

Association canadienne des compagnies d'assurances de personnes inc.

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Sir David Tweedie Chairman, International Accounting Standards Board 30 Cannon Street London, EC4M6XH United Kingdom

#### IFRS 4 Exposure Draft – Comments of the Canadian Life and Health Insurance Association

Dear Sir David.

The Canadian Life and Health Insurance Association (CLHIA) appreciates the opportunity to provide comments to the IASB on the Exposure Draft (ED) of IFRS 4.

The CLHIA is the national trade association for life and health insurers in Canada and its members account for 99% of the life and health insurance in force in Canada and administer about two-thirds of Canada's pension plans. Our membership is diverse. It includes large companies operating internationally as well as companies operating only in Canada, direct writers and reinsurers, those writing a wide range of products and those serving niche markets with products tailored to their markets. We wish to ensure that all of our members will be well served by the IFRS ultimately adopted and that none of them will be disadvantaged vis-à-vis either domestic or international competitors.

#### Introduction

We believe that it is vitally important that our financial statements continue to accurately reflect the economic results of our operations consistent with our long-term business model. The bulk of the insurance business of Canadian life insurers is, by any measure, long-term with insurance contracts extending 20, 30, 40 or more years into the future.

This is our initial, high level response to the ED. It focuses on our key concerns. In subsequent communications we propose to:

- Respond to the specific questions of the Board set out in the Introduction section of the ED;
- Further explain our concerns and support them with quantitative examples; and
- Comment on Presentation and Disclosure matters.

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While some of those are also of deep concern, we prefer to deal in this initial communication with the substance of measurement before turning to how its results are presented and explained to users. We look forward to working with your staff and the Board to develop solutions.

Our objective is to ensure that all of our members benefit from a robust and well accepted insurance contract standard that is consistent with the accounting standards for banking and mutual fund products, leases, and financial instruments. We urge the IASB to continue to work closely with FASB, to ensure that the content and timing of adoption of any final standard is converged with the US developments to the maximum extent possible.

We believe that the acceptance of a single set of financial statements by many audiences is a true measure of reliability, relevance and decision usefulness. In Canada, we rely on a single set of financial statements for all key purposes, including GAAP reporting to our investors and policyholders, solvency reporting to our regulators and the determination of taxable income.

# **Executive summary**

We believe that for long-term insurance the single most significant problem in the proposed standard is the determination of the discount rate.

We note the Board's reasons for the proposed measure of risk-free yields plus an adjustment for the liquidity – or more precisely the illiquidity – characteristics of the insurance contract portfolio being measured. We submit, however, that in the case of life insurance contracts, most of which are long-term in the Canadian and indeed North American context, the proposed approach is in such radical disharmony with the underlying business model and with economic reality as to result in financial reports that will be neither relevant nor reliable, extremely difficult to explain and likely lack comparability.

We understand that many, perhaps most, markets around the world have much shorter business horizons and are thus less impacted by the proposals. For us, however, the issue is vital. It is inevitable that the ED's discount rate proposals will lead to substantial unintended business consequences for us, which will include some, perhaps all, of the following:

- Substantially increased volatility of our balance sheets and income statements; moreover that volatility will often be pro-cyclical and thus may contribute to destabilizing capital markets;
- Material increases in the cost of capital, reduction in its availability, or both;
- Material weakening of long-term insurance guarantees, increases in their cost to the purchaser, or both. Possibly, their withdrawal from the market. As noted above, this is our primary market;
- Since investors hate balance sheet and income volatility, insurers will strive to minimize them. The most straightforward way to do so is by concentration into investment choices that are consistent with the insurance contract measure benchmark and, likely, that shorten credit horizons<sup>1</sup>. Such an increase in concentration is counterproductive, as was amply demonstrated by the recent financial crisis:

<sup>&</sup>lt;sup>1</sup> For example, by preferring a shorter maturity bond (to reduce credit risk exposure) together with a long interest rate swap with a highly rated counter-party, to produce a synthetic long bond.



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 Reduction in the availability of long-term financing for commercial mortgages, publicly traded corporate bonds and private placement bonds as insurers find themselves constrained to strive to moderate financial statement volatility. Reduction in the availability of funds for infrastructure investment.

We emphasize our concern with the discount rate proposal, because it overshadows all else. It is the first issue addressed in detail in the Primary Concerns section below. We do have several other primary concerns, which are listed in the Overview section and elaborated in the Primary Concerns section.

This should not obscure the fact that we do find much to agree with in the ED, as also set out in the Overview section below. We are therefore optimistic that the primary concerns can be addressed to the benefit of all.

#### The business model

The bulk of the policy liabilities<sup>2</sup> of Canadian life insurers consist of long-term illiquid or of relatively less liquid contracts. For terminology purposes, long-term in this context means at least ten years but liability cash flows can extend over 40 or more years.

In order to minimize economic mismatch, the practice of Canadian insurers is to build a portfolio of assets the cash inflows from which match the expected cash outflows of insurance contracts, increased by margins for adverse deviation (analogous to the risk margins of the ED).

