

November 15, 2007



LETTER OF COMMENT NO.

Technical Director
Financial Accounting Standards Board
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Fairfax Financial Holdings Limited – a financial services holding company which, through its subsidiaries, is engaged in property and casualty insurance and reinsurance, investment management and insurance claims management – is pleased to submit responses to the questions raised in the Invitation to Comment – An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, *Preliminary Views on Insurance Contracts*.

As a Canadian-based public company operating globally and an SEC registrant, we think it critical that all global accounting standards are converged, including those governing insurance accounting, and we encourage the FASB and the IASB to add Insurance Accounting to the Joint Project Agenda.

We appreciate your attention to this matter.

Yours truly,

M. Jane Williamson

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Vice President

# A FASB Agenda Proposal Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts

### 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?

We believe that the FASB should comprehensively address accounting for insurance contracts. As identified in this invitation to comment, there are many sources of guidance under U.S. GAAP which should be considered when determining the appropriate accounting for insurance products. As a preparer of financial statements, it is often challenging to ensure that all relevant guidance has been reviewed and given due consideration. One comprehensive authoritative source would greatly reduce the risk of error in these circumstances.

As a Canadian-based public company and an SEC registrant listed on the NYSE and operating in global markets with approximately 60 % of its operations in the US, it is burdensome that we do not have a common standard in both the U.S. and in the IFRS jurisdictions. Currently the majority of our U.S. operations are in two SEC registrants which are required to use U.S. GAAP. Their parent company - a Canadian-based company - will be required to report under IFRS as of January 1, 2011. If U.S. GAAP is not converged with IFRS, these two subsidiaries will need to maintain two bases of measurement for the required financial reporting — one under U.S. GAAP for their own reporting and one under IFRS to meet the parent consolidated financial reporting requirements. It is unlikely that these two subsidiaries would consider converting to IFRS for their own financial reporting requirements, as their main competitors operate primarily in the U.S. market and are expected to continue to follow U.S. GAAP.

### Ouestion 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?

We believe that the preliminary views expressed in the IASB's Discussion Paper are theoretically sound, however we are concerned that there will be significant issues with implementation thereof. We believe that certain of these implementation issues may

# A FASB Agenda Proposal Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper, Preliminary Views on Insurance Contracts

result in less consistency and comparability within the industry to that which we have today. We attach a copy of our response to the IASB on the questions raised in their Invitation to Comment on the Discussion Paper – Preliminary Views on Insurance Contracts.

## Question 4:

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

With any transaction or contract, the accounting should be symmetrical between the parties on each side of the transaction. Upon finalization of the accounting standard for insurers, all accounting guidance for policyholders should be reviewed to ensure consistency with the new standard on insurance contracts and should be amended where necessary.

### Question 5:

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?

There needs to be consistency across all standards for similar transactions. The consistency should be guided based on the conceptual framework, followed by determining the purpose of the financial statements (i.e. performance measurement or some other objective) from which will follow revenue recognition, the measurement of liabilities and equity and financial statement presentation.

The preliminary views of the IASB, as presented in their discussion paper on insurance contracts, either raise questions on each of the above topics or identify inconsistencies with certain standards which are currently in force.



November 15, 2007

International Accounting Standards Board 30 Cannon Street London, United Kingdom EC4M 6XH

Subject: Invitation to Comment – Preliminary Views on Insurance Contracts

Fairfax Financial Holdings Limited – a financial services holding company which, through its subsidiaries, is engaged in property and casualty insurance and reinsurance, investment management and insurance claims management - is pleased to provide responses to the questions raised by the International Accounting Standards Board (IASB) in its Discussion Paper dated May 3, 2007 on its Preliminary Views on Insurance Contracts. Our responses to these questions, from the point of view of a non-life insurer, are set out in the attached appendix.

For the North American insurance industry, we believe that a shift for the property and casualty industry away from the 'provider of service' model to a 'financial instrument' model is significant and will cause confusion in the market place until fully understood by all company stakeholders including shareholders and securities/investment analysts. We are not convinced that the proposed balance sheet model will provide better financial information.

While we believe the preliminary views presented in the paper are theoretically sound and have been well thought out, we are concerned that significant practical issues may arise on the implementation thereof. We believe it important that the accounting guidance ultimately provided in any accounting standard should be consistent within an accounting framework and harmonized with other existing standards.

