or other "high yield" assets should not be able to obtain a lower liability and create income in the period. Under the Canadian accounting methodology we have both preventive and detective controls to guard against this practice. The preventive control is embedded in the calculation of the discount rate. For matched asset and liability positions we use a net return approach which includes a best estimate credit default charge (similar to that being proposed in the amortized cost model under IFRS 9) as well as a risk margin for credit. (For positions which are not cash flow matched we also deduct a reinvestment risk margin). The detective safeguard is the disclosure of actual experience compared to what is included in the discount rate determination. Deterioration in credit quality, or insufficient return relative to assumptions would be reflected immediately in the quarter, and highlighted in the Source of Earnings or Performance Statement. In addition, as discussed above, the notes to the financials could include information related to the discount rates used.

Due process:

Over the last few months companies and associations globally have analyzed the implications of the ED and DP recommendations and identified a number of issues that need to be resolved. Ensuring the final standard is high quality and will work for all types of insurance contracts will require thorough assessment of the issues and recommendations as well as robust quantitative testing of the solutions. We urge the Board to allocate sufficient time for due process so that the resulting standard is truly high-quality.

Other comments:

Insurance is a complex business at the heart of which lies actuarial assumptions based on sophisticated modeling, finely tuned asset and liability matching strategies, and a myriad of product features and customer options. Further complexity is driven by product durations some twenty or more years into the future, well beyond the realm of market observable conditions. We therefore need relevance, transparency and simplicity when it comes to providing users with decision useful financial statements. We recommend that in addition to the discount rate, the FASB consider the following key changes to the DP:

1. Limit unbundling to account balances associated with Segregated and Separate Accounts only since the insurance component is the dominant component for the bulk of our products and any form of unbundling will result in arbitrary allocations and inconsistent application by insurers.
2. Incorporate the definition of acquisition and maintenance costs used in US GAAP as recently revised by the FASB. It is an appropriate reflection of the business model and asset and liability cash flows. The determination of acquisition costs should be made at the portfolio level consistent with all other assumptions in the insurance contract liability measurement as proposed in the DP.

3. Maintain the existing format for the performance statement and include premiums and other revenues earned by the insurer and sufficient detail into the nature of the changes in the insurance contract liabilities during the period. The “margin-based” presentation format can evolve over time as an analytical tool.
4. Adopt the concept of a specific risk margin and eliminate the concept of the residual margin as proposed by the IASB. The residual margin is currently derived as the difference between the present value of policyholder related cash inflows (premiums) and outflows (benefits, acquisition and maintenance expenses) where the cash flows and discount rate are defined by the accounting standards and not the pricing model. Conceptually this does not only represent a gain at issue, it also represents an amalgamation of all of the other liability characteristics included in pricing the product that are not currently explicitly identified by the DP measurement proposals or are not measured consistently with pricing. Assuming the discount rate issue is appropriately resolved and that the acquisition and maintenance costs are updated as described above, the “residual” amount could be rationally explained as the gain or loss at issue. Given that this gain is verifiable by virtue of its calibration to the premium, we believe it would be appropriate to record a day one gain and therefore a residual margin would no longer be required.
5. The transition provisions should include a residual margin on in-force business, assuming day one gains are not permitted. If we appropriately identified the components of the residual margin on new business than that information could be used to determine how to construct a residual margin at transition. The discount rate as well as the other items above need to be resolved before this analysis can take place.

We appreciate the opportunity to provide our comments on this critical topic and look forward to continuing our participation in the development of a high quality, globally applied standard for insurance contracts. Please refer to the attachment for our response to the specific questions you have asked about the DP.

Yours sincerely,



Lynda Sullivan
Executive Vice President and Controller

cc: Donald A. Guloiien, President and Chief Executive Officer, Manulife Financial
Warren McGregor, Chair, Insurance Working Group, IASB
Peter Clark, Director of Research, IASB
Jennifer Weiner, Senior Fellow, FASB

Attachment

Attachment

Definition and scope

1. **Are the proposed definitions of *insurance contract* and *insurance risk* (including the related guidance) understandable and operational?**
 - 1.1. Yes, we agree with the definition of an insurance contract.
 - 1.2. We recommend that the implementation guidance contained in the existing IFRS 4 be included in any final FASB standard.
2. **If the scope of the proposed guidance on insurance contracts is based on the definition of an insurance contract rather than on the type of entity issuing the contract, would financial reporting be improved?**
 - 2.1. Yes. This change would provide for consistent financial reporting of contracts that have the same characteristics, regardless of the entity that issues such contracts.
3. **Do you agree with the proposed scope exclusions? Why or why not?**
 - 3.1. Yes, we agree with the proposed scope exclusions.
4. **Should benefits that an employer provides to its employees that otherwise meet the definition of an insurance contract be within the scope of the proposed guidance? Why or why not?**
 - 4.1. Benefits that an employer provides to its employees differ in significant ways from an insurance contract and therefore should not be included in the scope of the proposed guidance. For example, in most cases there is no written contract that defines a set of cash flows between the employer and the employee, resulting in no explicit premium paid by the insured or any contractual obligation to continue to provide benefits.
5. **The Board's preliminary view is that participating investment contracts should not be accounted for within the proposed model for insurance contracts but, rather, should be included in the scope of the proposed model for accounting for financial instruments. Do you agree? Why or why not?**
 - 5.1. No, we believe financial instruments with discretionary participation features should be included within the scope of the proposed guidance as the current financial instrument standard does not provide sufficient guidance to measure the participating features for these products.
 - 5.2. We believe that the definition of investment contracts with discretionary participation features should not be restricted to those contracts that participate with insurance contracts in the same pool.
 - 5.3. The financial instrument standard does not provide guidance for the measurement of these discretionary participation features. Including both investment contracts that do not participate in a pool with insurance contracts and those that do under the scope of the proposed guidance will allow the discretionary participation feature to be measured consistently across all contracts.