In assessing that match, projected asset cash flows are reduced for both expected and unexpected credit losses and for any other issuer options or other risks that may be implicit in the asset. Given the inherent illiquidity of our liabilities, Canadian insurers strive to acquire illiquid assets that match the liability and offer better yields. Issuer options, including pre-payments are typically limited or avoided in order to support the matching position.

Liquidity is constantly tracked to ensure that the company is able to withstand unexpected policyholder demands but this is typically a secondary constraint<sup>3</sup>.

The essence of the business model, therefore, is the consistent management of policy obligations and the assets required to fulfill them, and Canadian GAAP ("CGAAP") requires that the liability measure be based on the cash generating capacity of the supporting assets and that it provides for adverse market movements (both interest rates and other applicable market variables). Note that does not mean that should such market movements actually occur, there will be no impact on surplus (or liabilities) for two key reasons:

<sup>2</sup> We refer to policy liabilities because some of the policies are not insurance contracts and contain no discretionary participating features. They are therefore classified as financial liabilities, commonly referred to as investment contracts, or service contracts. By far the vast majority of our policies are, however, insurance contracts as defined under IFRS 4. A recent informal survey of our members confirmed that over 90%, and perhaps as much as 95% of the total policy liabilities are insurance contract liabilities.

<sup>&</sup>lt;sup>3</sup> In fact there has been no precedent for a Canadian insurance company experiencing a "run on the bank". The most important threat of enhanced demand for liquidity has been experienced during a period of rapidly rising interest rates resulting in "disintermediation", but it was of relatively limited extent.



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- The long-term nature of the liabilities make it at least difficult and often impossible to match liability cash flows because sufficiently long-dated assets are not available, and even within the matchable range it is not possible to create a perfect match; and
- Once the adverse movement has taken place, the liability provision must then provide for a further adverse movement from that starting point.

In summary current CGAAP recognizes and follows the business model.

#### Overview

The Canadian life insurance industry supports the general scheme and much of the detail of the ED. For example:

- We support the fulfillment approach to the measurement of insurance contract liabilities. Given that the insurer will be called on to fulfill its obligations under its insurance contracts, this is by far the soundest and most defensible approach. It is relevant, it is practical and it is understandable.
- We support the building block approach to the measurement of (life) insurance liabilities and, in particular, the use of explicit current best estimates and identified risk margins.
- We concur that risk margins should be linked to, and set on the basis of, the uncertainty in the amount and timing of cash flows arising from insurance contracts.
- We understand the reason for, and reluctantly accept, the inclusion of a residual margin. We
  note, nonetheless, that current CGAAP does not require such a margin and its absence has not
  proven to be a problem.
- We understand the reason for and in general support measurement at the portfolio level.
- We concur with the criteria for recognition and derecognition.
- We understand and accept the unbundling of not closely related components of a host insurance contract, including embedded derivatives.
- We strongly support the non-reflection of "own credit risk" in the fulfillment cash flows.

We do, however, have grave concerns with several key components of the proposed ED, which we set out below. We are concerned that, if unaddressed, these issues could and frequently would result in insurance contract measurements that are neither relevant nor reliable for users of the financial statements for purposes of making economic decisions. Information about the financial position and performance of issuers of long-term insurance contracts will lack understandability and will likely also be inconsistent among preparers due to materially differing interpretations of key aspects of the measurement. We trust that the IASB can and will address our concerns about the measurement of long-term insurance contracts.

Our critical issues stem from the long-term<sup>4</sup> nature of much, indeed for many Canadian companies most or all, of their business. That long-term horizon has implications that shorter term businesses are not subject to, or only to a much smaller extent. The business model of our industry reflects that long-term aspect.

<sup>4</sup> Term of cover is a continuum. For purposes of convenience and clarity of interpretation, we refer as "long-term" to any insurance cover the expected term of which (using most probable or best estimate assumptions) exceeds ten years. This demarcation line has no specific significance. It would make little difference if we selected 15 years instead of ten.



Here is a list of our primary concerns, each of which is discussed below:

- 1. The determination of the time value of money (the "discount rate"). This is by far our most critical concern.
- 2. The acceptable methods of determining risk adjustment.
- 3. The limitation of expenses that may be included in the cash flows.
- 4. Unbundling and the meaning of "closely related".
- 5. Transition.
- 6. Income taxes.

Finally we are deeply concerned with the application of the IASB's due process in the case of IFRS 4.

In most, if not all, jurisdictions, the proposals under the ED for IFRS 4 represent a sea change in accounting for insurance contracts. Canada is such a jurisdiction. We are extremely concerned that ample time be provided to assess the impact of those changes in the interests of developing an accounting standard for insurance contracts that reflects the various business models, that reflects economic mismatch but does not introduce material accounting mismatch, and the implications of which are thoroughly understood before becoming final.

In our view, the revision of IFRS 4 is a major project, as that term is used in paragraph 42 of the IASB Due Process Handbook, so that a comment period longer than 120 days would have been well warranted. It will be critical for us and for other commentators to have the time to develop and present both qualitative and quantitative evidence to support our key concerns and to assist staff and the Board in finding solutions. Further, we anticipate that the IASB may find that it would be desirable to issue a second exposure draft given the extensive concerns (ours and others).