We also believe that the views proposed by the IASB in the discussion paper will require increased actuarial modeling incorporating significantly more assumptions and variables which cannot be readily obtained from or substantiated in the marketplace. The necessary reliance on these complex actuarial models may result in increased subjectivity and less comparability in reserves across the industry.

As a Canadian-based company with approximately 60% of its operations in the United States and operations around the world, we believe it critical that both FASB and the IASB work together to determine the future for insurance accounting with the objective of producing one converged standard for both US GAAP and IFRS.

Yours truly,

M. Jane Williamson

Vice President

Question 1: Shou-ld the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

We believe that the requirements for recognition and derecognition of insurance contracts should be consistent with those in IAS 39 for financial instruments.

As the IASB has developed an accounting framework to assist and guide them in their standard setting process, the IASB should strive to maintain consistency across the standards when determining guidance to account for transactions which are similar in substance.

- IAS 39 paragraph 14 states that an entity should recognize a financial asset or liability when the entity becomes party to the contractual provisions of the instrument.
- A contract between two parties documents a binding agreement whereby the parties to the contract expect to receive either certain benefits or expect to assume certain obligations should specified actions or events occur.
- An insurance contract is no different. One party pays a premium expecting to be compensated by the insurer should specified loss events occur. With the payment of the premium by the policyholder to the insurer, the policyholder has acquired certain rights and expects to receive reimbursement for losses (a benefit). At the same time the insurer has assumed an obligation to make payments to the policyholder with the occurrence of a loss covered by the insurance contract.
- An insurer would recognize the rights and obligations created by an insurance contract when it becomes a party to the contract.
- Under IAS 39, an entity will derecognize a financial liability when it is extinguished. Extinguished is understood to mean the obligation in the contract has been fulfilled, cancelled or the contract has expired.
- The criteria in IAS 39 are consistent with both US and Canadian GAAP for financial instruments and would appear to be logical in that if a company recognizes a contract when it is first entered into, then it should only derecognize the contract upon its exit or fulfillment.

We infer from this question that the IASB's intent is to move towards accounting for insurance contracts on a basis which is similar to that used for financial instruments and to move away from the 'provider of service' model of accounting which is currently used in the non-life industry. If we infer correctly, the accounting result would be to recognize the insurance contract on the date of contract signing, and adjustments to those results as recorded would only occur if there were a change in the underlying assumptions which impact the previously estimated and recorded liability. Premiums would no longer be 'earned' over the period of the contract from the effective date but would be fully earned on inception of the contract.

We believe that the move to this basis of accounting and away from the 'provider of service' model may result in skewed quarterly results for public companies whose

insurance contracts are renewed at specific points in time during the year compared to those companies which underwrite insurance contracts evenly throughout the year. We also believe that companies will encounter various implementation issues with this proposed guidance and may be required to gather more data than is their current practice. As an example, if a company did not track contracts signed and cancelled before inception, it would need to gather this data for consideration in developing its various cash flow scenarios and probability weightings used in determining the exit value on these contracts.

Question 2: Should an insurer measure all its insurance liabilities using the following three building blocks:

- (a) Explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,
- (b) Current market discount rates that adjust the estimated future cash flows for the time value of money, and
- (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)?

These three building blocks are sound in theory however, we have some concerns with the implementation as discussed below.

Setting aside discounting for a moment, if one assumes that current reserving practices (in North America for example) are appropriate where the use of actuarial models contribute to the determination of management's best estimates or actuarial point estimates which are used in recording claims reserves in the financial statements, the building blocks in points (a) and (c) are then quantifying and labeling inputs implicitly embedded in those current reserving practices. Discounting acknowledges the time value of money for claims that will be settled over time.

If the IASB is trying to ensure that the industry's reserving processes are more robust, then we are concerned that the increased number of variables and scenarios used as inputs in estimating the claims liability with these building blocks may not result in materially more reliable and relevant information, may not enhance consistency across insurers and may result in increased subjectivity in the claims liability estimate. Increased subjectivity could contribute to intentional or unintentional earnings misstatements and inaccurate valuation of liabilities.

Of the three building blocks, the current market risk free discount rate is the only readily observable input in the marketplace. From a practical perspective for similar books of business in two different entities, it is unclear how the industry would ensure in estimating these liabilities that similar cash flow scenarios and probability weightings would be used as inputs. Currently, this data is not readily accessible in the marketplace. A company would then use entity-specific data as its input and this data would not necessarily be consistent from one insurer to the next.