6. Do you support the approach for determining when non-insurance components of contracts should be unbundled? Why or why not?

- 6.1. We believe unbundling of insurance contract components is appropriate only in circumstances where separation results in a more faithful representation of the insurer and the insurance contract.
- 6.2. We agree with the principle in Paragraph 39 that an insurer shall not unbundle components of a contract that are closely related to the insurance coverage specified in the contract.
- 6.3. At a minimum, we believe that unbundling is appropriate for unit-linked contracts as described by the IASB in the IFRS 4 ED (separate accounts and segregated funds in North America). Beyond that, however, it is unclear whether additional unbundling will result in a more faithful representation.
- 6.4. We believe that the application of Paragraph 40 could result in the unbundling of components that are closely related to the insurance coverage. In particular, some insurance contracts include policyholder account balances (e.g., some universal life contracts) that provide for crediting explicit returns on those balances that are loosely tied to asset returns, but with discretion retained by the insurer regarding the amount and timing of the credited return. The example in Paragraph 40(a) may provide for a “bundled” measurement of some contracts and unbundled treatment of others that are substantially the same. Further, we are concerned that undue complexity arises in these instances resulting from arbitrary allocations of cash flows between the “host” insurance contract and the unbundled components which will not result in consistent, comparable application.
- 6.5. In applying the criteria in paragraph 40(a), it is often not clear whether or not the amounts that are credited to policyholders include all investment performance of a particular or notional pool of assets, net of contract fees and assessments.

Recognition and measurement

7. Do you agree with the use of the probability-weighted estimate of net cash flows to measure insurance contracts? Does that approach faithfully represent the economics of insurance contracts? Is it an improvement over existing U.S. GAAP?

- 7.1. We agree with the proposal to measure insurance contract liabilities using expected present value of future cash outflows less future cash inflows as, in isolation, it provides relevant information about our liabilities and further it aligns with our business model.
- 7.2. However, from a cost / benefit standpoint, we believe the standard should be more explicit in instances where a “best estimate” approach can be used for cash flows that are generally symmetrical or linear in nature, rather than a full stochastic valuation, and further, that the insurer can use judgment in determining the measurement approach when the outcome is not material.

8. Do you think that an entity’s estimate of the net cash flows should include a risk adjustment margin?

- 8.1. Yes, we think that an explicit risk margin should be included.

9. Is the objective of the risk adjustment margin understandable? If so, do you think that the techniques for estimating the risk adjustment margin (see Paragraph 52(b)), faithfully represent the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected?

- 9.1. We disagree with the principle that the “risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment of cash flows exceed those expected” given that, despite the use of the term “fulfillment value” in the principle, it reads much more like an “exit value” or fair value perspective.
- 9.2. Given that insurance liabilities don’t trade in active markets, the most readily observable transactions occur in business combinations or block sale transactions. Typically, the assumptions used on those valuations reflect estimates of the risk in the liability cash flows due to uncertainties in their measurement, rather than the “maximum amount an insurer would be paid to be relieved from risk”. In the absence of market transactions, there does not appear to be a reliable estimate of what this risk is in the marketplace, other than an entity’s own experience.
- 9.3. Furthermore, we believe the risk margin, as defined in the ED, is currently missing the asset related risks (such as asset / liability mismatch and interest rate risks), which in many cases are the most material risks associated with insurance liabilities and provide extremely relevant information of the insurers performance to users of financial statements. The Canadian actuarial approach to setting risk margins includes these risks and evidences that these risks can be reliably estimated and are verifiable.

10. Do you think that the risk adjustment margin would be comparable for entities that are exposed to similar risks?

- 10.1. In theory, we believe entities with similar risks should have comparable measurements, all other factors being equal. However, in practice all other factors are not always equal, especially when they are largely dependent on management’s estimates of entity specific risk factors. In addition, views often differ on how much uncertainty should be reflected in a risk margin as well as significant practical problems in articulating a standard quantum of uncertainty to be included in insurance contract liabilities. Therefore we do not believe that it should be prescribed that entities with similar risks must have comparable risk adjustment margins. We would rather see a situation where management decides the appropriate level of the risk margin along with robust disclosures concerning the entity’s approach to measuring and managing risk which would allow users of financial statements to draw individual conclusions about entities risk adjustment margins.

11. Do you agree with the description of cash flows that should be included in the measurement of an insurance contract? Is the proposed guidance operational?