It would be lamentable if, in the end, users of financial statements of insurers would come to prefer non-GAAP measures and regulators would be unable to use GAAP financials as the starting point for prudential requirements, simply because insufficient time was taken to understand and fully analyze the implications of the revision of IFRS 4. In so saying, we appreciate that it is impossible for the IASB to accommodate all concerns, some of which may well be inconsistent or diametrically opposite. But the time should be taken to arrive at the optimal solution given all concerns, so as to maximize the likelihood that the final standard will indeed become the accepted international standard and GAAP financials will be the cornerstone for decision-making for all users, both investors and other users.

# **Primary concerns**

#### Discount rate

The most important single problem for Canadian life insurers is the determination of the discount rate. We understand the Board's reasons for the proposed measure of risk-free yields plus an adjustment for the liquidity – or more precisely the illiquidity – characteristics of the insurance contract portfolio being measured. We submit, however, that in the case of long-term life insurance contracts, the proposed approach is in such radical disharmony with the underlying business model and with economic reality as to result in financial reports that will be neither relevant nor reliable, extremely difficult to explain and inconsistent among preparers and among industries. Such long-term life insurance contracts are pre-



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dominant in Canada and in the US and, we understand, important for a number of other jurisdictions including the UK.

The business model is presented above. Its essence is that our life insurance business is to manage assets and liabilities in an integrated fashion, pursuant to a model that could be described as analogous to a replicating portfolio or analogous to hedging the liability cash flows. The primary aim is to match future policy liability cash flows<sup>5</sup>, including risk margins (called Margins for Adverse Deviation or MfADs under current CGAAP) with net realizable future asset cash flows. "Net realizable" means that asset cash flows are reduced for expected and unexpected credit losses and their timing and/or amount adjusted for the exercise of issuer options (call, prepayment right etc.) where it is economically advantageous for the issuer to do so (although insurers strive, and to a large extent succeed, to acquire assets with no or minimal issuer options).

Although the model strives for accurate cash flow matching, full matching is never achieved because a replicating portfolio does not exist. Especially important in that regard is the impossibility of matching liability cash flows that are projected to occur past the horizon beyond which a sufficiently deep market for fixed income assets does not exist.<sup>6</sup>

Whether economic mismatch arises from imperfect or non-existent opportunities for matching or from other reasons, it is an integral and indispensable component of current CGAAP to provide for the risks of adverse market movements, also referred to as reinvestment/disinvestment risk.

In essence, the policy liabilities are measured on the basis of the balance sheet value of the assets that are projected to deliver the cash flows to satisfy the liability cash flow requirements, after provision for all plausible uncertainties of both asset and liability cash flows (including the liability liquidity risk of earlier than expected demand for cash withdrawal benefits). The measurements are consistent, recognize and provide for economic mismatch, but do not give rise to material accounting mismatch.

The discount rate proposed under the ED, by comparison may, and often would, give rise to accounting mismatch for the following reasons:

1. <u>Separate and inconsistent measurement of assets and liabilities fails to take account of the business model.</u>

The IASB has recognized the importance of consistency of the accounting model with the business model. The IASB has also espoused the objective for the accounting model to provide for economic mismatch while avoiding accounting mismatch as far as possible. A major specific example of the consistency of the accounting model with the business model is the adoption of the amortized cost model for fixed income assets (IFRS 9) and liabilities (IAS 39 and expected for IFRS 9) because it is consistent with the deposit-taking business model. We note that a key aspect of the amortized cost model is the consistent measure applied to assets and liabilities. We

<sup>5</sup> Under current CGAAP, all policies, including those that would not be classified as insurance contracts under IFRS, are measured using the same method.

<sup>&</sup>lt;sup>6</sup> Optimal matching may also not be achieved due to excessive frictional costs of too frequent rebalancing or because of possible anticipation of interest rate movements. The latter, however, is always subject to strict risk tolerance policy guidelines.

<sup>&</sup>lt;sup>7</sup> That provision is achieved by projecting the net cash flows (asset less liability cash flows by period) on a number of plausible adverse scenarios, stochastic or deterministic, and basing the liability measure on the worst plausible scenario (or, say, CTE 70 if the scenarios were stochastic).



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submit that it is equally appropriate to recognize the business model of long-term life insurance. However, the model of the ED imposes inconsistent measures on the two sides of the balance sheet, resulting of necessity in accounting mismatch and inappropriate volatility of net assets (accounting capital and surplus) and of accounting income, hence impaired reliability and reduced decision-making usefulness of the financial statements.