Companies should be compensated for assuming risk and the discussion paper proposes that this margin should be explicit and meet expectations of market participants. As the breakdown of the various market players' pricing is not known with any certainty, these risk margins will not be readily obtainable from the marketplace.

A company then appears to have two choices to determine a risk margin; 1) using management's best estimate predicated on basic actuarial modeling or 2) using complex stochastic modeling with increased reliance on actuaries. Complex modeling would increase the cost of determining the appropriate liability and given the difficulty in determining market based inputs for this variable it is not clear that it would produce a better result. The use of complex modeling may result in management not understanding the business and results as well as they should. With any complex modeling technique there is always a risk that the model becomes a black box. If complex modeling is used, minimum confidence levels should be specified.

We would argue that each company in the insurance industry could have a different risk appetite and as a result would charge a different risk premium. If this is a valid assumption, then with all else being equal, the exit value for similar books of business in two different companies would be different. Comparability across entities would not be achieved.

To facilitate comparability between companies, the IASB should consider necessary disclosures a company should provide with respect to policies followed in estimating exit values, sensitivities on input factors including risk factors or margins and confidence levels in their actuarial estimations. These disclosures will assist a reader of the financial statements in comparing similar books of business across competitors.

Question 3: Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

Appendix E – Estimates of future cash flows

Many of the paragraphs in Appendix E refer to 'end of reporting period' or 'at the reporting date'. It is not clear whether or not the IASB expects that all variables impacting estimates of future cash flows be reassessed at each reporting date. Given the reporting timelines of public companies in North America, it is not realistic to expect that these reassessments could be performed on a quarterly basis with any degree of rigor. As an example, payout patterns could not be accurately re-estimated on a quarterly basis.

If two objectives of financial statements are to measure the performance of a company and to assess management's stewardship of capital then the exclusion of entity-specific factors would be counterintuitive. If an entity can settle a liability more efficiently than its competitors and at a value which is lower than its transfer value, then the exit value should reflect these factors. It is the entity 'specifics' a stakeholder considers when judging management and the company. We believe that if the financial instrument model is adopted for insurance accounting, management may need to maintain existing systems based on the provider of service model to assess its management of the underlying business. The result may be two systems – one for financial reporting and one for management reporting.

The guidance in this appendix is general and reliance will be placed on the actuarial community to ensure that all cash flow scenarios have been identified and are realistically weighted. In countries with well developed insurance industries and actuarial practices the level of guidance included in this appendix may be appropriate, however in countries where both the insurance industry and actuarial practices are developing, the guidance may not be sufficient and reference to benchmark actuarial practices should be considered.

### Appendix F - Risk margins

Again, it is not clear whether or not the IASB expects that risk margins be reassessed at each reporting date. Given the reporting timelines of public companies in North America it is not realistic to expect that these reassessments be performed on a quarterly basis with any degree of rigor.

The guidance in this appendix is general and reliance will be placed on the actuarial community for assessment of risk margins. We understand that the International Actuarial Association (IAA) has issued an exposure draft (dated February 23, 2007) which deals with the measurement of liabilities for insurance contracts and more specifically risk margins. Perhaps Appendix F should consider making reference to other sources of guidance such as this from the IAA or other actuarial societies, if appropriate.

Question 4: What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.

- (a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognize a profit at the inception of an insurance contract.
- (b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence would be needed to rebut the presumption?

(c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognize a profit or loss at inception.

(d) Other (please specify).

As a non-life insurance company, we support option (c). Premiums charged vary based on the insurance cycle. In a 'soft market' rates per risk may be reduced due to competitive conditions or other factors. In a 'hard market' rates per risk are increased. The same risk underwritten at different points in time of the insurance cycle should have the same risk margin, however if the risk margin is calibrated to the premium as described in option (a), this would not occur.

Insurance companies vary premium pricing for many different reasons. An insurance company may accept reduced premiums to buy business, to increase market share or to create an advantage in competing for more profitable business in other lines. If the risk margin is calibrated to the premium, this may not result in the appropriate risk margin to use in estimating an exit price representing the value at which those liabilities could be transferred.