- 11.1. We generally agree with the description, but we believe that an allocation of overhead related to policy maintenance should be included in the cash flows.
- 11.2. We believe the draft application guidance in Appendix B of the IASB 4 ED on estimates of future cash flows provides an appropriate level of detail for a principles-based standard.
- 11.3. We believe that the appropriate “unit of account” for determining the relevant cash flows for all assumptions in the measurement of the insurance contract liability is the portfolio level, including acquisition cost.

12. Do you agree that the carrying amount of all insurance contracts should be discounted if the effect is material? Do you agree with the proposed guidance on the discount rate that should be used to measure the carrying amount of insurance contracts? If not, which discount rate should be used?

- 12.1. We agree that the carrying amount of all insurance contracts should be discounted if the effect is material.
- 12.2. We do not agree with the proposals in the proposed guidance that the discount rate for non-participating contracts should reflect only the characteristics of the liability and not the assets backing the liability. [Refer to our cover letter for a summary of the specific concerns and unintended consequences of the discount rate proposals in the DP].
- 12.3. The proposal to use a single vector of discount rates, whether it be risk free rate plus a liquidity premium, or a high quality corporate bond rate such as a double A rate, does not help the user of financial statements for the simple reason that spread changes or “basis risk” between the reference discount rate and the investable universe is great. This is magnified by discounting long term obligations (20 years or more) and creates volatility that is not in keeping with the change in economic circumstances that it attempts to measure.
- 12.4. The extreme volatility created will create false positives and false negatives, both of which do not serve the needs of investors in understanding the financial statements, assessing risk, allocating capital or assessing performance. You can be assured that insurers would likely resort to the use of non-GAAP measures to explain results in these circumstances, which would be a de facto repudiation of the standard.
- 12.5. The business model of life insurance companies involves meticulous matching of assets and liabilities, by duration and cash flow. This asset liability matching process reduces the entity’s overall reinvestment risk. Given liabilities of various durations and nature, a wide variety of assets, supplemented by derivatives such as swaps, are needed in order to produce the most effective cash flow match. The measurement of accounting results should reflect the change in economic circumstance – change in the outlook for reinvestment of future cash flows, the outlook for defaults, or other forms of economic loss.
- 12.6. The accounting mismatch that would arise from using a single discount rate could also result in macroeconomic consequences. If the impact of income and / or capital volatility associated with the basis risk was more volatile than shareholders would be willing to bear, life insurers may gravitate towards investment portfolios which mirror the reference rate used to discount the liabilities. For example, if the reference rate was a double A, the tendency could be for insurance companies to hold double A bonds. The result would be portfolios with higher concentration in a narrower bond universe, weighted to specific rating grades of fixed-income securities instead of a highly diversified portfolio.
- 12.7. Needless to say, this concentration will occur not just within a specific company’s portfolio, but amongst various life insurers’ portfolios. Additionally, it will create unnatural demand for assets which offer yields at, or highly correlated with, the reference rate, a demand significant enough to create pricing distortions totally out of keeping with the fundamental economics and risk. A key learning from the recent financial crisis is that concentration is not a good thing.
- 12.8. Insurance companies like Manulife are also large investors in the economy. Insurance companies’ investments in the turbulent capital markets of 2008 and 2009 were a stabilizing influence. The proposed changes would be procyclical and add volatility and therefore reduce our ability to provide long-term financing for industry, governments, infrastructure and other forms of investments essential to our economies.

- 12.9. Finally it could impair the ability of life insurers to offer long-term guaranteed financial products that are critical for retirement security. This, in turn, would increase pressure on governments that can ill afford the additional fiscal strain.
- 12.10. In Canada our financial reporting system for life insurers, while not perfect and somewhat complex, is regarded as a success by most users. It is essentially what many refer to as the "own assets" approach. We use a current measurement model for both our invested assets and insurance contract liabilities, with the changes in current values flowing through the income statement. The current measurement of the liabilities considers the linkage to assets, includes dynamic assumptions related to credit defaults and a cost for uncertainty related to future investment returns. Deterioration in credit quality or insufficient return relative to pricing assumptions is reflected immediately in the quarter, and is analyzed in the Source of Earnings Analysis.
- 12.11. Given the significance of the discount rate approach we urge the FASB and the IASB to fully assess and test the merits and weaknesses of each of the different alternatives currently being recommended. We understand that there are at least four alternatives that are not dependent on a single reference rate being discussed.
- 12.11.1. Use Own Assets to derive a discount rate, together with significantly heightened disclosure;
 - 12.11.2. Use a Reference Portfolio i.e. use a number of discount rates linked to realistically investable assets representing a typical portfolio, with appropriate deductions for default and risk;
 - 12.11.3. Amortized Cost for both invested assets and insurance contract liabilities; and,
 - 12.11.4. Available-for-sale classification for invested assets and use of OCI for the difference between the locked in amount and the fair value amount for insurance contract liabilities.
- 12.12. We strongly endorse the first alternative. A methodology based on multiple discount rates reflective of the company's own investment strategy is consistent with the business model and therefore would provide the most relevant information. The rates would include dynamic assumptions related to credit defaults and a cost for uncertainty related to future investment returns, be applied at the portfolio level, and meet the criteria of being realistic, attainable and transparent. In addition, the goal of comparability could be achieved by disclosing, in the notes to the financial statements, the amount of the liability calculated using a single reference rate such as a double A bond rate.
- 12.13. Failing that, the use of a reference portfolio should be considered. Such a portfolio would consist of a range of asset classes and quality that would be appropriate to support the fulfillment of the policy liabilities; for argument's sake, between 8 and 12 asset classes could be referenced. This would permit intelligent portfolio construction, cash flow matching, diversification of asset classes both within a given company and diversification of asset classes amongst different companies. It could also minimize basis risk, by creating a portfolio that mimics the investible universe.
- 12.14. In reaching its recommendations we noted two reasons why the FASB and IASB did not consider it appropriate to consider the linkage to assets in the determination of a discount rate. As input to further discussion of an appropriate discount rate for insurance contracts, we would like to address each of these points:
- 12.14.1. The first point relates to comparability. In joint FASB and IASB deliberations, the Committee has expressed that that it does not believe that identical liabilities should be measured at different amounts simply because two obligors decide to