## 2. Discount rate is not tied to the asset earning capacity pursuant to the business model.

BC96 states: "...the Board rejected asset-based rates because those rates are irrelevant for a decision-useful measurement of the liability...". We respectfully dispute that assertion in the case of long-term illiquid insurance contracts (including those with some, but limited, liquidity), which represent the bulk of the insurance contract obligations of Canadian (and US) life insurers. We submit that it is inconsistent with the fulfillment concept and utterly inconsistent with the business model. Essentially, the ED attempts to set a current fair value on the insurance contracts. But the essence of both our business model and the fulfillment model is (or should be) that cash has to be available to fulfill insurance obligations with a sufficiently high degree of likelihood. The further those obligations are in the future, the less relevant the basis proposed by the ED, linked to current interest rates, becomes, and much or most of them tend to be far in the future. Hence ignoring the cash generating capacity of the assets in measuring the liabilities makes the proposed measure less decision-useful and potentially highly misleading. We submit what matters to both investors and other users (e.g. insureds and regulators) of life insurer financial statements is being able to form a sound judgment about the ability of the enterprise to fulfill its contracts and generate profit. For that purpose, the relationship of asset and liability cash flows is critical. Surveyed views of both buy and sell side analysts confirm the primary importance they place on that relationship (i.e. net cash generating capacity). A selection of recently published such views is shown in the Appendix. To date, we are not aware of any Canadian analysts who support the ED with respect to life insurance.

#### 3. Does not separately deal with very long duration liability cash flows.

The extension of the yield curve to points beyond where deep and liquid markets for assets exist may be unimportant for short-term businesses but is of critical importance for life insurers much or the bulk of whose business is long-term. The discounted value of fulfillment cash flows that simply cannot be matched, because no assets long enough exist, can be a material component of the total insurance contract measure. We submit that any notional extension of the current yield curve that in essence projects an extension of the current term structure introduces unwarranted volatility in the measure, since the discounted value of unmatchable cash flows is highly sensitive to changes in the discount rate. Once again, such volatility is spurious in that current interest rates are irrelevant in predicting yields 20 or more years into the future. We propose that the discount rate for time periods beyond what is currently matchable be based on a long-term moving average, so that it would respond to major and enduring trends but not to momentary yield curve volatility, a concept that we understand CEIOPS is also espousing.

#### 4. Lack of guidance with respect to the liquidity adjustment.

The ED does not offer guidance on how to determine the liquidity adjustment. No method for so doing is prescribed on the reasonable grounds that no consensus exists on how to do so, yet this obligation is imposed on preparers. This will inevitably lead to differences of interpretation and



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lack of comparability. The language of the ED (paragraph 34 and BC99) presents the concept that the liquidity adjustment should be based on the value of the theoretical embedded put option implicit in the price of highly liquid risk-free instruments, but no generally accepted method exists for determining the value of such a theoretical derivative<sup>8</sup>. Consequently, the reliability of the measurement of long-term insurance contracts will be suspect and users will be hard pressed to understand the financial statements.

There exists extensive empirical historical evidence that the "illiquidity premium" in illiquid instruments such as commercial mortgages or private placements is substantial, if that illiquidity premium is defined as the excess of the yield on such an instrument less a provision for both expected and unexpected credit losses. Moreover, empirical evidence confirms that spreads on corporate bonds with limited or no embedded options (such as call or prepayment features) that are generally traded in relatively deep and liquid markets – hence their yields are lower than corresponding instruments with no liquidity – are nonetheless well in excess of what expected and unexpected credit risk would be priced at. We will be presenting such evidence to the Board in a follow-up submission.

#### 5. Inconsistency of asset and liability measures.

However the liquidity adjustment is measured, there can be no doubt that the measurement of insurance contract liabilities will be inconsistent with the measurement of the supporting assets, even when the cash flows are near-perfectly matched<sup>9</sup>. The consequence is inevitable accounting mismatch. That is true when assets are measured at fair value and even more true if eligible assets are measured at amortized cost. In fact, the amortized cost option for assets is of no value to the measurement of long-term life insurance because of the extreme potential accounting mismatch and so would be unlikely to be taken advantage of.<sup>10</sup>

#### 6. Impacts from increased volatility arising from accounting mismatch.

We note that the likely accounting mismatch we perceive to be embodied in the ED is in general unfavourable to life insurers in that, for reasons set out above, it is likely to lead to unjustifiably (from an economic perspective) increased volatility of results, hence increased cost of or reduced access to capital. It may also materially and needlessly increase the quantum of insurance liabilities, depending on the interpretation of how the liquidity characteristics of insurance contracts are taken into account.

But we note that opposite effects may also arise, which are also inappropriate. For example, if the illiquid liabilities are extensively backed by highly liquid assets, then material future cash flow shortfalls can arise, because the measurement of the liabilities implicitly expects the "illiquidity premium" in the discount rate to be available to fulfill the contract obligations, but that may not be the case. <sup>11</sup> Indeed, the measurement of insurance contracts can be materially understated, obscuring the insufficiency of asset cash flows to fulfill the liabilities. A model based on cash flows avoids that pitfall.

<sup>&</sup>lt;sup>8</sup> One approach that has been suggested is the spread between the swap curve and the treasury curve, which is small in normal times (perhaps 10 to 20 bps) but does expand in times of financial stress.

<sup>&</sup>lt;sup>9</sup> Perfect match is not possible since a replicating portfolio does not exist.

