

# **APEC Business Advisory Council**



25 August 2011

ABAC Chair 2011

## Mr. Hans Hoogervorst

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

#### Ms. Leslie Seidman

Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-05116
USA

Dear Chairman Hoogervorst and Chairman Seidman:

The APEC Business Advisory Council (ABAC) is the formal private sector advisory group of the Asia-Pacific Economic Cooperation (APEC) Forum. Representing the business communities of all 21 APEC member economies, ABAC is tasked with supporting the success of APEC by providing private sector insights on how best to achieve APEC's goals, both through APEC's own initiatives, and in dialogue with other international organizations.

In ABAC's 2010 Report to APEC Economic Leaders, we expressed our support for adoption of International Financial Reporting Standards (IFRS) throughout the APEC region as part of APEC's goal of encouraging regulatory coherence, enhancing the development of regional capital markets and promoting sustainable economic growth. At the same time, ABAC noted that implementation of IFRS should be undertaken in a manner that does not significantly distort reporting of real economic activities and that reflects each economy's business practices.

The insurance industry plays an important role in the development of the Asia-Pacific region. However, insurance companies in the region face unique challenges and circumstances and we are concerned that the adoption of an IFRS for insurance contracts based on the tentative conclusions to date of the IASB and FASB could have significant negative impacts on the industry. Such negative impacts include non-economic volatility in earnings and shareholder equity along with a lack of transparency in the reported results of insurance companies in the region. In addition, there may be a reduced availability and/or increase in the price of many long-duration insurance products that are particularly important for economies in the region with aging populations. We are confining this letter to four issues that are of primary concern to us, namely: 1) the discount rate to be used in the valuation of life insurance liabilities; 2) the use of



Other Comprehensive Income for reporting of market value fluctuations in insurance company assets and liabilities; 3) the presentation of life insurance company financial statements; and 4) the proposed changes in the measurement of short-duration insurance contracts, primarily for property and casualty insurance companies.

#### 1) Determination of discount rates

Following consideration of the concerns expressed by many stakeholders, the IASB and FASB have tentatively decided to permit the use of either a bottom-up or a top-down approach to determine the discount rate to be used in the valuation of life insurance liabilities. The bottom-up approach outlined in the exposure draft released in July 2010 prescribes that the discount rate shall reflect the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, with an adjustment for illiquidity. The tentative top-down approach decided by the IASB and FASB prescribes that the insurer may base its determination of the yield curve for insurance contract liabilities on a yield curve that reflects current market returns for an actual or reference portfolio of assets with characteristics similar to those of the insurance contract liabilities.

We support the use of a top-down approach in determining the discount rate for insurance liabilities but are concerned that our view of a top-down approach may be significantly different from that of the IASB and FASB. We believe that a top-down approach should take into account the following:

- The discount rate needs to reflect the characteristics of the liabilities and the business model of the insurer. It should also be consistent with the fulfillment model of insurers under which insurers must fulfill the contractual obligations they have to their policyholders.
- The starting rate should be consistent with the basis on which the assets are held on the insurer's balance sheet. The starting rate may be a blend of different rate bases as the actual or reference portfolio of assets may include assets that are held at different measurement bases (e.g., fair value or amortized cost).
- The discount rate should be based on the insurer's expectations, including projected future yields on assets currently owned and investments to be made from future net cash inflows. The projection of future yield rates should be determined based on current yield curves after full reflection of investment expenses, expected future default costs and other asset risks retained by the insurer.
- The application guidance for unobservable (non-investable) points on the discount rate yield curve should allow the use of Level 3 estimates for unobservable market inputs. In addition, the IASB and FASB should clarify that the use of returns (including appreciation) on non-fixed income investments, with appropriate adjustments for risk, is acceptable. This will result in a more stable discount rate at longer durations, and will be consistent with the insurer's actual returns and investment strategy.

## 2) Use of Other Comprehensive Income

The nature of the life insurance business is to underwrite risks over a long period of time, while diversifying such risks through portfolios of insurance contracts, as well as to securely fulfill the obligations to policyholders. Life insurance companies do not primarily intend to gain profits

through the timing of changes in the fair value of financial assets and liabilities they hold. We believe that an IFRS for insurance contracts should reflect these fundamental business principles and therefore believe that:

- Changes in the valuation of assets and liabilities based on financial assumptions, such as
  interest rates, should be presented in Other Comprehensive Income and not in the income
  statement since they do not represent actual economic events. Instead, changes in the
  valuation of assets and liabilities should be recycled through the income statement when
  actual gains or losses are realized.
- Other changes, such as changes in mortality and morbidity experience, should be reported directly in the income statement.

Reflecting changes in the valuation of assets and liabilities in Other Comprehensive Income is not only consistent with the business model of insurers, but is also wholly consistent with the goal of having financial statements provide investors and financial markets with an accurate picture of an insurer's performance. Further, it helps avoid non-economic volatility, such as short-term mark-to-market movements resulting from illiquid markets that can be misleading and destabilizing.

## 3) Presentation of life insurance company financial statements

The exposure draft proposes to eliminate the existing presentation model that presents premiums earned as income and claims paid as cost. The new model proposed to replace the existing model is a margin approach which directly presents the sources of profit and requires insurers to disclose premiums earned, claims paid and benefits in the financial statements. As the proposed margin approach requires excessively complex calculations, we are deeply concerned about its feasibility including auditability. Thus, we propose that the existing presentation model be maintained, instead of introducing the margin approach.

### 4) Measurement of short-duration insurance contracts

The financial reporting for property and casualty insurance contracts that is currently used in most of the region is working well, and generally should be maintained. In particular, the measurement approach in place in most of the Asia-Pacific region is time-tested, well-understood, and presents a transparent view of the financial results of property and casualty insurers. We are pleased to see that the IASB and FASB are moving in the direction of a measurement approach for pre-claims liabilities of property and casualty insurance contracts that is generally consistent with the current unearned premium approach.

However, we are concerned with the recommendation that discounting should be required for post-claim liabilities. We believe that discounting will not provide decision-useful information since payout patterns for many liabilities are long and speculative, and reliable estimates cannot be made. Financial statement users rely primarily on ultimate (i.e., undiscounted) values, that enable users to understand the accuracy of estimates of ultimate claim amounts that management makes over time. We hope the IASB and FASB will reconsider the need for discounting for short-duration insurance contracts and related claim reserves.

At present, international accounting changes remain in flux and there are still important issues that need to be decided. We believe that any new standards that are implemented must take into

account the business principles and unique challenges of different industries, including the insurance industry. Given the potentially adverse impact an IFRS for insurance contracts may have on insurance companies in the APEC region, we hope that the IASB and FASB will take into careful consideration the concerns and recommendations we have provided. We would be happy to continue a dialogue with you on these matters.

Sincerely,

Deb Henretta

ABAC Chair 2011

John W. H. Denton

Chair, ABAC Finance & Economics Working Group