hold different assets. While we agree with the concept of comparability, we submit that it is more important that the measurement model meet the fundamental principle of faithfully representing an entity's financial position and performance. To achieve this, the measurement of a company's asset liability matching performance, which is a material and quantifiable component of an insurer's business, needs to be included in the measurement of the liability. The objective of comparability of two insurers' insurance contracts liabilities can be achieved through comprehensive disclosures in the notes to the financial statements.

- 12.14.2. The second point relates to the fact that insurers who invest in junk bonds should not be able to obtain a lower liability and create income in the period. Under the Canadian accounting methodology we have both preventive and detective controls to guard against this issue. The preventive control is embedded in the calculation of the discount rate. For matched asset and liability positions we use a net return approach which includes a best estimate credit default charge (similar to that being proposed in the amortized cost model under IFRS 9) as well as a risk margin for credit to discount the liability. (For positions which are not cash flow matched we also deduct a reinvestment risk margin to determine the net return). The detective safeguard is the disclosure of actual credit experience compared to what is included in the discount rate determination. Deterioration in credit quality, or insufficient return relative to assumptions would be reflected immediately in the quarter, and highlighted in the performance statement. In addition, as discussed above, the notes to the financials could include information related to the discount rates used.
- 12.15. We believe that the objective of comparability and soundness of assumptions can be accomplished through disclosures. These disclosures should include:
 - 12.15.1. Material assumptions;
 - 12.15.2. Sensitivity of net income and policy liabilities to these assumptions; and
 - 12.15.3. Quantification of the amount the actual results differed from the expected returns in the period.
- 12.16. Given the significance of the discount rate approach we urge both the FASB and IASB to fully assess and test the merits and weaknesses of each of the different alternatives currently being recommended around the globe.
- 12.17. **Liquidity Premium** - We do not agree with the use of a liquidity premium. There are several significant shortcomings to the inclusion of a liquidity premium in the measurement of insurance contracts including:
 - 12.17.1. *No active market* - Given that insurance liabilities do not trade in active markets, there is no externally observable or verifiable approach for determining the liquidity characteristics of insurance liabilities, and therefore, there will not be consistent application. We note from public disclosures of Market Consistent Embedded Value in Europe that insurers have used liquidity premiums ranging from 50 basis points to over 450 basis points for the exact same product sold in the same markets.
 - 12.17.2. *Not linked to the business model* - The addition of a liquidity premium is not linked to the business model of most life insurance companies and therefore would not produce relevant, reliable financial information to users of financial statements.
 - 12.17.3. *Inconsistent with current fulfillment value* - The concept of a liquidity premium is a carry-over from the previous "current exit value" measurement model and is not relevant to the current fulfillment value approach.