An historical asset value compared to a current liability value is a classic example of an accounting mismatch.

This is actually a potential defect of the amortized cost model too.



# 7. The proposed model fails to reflect reinvestment risk.

Similarly, should the fulfillment cash flows be negative at times, the ED discount model is silent on how to provide for reinvestment risk. This is a consequence of the model providing risk margins for uncertainty of the best estimates for all insurance risks, but not providing for the uncertainty of the discount rate estimate. Fulfillment cash flows are inevitably negative – that is, inflows – for new annual premium life insurance business, but tend to be positive for in force business. However, ample precedents exist where that is not the case, such as the business of recently formed companies or those with immature portfolios.

Applying the ED discount model in such cases can result in a material understatement of insurance contract liabilities, since the risk that future cash inflows, when received, could not be invested at the assumed discount rates is ignored <sup>12</sup>.

Analysts in Europe, Asia and North America use, and expect to continue to use post IFRS, non-GAAP measures in order to attempt to get closer to economic results and to cash flow generating ability, hence profitability. They currently do so, we understand, because in a number of jurisdictions, material mismatches may exist between asset and liability measures. That does not tend to happen currently in Canada, but will happen inevitably absent changes to the ED. Regulators may also find it necessary to adjust the GAAP financials prepared pursuant to IFRS, as a result of concerns of the type presented in this letter. In Canada, we are in the fortunate situation currently of being able to use a single set of financials, prepared pursuant to CGAAP, for all purposes: public financial reporting, prudential regulation and even corporate income taxation<sup>13</sup>. That felicitous state of affairs contributes to credibility, relevancy and decision-usefulness that we would be reluctant to lose as a result of an accounting model less pertinent to our business model. We are anxious to assist the IASB and staff to achieve that end. We are convinced it can be done.

# Acceptable methods of determining risk adjustment

Paragraph 35 of the ED prescribes that the risk adjustment for the risk should be "...the maximum that the insurer would rationally pay to be relieved of the risk that ultimate cash flows exceed those expected." It further prescribes that the risk should be estimated at the portfolio level. We accept both of those requirements.

The preparer is then referred to B67 through B103 of the ED for guidance for estimating the risk adjustment. That guidance directs that:

- > The risks to be provided for are those embodied in the insurance contract and exclude investment risk (unless such risks affect the amount of payments to policyholders); and
- Any of three, but only those three, techniques is to be followed in estimating risk adjustments.

<sup>12</sup> Consider, for example, an attempt by the insurer to hedge the risk by borrowing today or by using interest rate derivatives. The cost of that hedging can readily be seen to be missing from the proposed liability measure.

<sup>&</sup>lt;sup>13</sup> The *Income Tax Act* does impose a number of adjustments; still the consistent starting point and reconcilability are considered important aspects.



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The three techniques are confidence level (or VaR), conditional tail expectation (CTE or TailVaR) and cost of that portion of total capital that is related to the insurance risk.

We accept that CTE and the cost of capital related to the insurance risk are reasonable theoretical approaches to estimating risk but, for the very reasons set out in the ED (paragraph B76), we think that confidence levels are inapplicable in enough situations to call their general acceptability into question. Most of the important insurance risks, other than perhaps mortality (and sometimes even mortality), tend not to be distributed normally. Many tend to be concentrated in the tail of the distribution. For that reason, we wonder about the inclusion of confidence level among the acceptable techniques and we do not understand the reason for the translation of all other measures to the least meaningful one for disclosure purposes.

We concur that CTE is a sound measure theoretically. However, in the practical world, it is often a difficult or impossible measure to apply because at the current stage of technological development, multivariate stochastic distributions over many variables cannot be directly modeled. We do use the CTE measure in Canada in at least two situations: estimating the risk in guarantees under segregated fund products (both equity and bond) and estimating the interest rate (reinvestment/disinvestment) risk in insurance portfolios by means of stochastic interest rate generators.

We further concur that cost of capital may be a sound indirect measure in that it reflects the cost of maintaining sufficient economic (or regulatory) capital to provide for the insurance risk. However, it has the key practical disadvantage that it is unobservable in practice, because it is only a component of the total cost of capital, hence open to considerable differences of interpretation unless further guidance is provided. For that reason, interpretations are likely to diverge in practice leading to lack of comparability and perhaps opportunities for income or balance sheet "management".

Because of the actual or potential disadvantages of both techniques that we concur are theoretically sound, we would recommend that simpler, perhaps theoretically less elegant, but more readily implementable techniques also be permitted. For example, one such possibility is to propose a standard range of risk adjustments, set out conditions which would justify being nearer the low or high end of the range and also set out circumstances (expected to be rare) that might justify going outside the range. Again, we would be ready to assist the Board and staff in fleshing out such a technique.

Risk measurement techniques are evolving rapidly. It would be regrettable if the prohibition of all techniques other than the specifically permitted ones would inhibit the development and application of sound new techniques.