Option (a) does not result in consistent accounting. If the premium calibrates to a loss at inception of the contract (after consideration of the liability adequacy test), that loss must be recognized, however if the premium calibrates to a gain, the gain is deferred. This is not a logical or consistent accounting answer. If the margin is to represent a building block in determining the current exit price, deferring gains results in additional prudence in the estimated claims value which is not consistent with the proposed objective of estimating the transfer value.

Option (c) is the most logical choice where calibration to the premium is used to check the reasonability of the risk margin. It results in recognition of deficiencies and gains at inception and is appropriate based on an insurance company's product pricing which may be dependent on the point in time of the insurance cycle in which it is operating. In a 'soft cycle' a company understands that it may be underwriting loss producing contracts whereas in a 'hard cycle' it understands that it is underwriting with good margins in hopes of offsetting the impact from potential loss business underwritten in the soft cycle.

(Please note that if a company always prices for underwriting profitability, in theory options (b) and (c) would be the same.)

Question 5: This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.

- (a) Is that measurement attribute appropriate for insurance liabilities. Why or why not? If not which measurement attribute do you favour and why?
- (b) Is 'current exit value' the best label for that measurement attribute? Why or why not?

In developing a framework for a model that incorporates the probabilities of all possible cash flow scenarios, market rate inputs and risk margins, the IASB is attempting to approximate the value that insurance liabilities could be exchanged between arm's length parties. This should theoretically represent fair value. It should be understood, as a result of the lack of a market for transfers of liabilities and the difficulty in obtaining market pricing and data after inception of a contract, that values can only be estimated and supported by complex modeling.

From our perspective, the real issue remains the quantum of the risk premium. If a company were to acquire a book of business from a competitor, the acquirer would require an additional risk premium for uncertainty in managing a book of business which it did not underwrite. This additional risk premium would impact the value at which the claims liability would transfer between two arm's length parties. Therefore in a market transaction, the exit value as contemplated in this paper would not necessarily represent the value at which claims liabilities would be transferred.

Question 6: In this paper, beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:

- (a) Incorporate them in the current exit value of a separately recognized customer relationship asset? Why or why not?
- (b) Incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?
- (c) Not recognize them? Why or why not?

No comment.

Question 7: A list follows of possible criteria to determine which cash flows an insurer should recognize relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?

(a) Cash flows resulting from payments that policy holders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.

- (b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?
- (c) All cash flows that arise from those terms of existing contracts that have commercial substance (i.e. have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).
- (d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.
- (e) No cash flows that result from beneficial policyholder behaviour.
- (f) Other (please specify)

No comment.

Question 8: Should an insurer recognize acquisition costs as an expense when incurred? Why or why not?

Key measures used by the non-life insurance industry to assess performance are the combined ratio and the expense ratio. Currently, both ratios include premiums earned and the impact of acquisition costs which have been amortized to operating expense. Under the 'provider of service' model, both premiums and acquisition costs have historically been amortized to the income statement over the term of the underlying insurance contract. (In effect the industry accepts that a component of the premium charged is a recovery of acquisition costs.) If the acquisition costs are expensed immediately and equivalent premium is recognized there should be no difference in the underwriting results over the term of the contract (assuming that the remaining premium is recognized over the term of the contract), however in the interim period in which the acquisition costs are expensed, those contracts will appear less profitable and the combined and the expense ratios will be higher.

Question 9: Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

Given that the current exit value is to reflect market rates and should be a value at which the liability can be transferred to a third party, this measurement should be consistent with fair value accounting as required for business combinations.

If this is the case and if there is a significant divergence between the fair value as determined in the business combination compared to the value for those insurance contracts as determined according to the acquiring company's policies and processes, it may indicate an issue with either of the valuations. Further investigation and resolution is then required.

Question 10. Do you have any comments on the measurement of assets held to back insurance liabilities?

Insurance companies manage their balance sheets by employing strategies to match assets and liabilities. It is logical that mismatches resulting from existing accounting standards should be minimized to help ensure that the true economic position is transparent to the users of the financial statements.

If current exit value approximates fair value and with the ability to designate financial assets at fair value through the profit and loss statement (IAS 39), any material accounting mismatches should effectively be eliminated assuming an insurance company takes advantage of this accounting option.