- 12.17.4. *Would not appropriately address extreme balance sheet/capital and earnings volatility issues* - if the liquidity premium is truly meant to reflect the illiquid nature of insurance liabilities, and given that such liabilities do not trade, this would likely be a one time adjustment to the discount rate unless product feature changes occurred in subsequent periods to justify changes in the liquid / illiquid nature of the liability. The fact that an insurance liability is liquid / illiquid is a function of the products' features and in principle therefore should not change simply because market interest rates have changed. Even if the liquidity premiums could be defined as a function of spread levels, such as proposed in the CEIOPS approach determining liquidity premiums, it would not resolve the extreme balance sheet volatility issue and lack of usefulness and relevance of the financial statements.
- 12.18. **Volatility and Loss at Issue** - We note that in addition to the extreme balance sheet and earning volatility concerns, significant losses at inception of the contract, particularly for long duration contracts, will exist under the discount rate proposals in the DP, for products that the insurer expects to be profitable in the future.
- 12.19. In order to illustrate the extreme earnings volatility that arises from discounting long duration insurance contracts using a single reference discount rate (risk free, risk free plus an adjustment for liquidity or a high quality corporate bond) compared to a discounting approach using the expected return on assets, we have provided two examples in the attached **Appendix**. These examples compare the earnings arising from investment income reported on a AA corporate bond carried at fair value through profit and loss to the change in value of a guaranteed investment certificate (GIC) under various discounting scenarios (risk free, risk-free plus liquidity, high quality corporate bond rates, expected return on assets and amortized cost). The cash flows of both the asset and GIC liability are exactly equal to remove any unnecessary complexity and to clearly illustrate the volatility arising from using a different measurement basis between the asset and liability.
- 12.20. These examples demonstrate that the longer the duration of the liability, the more significant the earnings volatility that exists, even where the cash flows of both the asset and liability are perfectly matched.
- 12.21. We believe a discounting approach that incorporates the expected return on assets, including dynamic assumptions relating to credit defaults and a cost for uncertainty related to future re-investment assumptions will address these volatility concerns, is more reflective of the insurance business model and therefore will result in decision-useful information for users of financial statements.
- 13. Do you think that acquisition costs should be included as one of the cash flows relating to the contract? If not, how would you account for acquisition costs?**
- 13.1. We agree that incremental acquisition costs should be included in initial measurement of insurance contracts as contract cash outflows under the building block approach.
- 14. Do you agree that acquisition costs included in the cash flows used in the measurement of the insurance contract should be limited to those that are incremental at the individual contract level? If not, which acquisition costs, if any, would you include in the measurement of the insurance contract?**
- 14.1. No. We think that the acquisition costs that are included should be incremental to the insurer at the portfolio level (rather than at the level of individual insurance contracts) so as to be consistent with the "unit of account" for all other assumptions used in the valuation. For example, costs associated with an insurer's underwriting process, which is necessary for acquisition of insurance contracts, should be included if these

costs are incremental for a portfolio of insurance contracts (i.e., insurance contracts that are subject to broadly similar risks and managed together as a single pool).

- 14.2. We believe that the current definition of acquisition costs in the proposed guidance might inappropriately motivate insurers to arbitrage the standard by outsourcing services and changing commission approaches in order to preserve the ability to defer these costs and therefore, the standard may drive inappropriate outcomes.

15. Do you agree with the use of either the composite margin approach or two-margin approach to measure the net insurance contract? Does either approach faithfully represent the economics of insurance contracts? Is either approach an improvement over the measurement used in current U.S. GAAP?

- 15.1. We support the use of a separate risk margin. However, as outlined more fully below if a sufficient analysis of the cash flows and other components that currently make up the definition of a residual margin are appropriately identified, the resulting day one gain or loss should be recognized immediately, such that a residual margin would not be required.
- 15.2. We do not believe that the residual margin entirely represents the “gain at issuance” of the contract. Instead, as currently defined, the residual margin reflects an amalgamation of cash flows that are currently reflected in the determination of the premium, such as non-deferrable acquisition costs, maintenance costs, tax and other benefits including any residual profit. As currently defined, the residual margin includes items such as non-direct acquisition costs, maintenance costs, tax and other priced-in assumptions that we believe should instead be separately identified in the cash flows, acquisition or maintenance cost assumptions.
- 15.3. If all of the performance obligations of the insurer are separately identified in the cash flows, then we believe any residual would represent a day one gain or loss. Given that the measurement of the liability is currently calibrated to the premium, this represents an externally verifiable input which provides the necessary credence to the valuation of the insurance liability. Therefore, we believe that the standard should permit a day one gain, where such gain can be supported by external evidence (such as the premium or transaction price). There are instances where an insurer may maintain a dominant market presence in a given jurisdiction (such as parts of Asia) that would support product pricing to achieve a day one gain.
- 15.4. The risk margin should be updated on a current basis and be amortized into earnings based on the insurers release from such risks. If day one gains are not permitted, we believe the residual margin, should unwind over the life of the contract.
- 15.5. As outlined above, we do not believe a residual margin is required if the individual cash flows of the insurance liability are appropriately identified. However, if the components of the residual margin are not appropriately identified as separate components of the cash flow assumptions and day one gains are not permitted in the final standard, we believe the residual margin should be amortized in a simple and transparent manner over the life of the contract. One exception to this amortization approach could exist in instances where there is an overall loss on the portfolio that exceeds the residual margin. In such situations, we believe the corresponding residual margin should be recognized in profit or loss to appropriately recognize the overall loss on the portfolio. Without recognition of the corresponding residual margin in such circumstances, the appropriate carrying value of the contract would not be reflected in the measurement of the loss.

16. Do you think that the composite margin should be recognized in earnings in subsequent periods using the ratio described in Paragraph 83? If not, how would you recognize the composite margin in earnings?

16.1. We do not support the use of a composite margin.

17. Do you agree that interest should not be accreted on the composite margin? Why or why not?

17.1. We do not support the use of a composite margin.

18. Do you think that all insurance contracts should be recognized and measured using one approach or that some insurance contracts should be recognized and measured using an alternative approach (for example, the modified approach)? Why or why not?

18.1. We do not have material short duration contracts and therefore do not have any significant comments on this question.

19. If an alternative approach is required for some insurance contracts, what recognition, measurement, and presentation provisions should be applied (including those items noted in Paragraph 106)?

19.1. We do not have material short duration contracts and therefore do not have any significant comments on this question.