#### Limitation of expenses that may be included in insurance contract cash flows

#### 1. Acquisition expenses

We understand the motivation of the Board in restricting acquisition expenses, but we submit that restriction thereof to the individual contract level is inconsistent with the scheme of the ED, which adopts the portfolio (as defined in Appendix A of the ED) as the unit of measure. It is also inconsistent with the annual premium life insurance business model, because there are a number of types of acquisition expense that are current incremental acquisition expenses and that can be



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tied directly to the new business component of a portfolio, but that cannot be tied directly to individual contracts. Examples of such portfolio level incremental expenses include:

- The costs of direct marketing, that is, the costs of specific offer campaigns and the related costs of contract delivery. <sup>14</sup>
- The portions of the costs of supporting a tied agency force that are not related to particular contracts, but are directly and incrementally related to the portfolio. Such costs include volume or success bonuses that are dependent on aggregate sales levels, subsidies to new career agents, new business bonuses to supervisors and managers that are not directly incremental at the contract level, such as those dependent on aggregate production of the unit or branch and which can also be dependent on persistency.
- Volume and like bonuses that are payable to brokers, general agents or managing general agents.

Even including such portfolio level acquisition expenses would not cover anything like total acquisition expenses normally incurred, so that compared to current CGAAP the capital investment in new business would increase, leading to the unintended consequence of higher prices to consumers to support the cost of carry of the additional capital. The key safeguard in both the current Canadian system and under the ED is that should acquisition expenses considered in the cash flows result in a loss on sale (be less than fully recoverable under assumptions used in the liability measure) then the loss must be recognized immediately.

#### 2. Administration (maintenance of in force) expenses

We perceive a contrary problem with respect to administration expenses. The fulfillment principle that is the cornerstone of the liability measure requires that the liability measure be sufficient to allow fulfillment of all in force contracts. At the same time, the ED prescribes (see paragraph B61) that only those cash flows be taken into account that are incremental to the portfolio, both "direct costs and systematic allocations of costs that relate directly to the insurance contracts or contract activities."

Our concern is with systematic allocations of costs that <u>relate directly</u> to the insurance contracts. That definition may leave out expenses that are clearly necessary on a going concern basis to enable the insurer to fulfill in force contract obligations but that cannot be related directly to the insurance contracts in the portfolio. There can be several types of such expenses, such as IT, human resources, costs of accounting and taxation etc. It is possible, however, to identify the portion of such costs that are necessary to preserve the ability to fulfill all in force contracts at the entity level and, in our view, such costs should also be allocated to and incorporated in the liability for in force contracts.

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<sup>&</sup>lt;sup>14</sup> In the case of direct marketing, the incremental sales cost at the individual contract level is trivial because response rates are typically a small fraction of mailings, yet indisputably it is the aggregate cost of the campaign that is incremental at the portfolio level and is spent to acquire new business.



# Unbundling and the meaning of "closely related"

The ED requires that not closely related components of a host insurance contract that would otherwise be accounted for under a different IFRS be unbundled and accounted for under that other IFRS. The term "closely related" is not defined in the ED, nor discussed in the Basis for Conclusions. It is used in IAS39, but in that case also there is limited guidance only, in particular with respect to embedded derivatives (paragraphs AG 27-33), mostly by examples of what would be considered closely related or not closely related.

Although generally most components of insurance contracts are closely related as we interpret that term, we accept that there can be components that are either not closely related or about which views can legitimately differ. Without more guidance, it is likely that different preparers will come to different conclusions about which components need or need not be unbundled, leading to loss of comparability.

A particularly important case for us concerns Universal Life (UL) policies. The ED specifies (paragraph 8(a)) that an account balance that is credited with an explicit return and the crediting rate for which is based on the performance of a pool of investments (the pool may be a pool of general account investments) should be unbundled. All UL policies possess an account into which premiums are paid, out of which the costs of insurance coverages and expense charges are deducted, and by reference to which liquid values are determined. It is important to note, however, that liquid values often differ materially from the account value.

Often such accounts under UL policies consist fully or in part of the type that the ED instructs should be unbundled. The implicit assumption is that such account balances are deposit-like and should be treated as deposits for accounting purposes. But rarely, if ever, is that the case in practice. The account is simply a convenient reference for determining the quantum of benefits under the contract. It is not a deposit in the normal sense, because some or even all of it may be unavailable to the owner as liquid value and because its development is inextricably linked to the operation of the contract.

We would appreciate confirmation that, notwithstanding paragraph 8(a), such UL account balances need not be unbundled, because their closely related nature trumps the requirements of 8(a). Were that not the case, issuers of many types of UL policies would be hard pressed to determine the residual insurance contract cash flows<sup>15</sup>, and the measure of the contract as a whole would be internally inconsistent, hence not decision-useful. For many companies such contracts represent a substantial proportion of their total business, so the matter is of primary importance.

<sup>&</sup>lt;sup>15</sup> Further complicating this task is the requirement to remove cross-subsidies.



#### **Transition**

There is a potential conflict arising from the effective dates of IFRS 4 and IFRS 9. The latter will govern accounting for financial assets and financial liabilities other than insurance contracts. Not only is there a risk of the cost and complication of a potential double conversion, but it may not always be evident what the optimal choices are if one is effective before the other.