## Question 11. Should risk margins:

- (a) Be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?
- (b) Reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?
- (a) Insurance companies manage their risks either by portfolio or by line of business. Determination of risk margins should be at the portfolio level and this would be consistent with management's risk management strategies and operating polices and procedures.
  - The definition of the portfolio is appropriate. We would equate this to a line of business (in our company) which includes products with similar limits, coverages/exposures and development patterns, payout patterns and geographic location, i.e. a group of products managed together exhibiting similar risks.
- (b) Provided that capital is fungible, we believe a company should consider the diversification benefits (negative correlations) between portfolios to depict a transparent view of the entity. Only then can one compare entities which may or may not have portfolios with similar benefits or correlations. We recognize however, that while this concept in theory is sound, the modeling required to estimate these benefits would be very complex, difficult to audit and for many difficult to understand.

### Ouestion 12.

- (a) Should a cedant measure reinsurance assets at current exit value? Why or why not?
- (b) Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?
  - i) A risk margin typically increases the measurement of the reinsurance asset and equals the risk margin for the corresponding part of the underlying insurance contract.
  - ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.
  - iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.
- (a) Yes, a cedant should measure reinsurance assets at the current exit value to maintain a consistent basis of measurement with the liability. If the reinsurance program is valid, a cedant would not expect to recover on losses at a lesser amount than as recorded.
- (b) i) Measuring reinsurance assets at current exit value will include a risk margin which increases the asset as it equals the risk margin in the underlying insurance contract. Inclusion of the risk margin in the reinsurance asset essentially results in a gross up on the balance sheet as it is also included in the claims gross up line and ultimately in gross claims liabilities. The risk margin is effectively removed from the net claims liabilities for the portion of the losses which have been ceded to a reinsurer.
  - ii) Losses should be recognized when credit events indicate that an asset has been other than temporarily impaired or when disputes have arisen which indicate that an asset may not be fully recoverable. Credit issues and disputes are usually triggered by specific events. The application of an expected loss model on an asset balance estimated by an actuarial model results in a provision which may have little meaning and would be unlikely to approximate the ultimate loss outcome as an actual loss has not yet been incurred. The use of an expected loss model versus an incurred loss model is interesting as it will only function appropriately when applied to a large population of reinsurance recoverable balances which are homogenous. The incurred loss model would be consistent with current practice in the US and Canada as well as with IFRS 4 (phase I) and IAS 39.
  - iii) Rights to obtain reinsurance for contracts that have not yet been written will have a value but provided that pricing is based on current exit prices (or fair value), the value of the right should not be significant. Values of rights

normally would only fluctuate significantly if based on fixed pricing and the market value subsequently moves.

Question 13. If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?

In theory and for comparability across industry groups, deposits and service components of insurance contracts should be unbundled to ensure consistency in accounting regardless of whether the financial instrument is held by a bank or by an insurance company.

However, we believe these deposits and service components of insurance contracts are so interdependent with the underlying contract that it is very difficult to bifurcate and measure the components separately. (This issue is similar to that encountered with the bifurcation of derivatives from host contracts where many companies have elected to carry these hybrid contracts at fair value to avoid the cost of accounting for derivatives separately.) As insurance contracts are to be measured at current exit value, we suggest there is little risk in valuing the full contract at current exit value and in not unbundling these components.

### Question 14.

- (a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?
- (b) Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?
- (a) The current exit value of a liability neither improves nor impairs its credit characteristics. The value is what it is. The analogy drawn in the discussion paper is to debt. As many debt instruments are actively traded in the open market, the credit characteristics of an issuer are incorporated in the market pricing and are reflected in the yield on the instrument. An investor in debt instruments anticipates earning an investment return where he is appropriately compensated for risk as yields change. A policyholder is not anticipating an investment return on their insurance claims, but is expecting to be reimbursed for losses which the insurance policy covers. There is a difference in objectives between a debtholder and policyholder and as a result, perhaps the accounting for these instruments for this aspect should not be consistent.
- (b) It is unlikely that an insured would place its business with an underwriter which would not be able to support the claims payments as required. There is likely little impact from changes in credit characteristics to the current exit value of short tail liabilities, however, it may be more significant with longer tail liabilities. Policyholders expect to have their claims honoured and regulators closely monitor the solvency of insurance companies with the intent of protecting policyholders.