20. Do both the building-block approach and the modified approach (with the latter approach applied only to certain short-duration contracts) produce relevant and decision-useful information? Why or why not?

20.1. We do not have material short duration contracts and therefore do not have any significant comments on this question.

21. How should the scope of insurance products for each approach be defined (for example, duration of coverage period, duration of claims payment period, or type of insurance)?

21.1. We do not have material short duration contracts and therefore do not have any significant comments on this question.

22. Are there specific types of insurance contracts for which the approaches would not provide decision-useful information?

22.1. We do not have material short duration contracts and therefore do not have any significant comments on this question.

23. What are the implications of the recent U.S. healthcare reform to the application of the proposed contract boundary principle, including whether health insurance contracts

written under the new reforms would meet the conditions in the proposed guidance to be accounted for under the modified approach?

23.1. We do not have material short duration contracts and therefore do not have any significant comments on this question.

24. What other changes should be considered to both improve and simplify U.S. GAAP for short- and long-duration insurance contracts?

24.1. We do not have material short duration contracts and therefore do not have any significant comments on this question.

25. What are the incremental costs of adopting the alternatives described in this Discussion Paper? Please separately describe one-time costs and ongoing costs.

Reinsurance

26. The scope of the proposed guidance includes reinsurance contracts that an insurer issues or acquires. However, insurance contracts held directly by other policyholders would be excluded from the scope of the proposed guidance. Do you agree with this exclusion? Why or why not?

26.1. We agree that insurance contracts held directly by other policyholders should be excluded from the scope of the proposed guidance. Ceded reinsurance contracts are relieving an entity from an original risk (the underlying contract) that has been recognized and recorded by the entity. Recording the relief from risk on the same basis as the original risk is a logical measurement outcome. Application of the building blocks approach to contracts (other than ceded insurance) that are held by other policyholders would most likely not produce a logical result because the original risk is not being measured by a building blocks approach.

27. Should there be symmetry between the recognition and measurement of reinsurance contracts and the underlying contract ceded?

27.1. There should be symmetry on the books of the insurer/ceding entity between the recognition and measurement of reinsurance contracts and the underlying contract ceded. The reinsurer may have a different view of the underlying contract, however, and should not be expected or required to make assumptions that mirror those of the ceding entity.

Presentation and disclosure

28. The margin presentation approach highlights the changes in the insurance liability, rather than the current approach in U.S. GAAP, which presents, among other items, premium revenues, benefits paid, operating costs, and changes in loss estimates. Would this change improve your understanding of the performance of an entity that provides insurance (for some types of insurance or for all)? Please explain.

28.1. While the Canadian presentation and disclosure requirement have a similar principle to the "margin approach" being advocated by the IASB, we do not believe that this

presentation is a useful substitute for an existing “income statement” which includes premiums / revenue and expenses.

28.2. Without sufficient application guidance, the Canadian experience is that an inordinate amount of time is spent deciding which line the components of the changes in the contract liability should be presented when using a “margin-style” presentation format. This inevitably will lead to period to period restatements based on changes in geography between reporting periods which will provide increased confusion to the reader of the financial statements.

28.3. Instead, if sufficient granularity of the components of the change in the insurance contract liability is presented on the face of the Income / Performance Statement, we believe that this will provide sufficient transparency to the reader of the performance and risks of the insurance company operations. A proposed format for the income statement presentation could include:

Change in Insurance Liability attributable to:	
Cash flows attributable to:	
New business	XX
In force business	<u>XX</u> <u>XX</u>
Change in risk margins	XX
Amortization of residual margin	XX
Change in investment assumptions	XX
Other changes in liability assumptions, etc	XX
Total Changes in Insurance Liabilities	<u> XX</u>

29. Should insurance contracts measured under the building-block approach be presented using a margin presentation approach or a premium presentation approach that would require a true-up amount as described in Paragraph 119 (for example, the written allocation presentation approach or the allocated premium presentation approach)?

29.1. Insurance contracts measured under the building-block approach should be presented under a premium presentation approach that would require a true-up amount. Please see our response to question 28.

30. Should short- and long-duration (or non-life and life) contracts be presented in a similar manner if such contracts are measured under different approaches?

30.1. We do not have material short duration contracts and therefore do not have any significant comments on this question.

31. Do you agree with the proposed disclosures in the IASB’s Exposure Draft? Why or why not? If not, what would you recommend and why?

31.1. In general, we agree with the proposed disclosure principles in the IASB Exposure Draft. However we find the disclosure proposals to be excessive. The reconciliations in paragraphs 86 through 89 do not appear to be at a sufficiently aggregated level to provide relevant financial information to users of financial statements.

31.2. Further, the requirements in paragraph 92 appear to be more applicable for non-life insurance risks and should therefore only need disclosure if they represent a material risk to the company.

- 31.3. We believe that there are other relevant disclosures that could provide useful information to users including:
- 31.3.1. Further details of the discount rate used and the sensitivity to the liability of using different rates (for comparability purposes);
 - 31.3.2. Disclosure of material changes in actuarial assumptions during the period;
 - 31.3.3. Material variations in expected versus actual assumptions experienced during the period.