The industry has already noted this issue and we believe that the IASB is well aware of it. Nonetheless, we wish to reinforce the point that it will be important for the IASB to ensure the opportunity for a single conversion date for both IFRS 4 and IFRS 9 for all preparers, to avoid putting them in a difficult situation.

A second material point to note with respect to transition arises from the proposal under the ED to measure in force insurance contracts without any residual margins. It is understandable why the IASB opted to stay away from residual margins on conversion, but the result for some companies will be a one-time increase in capital (because for those companies insurance contract liabilities will decrease) and a corresponding decrease in the present value of future earnings, hence a decrease in ROE (because the one-time increase in capital would normally have flown through year-by-year earnings). Whether the impact will be material is unforeseeable at this time, but for some companies it may well be. One potential solution to this issue would be to permit an initial residual margin on conversion equal to the reduction, if any, of the insurance liability at that point, to be amortized over the remaining lifetime of the insurance contracts in force at conversion.

Finally, there is no doubt that for virtually all preparers (not only Canadians) the revision of IFRS 4 whatever its final form, will impose massive preparations. This applies not only to the substance of the measurement model but also to the extensive new disclosure requirements. It is therefore imperative in our view to

- 1. Ensure that the measurement model is appropriate, and
- 2. Allow sufficient lead time for revisions of systems and processes, the development of comparables and the design of disclosures judged to be the most relevant in the circumstances of the insurer.

#### **Income taxes**

IAS 12 and proposed revisions all specify that future income taxes are not to be discounted. This is also consistent with current CGAAP, except in the case of future income taxes related to policy liabilities. For the latter, the Canadian Actuarial Standards, imported by reference into CGAAP, stipulate that future policy related income taxes should be considered as any other policy cash flow, hence discounted. There is good reason for this; there have been many instances where the present value of future income taxes differed substantially from the undiscounted value. In such cases non-discounting of income tax cash flows related to policies would result in material misstatements of balance sheet values for long-duration contracts.



This would perhaps be less bothersome if the reader of financial statements could be confident that nondiscounting always results in overstatement of liabilities, hence balance sheet conservatism (though at the cost of loss of reliability), but there have been many observed cases in the Canadian context where the opposite was the case. Indeed, there have been cases where a material undiscounted income tax asset turned into a material liability once discounting was applied.

Whether this issue will be material in future in the Canadian context is not predictable at this time, because the Department of Finance will likely react to the change in accounting model, but it is likely to be. For other jurisdictions, the less the relationship between financial accounting and the tax base the more likely is the issue to be material. Since several Canadian companies have substantial businesses outside Canada, this may become a material issue for some or all of them.

Yours sincerely,

(Original signed by)

Frank Swedlove

cc: IASB Board members,
Peter Clark, Director of Research, IASB

FS: 211



# **Appendix: Comments of analysts**

#### Canaccord Genuity (Mario Mendonca) – Research Report - August 3, 2010

"Without the link between assets and liabilities, the greater the extent to which the mix of assets supporting liabilities differs from 100% risk-free bonds, the greater the volatility...The result would be a massive (and nearly meaningless) loss in the quarter, only to be followed by massive gains in subsequent quarters...leaving investors and analysts trying to block out all of the noise caused by an absurd accounting standard."

"In any event, without some wholesale changes to IFRS for insurance contracts as it stands today, the impact on book value, earnings volatility and potentially returns (to the extent that the insurers change asset mix) will vary from negative to very negative."

"Importantly, however, if the insurers migrate to lower yielding securities and government bonds, the expected returns on new business will collapse causing the insurers to raise premium levels significantly on long-dated life insurance."

"Perhaps one of the most attractive and distinguishing features of CGAAP is the strong link between assets and liabilities...the IASB states that this approach means the insurer takes credit immediately for the investment performance it hopes to achieve in the future...In our view, the CGAAP approach is not about taking credit for hoped for asset performance; instead is based on expected asset cash flows, in a manner no different than expected premiums, claims, policyholder behaviors, or any other set of liability-based assumptions"...

"Essentially, the IASB wants the liability to be discounted at rates reflective of the liability not the asset. In this way, the important link between assets and liabilities under CGAAP is broken."

## Desjardins Securities (Michael Goldberg) – Financial Services Focus – September 30, 2010

"The recent proposal by the FASB for US insurance companies to abandon US GAAP in favour of adopting IFRS means Canadian companies gain a big powerful ally in their effort to preserve the linkage between asset and liability valuations as opposed to the de-linkage proposed by the IASB. It also heightens awareness of the problem created for regulators by the de-linkage. The proposal also increases the likelihood that regulators and investors will have available more relevant and usable financial information than the IASB's flawed proposal".