Under (b), in the event of a deterioration in its credit characteristics, an insurance company could reduce the value of the liability to something less than will ultimately be paid on settlement, thereby creating income at the same time. Assuming the company does not default on settlement, this income would be reversed in future periods. This does not seem logical. As financial statements are prepared on a going concern basis, it is not appropriate that an insurer by adjusting for credit characteristics would value the liability at something other than a value approximating the settlement value at that specific point in time or the value at which it could be transferred to another insurance company.

As an example, two identical insurance companies each underwrite identical risks for which they each charge the same premium. The exit value for each of these contracts on day 1 is 1,000CU. Assume six months later one company has suffered a credit rating downgrade. The impact of reflecting this credit characteristic in the exit value of the above contract would be to reduce the liability to 900CU, thereby creating 100CU in income. To transfer this liability to its competitor company, the liability would need to be increased back to the 1,000CU as the competitor company would not accept 900CU as adequate compensation for assuming an identical risk to that which is already recorded on its books at 1,000CU.

It may be relevant to adjust for credit characteristics if an insurance company was actively attempting to sell its portfolios or books of business to a third party or if there was an active trading market for insurance liabilities similar to debt (which has been used as the analogy to consider the impact of credit characteristics on claims liabilities).

Question 15. Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

IAS 39 and IFRS 4 Phase II should be consistent. An objective of an accounting framework is that similar transactions should be accounted for on a similar basis. In determining the accounting treatment of transactions for which there is no specific guidance by using professional judgment based on first principles, an accountant should conclude that the accounting treatment would be the same for transactions which in substance are the same. However, if two standards provide different guidance for similar transactions or instruments, consistency will be very difficult to achieve.

The IASB should consider removing the accounting option in IAS 39 whereby liabilities may continue to be accounted for based on amortized cost – this is

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inconsistent with the fair value model or current exit price proposed for the valuation of insurance liabilities.

As the insurance industry is highly regulated in most countries and regulators along with other stakeholders in a company would not want the value of the insurance liabilities as recorded in the financial statements to fall below settlement value, the IASB should consider implementing a floor value for insurance liabilities similar to financial liabilities with a demand feature under IAS 39.

The IASB also needs to focus on the revenue recognition guidance with respect to premiums. If a transaction is a financing transaction, it is logical that any monies received from a customer are recorded on the balance sheet. However, if premiums are received for a performance of service – i.e. assuming risk through the contract period - these premiums should be recorded as revenue as the insurer is providing a service for which it is being compensated, i.e. it is maintaining capital and liquidity to ensure it is able to fund future loss claims.

### Question 16.

- (a) For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?
- (b) An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247-253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?

No comment.

Question 17. Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?

- (a) Permit or require insurers to recognize treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the Framework's definition of an asset).
- (b) Permit or require insurers to recognize internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).
- (c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).
- (d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).

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No comment.

Question 18. Should an insurer present premiums as revenue or as deposits? Why?

Premiums for non-life contracts should be presented as revenue provided that there is risk transfer. Insurance companies are providing a service in that they are standing ready to reimburse policyholders for losses which may or may not occur, and for those that do occur, the timing is uncertain. Deposits imply that the insured will receive its premium back sometime in the future, however if there is no loss, those premiums will not be returned to the insured. Those funds will be used to pay for another insured's losses. Funds held on deposit with banks or fund managers are different in nature than a deposit component of a premium payment as there is a contractual right of the original depositor to the return of those funds.

Question 19. Which items of income and expense should an insurer present separately on the face of its income statement? Why?

For a non-life company, all of the following should be presented separately in the income statement:

- Gross premiums written as they give an indication of the volume of business an insurer writes;
- Net premiums written, as they provide certain important information about the level of risk an insurer is undertaking, particularly as to the extent to which reinsurance being used to manage risk;
- Earned premium as this is necessary to help understand the earning process.
- Losses, as they are necessary to understand the change in the liability account other than from claims payments. Additional detail, if necessary, can be provided in the notes to the financial statement on the changes in estimates;
- Policy acquisition expenses, as they indicate the cost of obtaining contracts;
   and
- Operating expenses, as these indicate the efficiency or productivity of the insurance company's administration.

Question 20. Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

Yes, all income and expense arising from changes in insurance liabilities for a non-life insurer should be reflected in the income statement. To record any changes directly through equity or by balance sheet movements only (deposit accounting) will only obscure the transparency of the financial reporting.