Additional question for respondents

32. After considering your views on the specific issues contained in this Discussion Paper and the IASB's Exposure Draft, what do you think would represent the most appropriate improvement in U.S. GAAP?

- a) **Pursue an approach based on the IASB's Exposure Draft?**
 - b) **Pursue an approach based on the IASB's Exposure Draft with some changes? Please explain those changes.**
 - c) **Pursue an approach based on the Board's preliminary views in this Discussion Paper?**
 - d) **Pursue an approach based on the Board's preliminary views in this Discussion Paper with some changes? Please explain those changes.**
 - e) **Make targeted changes to address specific concerns about current U.S. GAAP (for example, items included in paragraph 7)? Please describe those changes.**
- 32.1. We strongly support the objective of a high quality global accounting standard for life insurance. Because the FASB and IASB proposals are very similar, both provide a reasonable basis, with some changes, for an ultimate U.S. GAAP and global standard. Assuming a response of d) above, we believe the following changes would produce a decision useful global standard:
- 32.1.1. The appropriate discount rate under a current fulfillment model with assets being measured at fair value through profit and loss is a current asset earned rate. As outlined in our cover letter, the proposal to use a single vector of discount rates, whether it be risk free rate plus a liquidity premium, or a high quality corporate bond rate such as a double A rate, does not help the reader of financial statements for the simple reason that spread changes or "basis risk" between the reference discount rate and the investable universe is too great. This is magnified by discounting long term obligations (10, 20 years or more) and creates volatility that is not in keeping with the change in economic circumstances that it attempts to measure. The extreme volatility throws up false positives and false negatives, both of which do not serve the needs of investors in understanding the financial statements, assessing risk, allocating capital or assessing performance. [See our response to Question #12 for further details];
 - 32.1.2. Limit unbundling to account balances associated with Segregated and Separate Accounts. [See our response to Question #6];
 - 32.1.3. Adopt a two margin approach. [See our response to question #15];
 - 32.1.4. Incorporate the definition and treatment of acquisition and maintenance costs used in US GAAP as recently revised by the FASB which should be determined at the portfolio level consistent with all other assumptions. [See our response to Question #14];

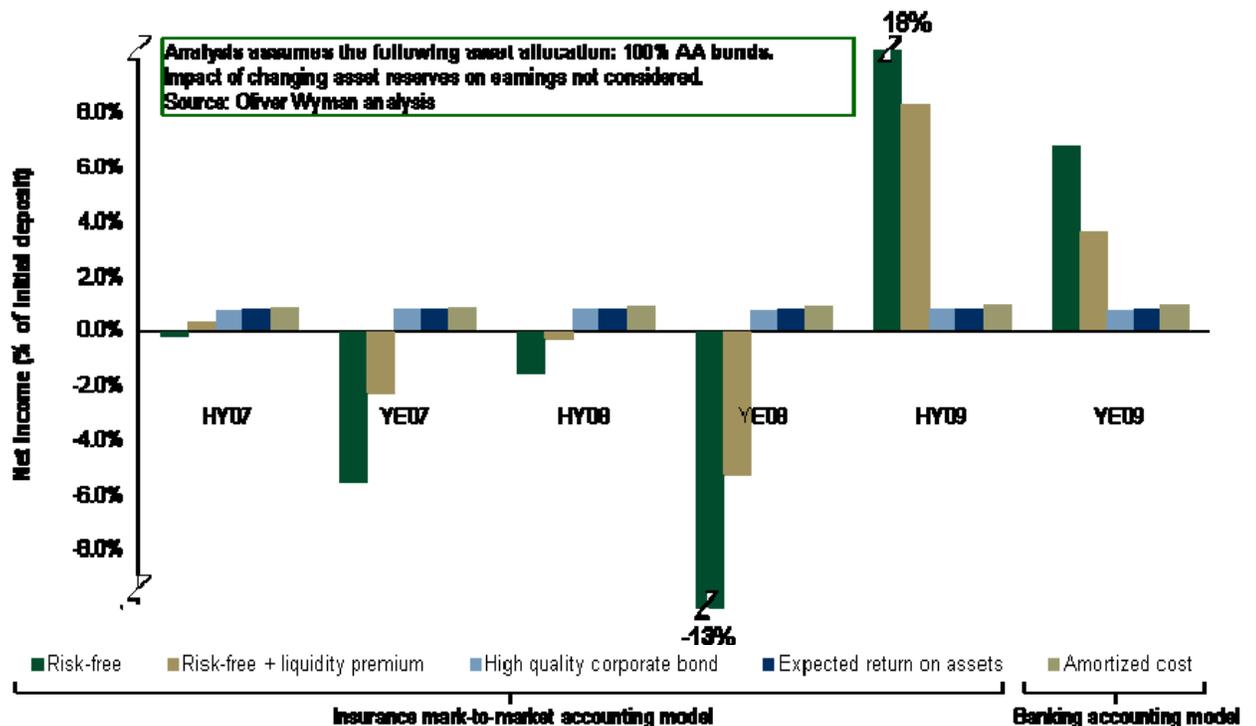
- 32.1.5. Maintain the existing format for the performance statement to include premiums and other revenues earned by the insurer and sufficient detail into the nature of the changes in the insurance contract liabilities during the period. [See our Question #28];
- 32.1.6. Assuming the discount rate issue is appropriately resolved and that the acquisition and maintenance costs are updated as described above, the “residual” amount could be rationally explained as the gain or loss at issue. We believe that if the external transaction price (i.e. premium) can be observed, then it would be appropriate to report a day one gain, such that the concept of a residual margin would not be required; and
- 32.1.7. The transition provisions should include a residual margin (assuming day one gains are not permitted). By appropriately identifying the components of the residual margin on new business we could use that information to determine how to construct a residual margin at transition. The discount rate as well as the other items above need to be resolved before this analysis can take place.