# BMO Capital Markets (Tom MacKinnon, John Reucassel, Atul Shah) - Financial Services Weekly Update - July 12, 2010; August 2, 2010

"...the volatility still lies in the fact that lifeco liabilities will be discounted at a risk-free rate, rather than a rate that reflects the assets backing the liabilities. We've always had a problem with this supposed delinking, proposed by IASB in its 2007 Discussion Draft and once again confirmed in the recently released Exposure Draft. Under CGAAP, liabilities are essentially discounted at a rate that reflects the assets backing them, so changes in the market values of assets and the statement values of liabilities essentially



move together. We get some interest rate sensitivity currently under CGAAP largely due to the fact the CFs are not perfectly matched ... But under the IFRS Phase II proposals, the interest rate sensitivity will be significantly higher. And not only that, lifecos will essentially get no credit for very good and sophisticated asset/liability matching."

"We suspect OSFI may...consider the results of these stress tests for assessing the adequacy of capital/solvency buffers as it works towards a new approach to capital in a post-IFRS Phase II world – at which time these new accounting methods will be implemented, which, in their current form could significantly change the way life insurance contracts are valued and will therefore necessitate modifications to capital requirements."

# RBC Dominion Securities (Andre-Philippe Hardy) - Research Report - May 7, 2010

"If Phase II is implemented as currently proposed, we believe it would lower shareholders equity and introduce more quarterly volatility in financial results"

"The two important items that may cause material balance sheet and income impacts are (1) the use of a risk-free rate as the discount rate for liabilities plus an adjustment for illiquidity....and (2) the removal of the existing CGAAP link between actuarial liabilities and the investment assets that back those liabilities."

#### TD Newcrest (Doug Young) - Action Notes - MFC - August 6, 2010

"All changes will decouple the valuation of policy liabilities from the valuation of supporting assets. For policy liabilities, market discount rates will be the significant input. Generally, this rate is lower than portfolio investment rates, leading to higher liabilities and significantly higher earnings volatility driven by changes in market discount rate spreads versus investment yields."

#### Cormark Securities (Darko Mihelic) - Broken Trust Breaks Our Thesis - August 6, 2010

"We no longer trust the accounting system about to be thrust upon the lifecos. Recent exposure drafts and the early read from the lifecos themselves suggest that eventually, once IFRS is fully phased in, it will look like CGAAP on steroids. The transition could be painful as could the quarterly EPS volatility. This cannot be good for the stocks no matter how much the lifeco's draw our attention to USGAAP and the easy treatment therein."



## **UBS** (Peter Rozenberg) - Canadian Life Insurers: Initiating Coverage

"We note that new IFRS accounting rules in 2011, and specifically the second phase of IFRS rules which will likely come into force by 2013, could also result in increased earnings volatility and higher capital requirements."

"We expect this may lead to increased initial capital requirements, as well as even more earnings, capital and book value volatility in the future."

# <u>Citigroup Europe UK (James Quin) - European Insurance: (Not Too Many) Happy Returns. A</u> Painful Decade — The insurance sector - July 29, 2010

"Of course, measuring value in the life business has its challenges, and IFRS equity here has a number of flaws — most notably, the mismatch in how assets and liabilities are valued. In addition, IFRS earnings tell us nothing about the quality of new business, and current life disclosures are not good enough to give investors any real level of insight as to the drivers of performance."

# <u>Citigroup (Colin Devine) - Canadian Insurers Facing Difficult Earnings Quarters in 2Q10 and 3Q10 – July 13, 2010</u>

"It is also possible that the pending implementation of International Financial Reporting Standards (IFRS) that will cause the earnings volatility of long duration liabilities such as SGUL and variable annuities with living benefits to rise meaningfully, could lead ...to effectively exit these businesses lines and place them into run-off."

# <u>Caldwell Securities (Rob Callander) - Interview on BNN's The Street, with Michael Kane – September 2, 2010</u>

"The international accounting standards (IFRS) are going to cause a lot more volatility in corporate earnings in general, and in insurance and bank earnings. We saw that with Manulife where they reported a \$2.5 billion loss last quarter. And according to U.S. accounting, they actually made a profit. So, I think we're going to see more volatility in earnings because of this international financial accounting. And investors don't like volatility. Maybe some brokers like it. But generally speaking, investors don't like it. So, it's going to cause a lot of confusion for individual investors when trying to evaluate quarterly earnings for the banks, going to 2011."



# <u>Sprung Investment Counsel (Michael Sprung) - Interview on BNN's Market Call, with Mark Bunting – August 8, 2010</u>

"...You used to try to match those liabilities with assets, but if you have to mark those assets to market every moment, you're going to get a lot of volatility in the earnings. I think we're going to see that a lot as we move into the IFRS over the next year or so in other companies as well, it's going to introduce much more volatility into earnings."

# <u>Capital Group of Companies (Maurizio Lualdi) - Geneva Association Papers: "Rating Agencies and Investment Advisors in Insurance: Their Changing Role in the Communication of Information to Markets" - February 4, 2009</u>

"The industry needs to solve the problem under an accounting framework based on <u>earnings</u>, this is what all industries have".

## Goldman Sachs (Michael Moran, Abby Joseph Cohen) - Accounting Policy Update - June 14, 2010

"IFRS potentially distorts presentation of true and reliable financial information for investors."

"We believe it is very important for the FASB, IASB and SEC to receive feedback from investors".