Appendix

Example 1:

The following example compares the earnings arising from investment income reported on a AA corporate bond carried at fair value through profit and loss to the change in value of a 10-year guaranteed investment certificate (GIC) under various discounting scenarios (risk free, risk-free plus liquidity, high quality corporate bond rates, expected return on assets and amortized cost). The cash flows of both the asset and GIC liability are exactly equal to remove any unnecessary complexity and to clearly illustrate the volatility arising from using different measurement basis between the asset and liability.

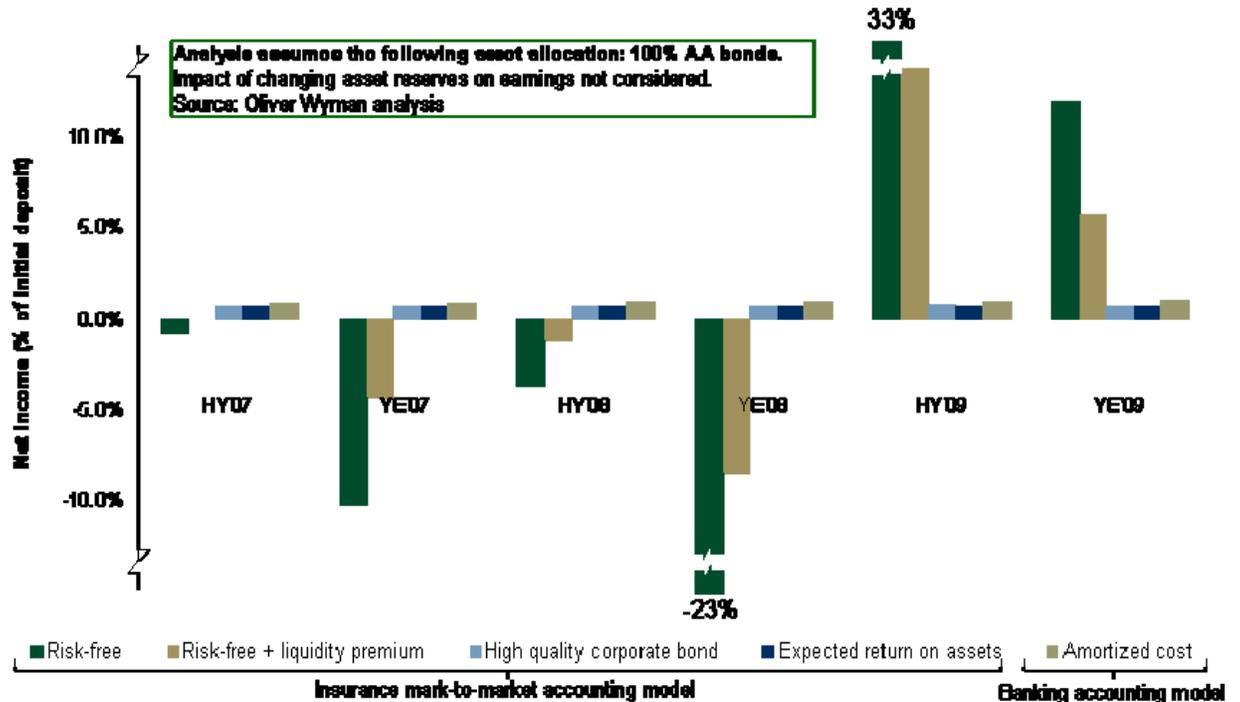
Case study: Illustration of earnings arising from a 10-year GIC under different accounting models



Example 2:

Same as Example 1 above, only using a 20 year Bond and a 20-year GIC liability:

Case study: Illustration of earnings arising from a 20-year GIC under different accounting models



Conclusion / Observations:

- The examples above illustrate that, although the cash flows are perfectly matched (and the characteristics of the asset and the liability are the same), net income will vary significantly when using a risk-free rate or a risk-free rate adjusted for liquidity, over a three year period.
- This volatility becomes more pronounced, the longer the duration of the liability as evidenced in the 20-year example.
- The volatility is only partially reduced when a high quality corporate bond rate is used for the liability because it includes default risk for that class of issuer in the market (i.e., sector credit spread) and that risk matches that of the asset.
- We believe that these examples illustrate that the discounting proposals in the DP will not provide decision-useful information to users of financial statements, as the volatility introduced by the proposals is not reflective of the underlying characteristics of the liability or the insurers' business model or risks.