

Board for Actuarial Standards

Aldwych House, 71-91 Aldwych, London WC2B 4HN
Telephone: 020 7492 2300 Fax: 020 7492 2399
www.frc.org.uk/bas

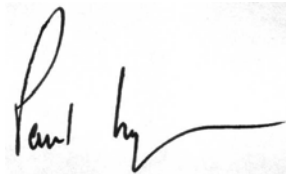
Sir David Tweedie
IASB
30 Cannon Street
London
EC4M 6XH

14th December 2007

Dear David,

It was good to speak to you, albeit briefly, at the CSFI on 21st November. I now enclose the response of the Board for Actuarial Standards to the IASB's consultation paper on Insurance Contracts. We are sorry for the delay in sending this. We would welcome the opportunity to discuss it with you and your staff.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Paul Seymour', with a long horizontal flourish extending to the right.

Paul Seymour

Chair

DDI: 020 7492 2350

Email: p.seymour@frc.org.uk

Summary

The principal views set out in our response are that:

- (a) We support the concept of Fair Value measurement.

However, insurance liabilities cannot be measured directly from prices in any market (and nor can the “building blocks” other than the time value of money), so their value needs to be derived through a measurement “process”. Hence the only effective control over the measurement of the various components is through clear process controls, and more detailed guidance over the process is required. Since most of the factors involved concern actuarial measurement, the best sources of further detail are likely to be standards set by independent actuarial standard setters across the world (rather than IASB guidance).
- (b) We agree that this process can usefully be based on a “componentary structure” for the various relevant factors, but we do not believe that the “building blocks” proposed in the discussion paper adequately reflect the differences that exist between retail and wholesale markets. For this reason we have proposed an alternative componentary structure for the calculation of “current exit value” (even though this is not the conceptual approach we advocate). Under this structure we note that the actual premium charged has no role to play in the calibration of margins (and therefore we do not support any of the alternatives presented in paragraphs 78 to 85).
- (c) The processes followed in the calculation of insurance liabilities should conform to actuarial principles and be consistent with market prices of such variables as are observable, and in these respects we agree with most of the guidance in Appendix F of the DP.
- (d) We agree that the portfolio is an appropriate unit of account, and for this reason we find it unnecessary and artificial to rely on the concept of guaranteed insurability to define the scope of the cash flows.
- (e) We believe it is more useful to use the insurer’s own servicing costs, rather than the costs of other market participants, because it will result in greater consistency with the other elements of the calculation of the liability measure. We therefore prefer “value in settlement with the policyholder” for an insurance entity, rather than “current exit value”.
- (f) We believe that the credit characteristics of the insurer (entity credit risk) should be excluded from “value in settlement”, but are implicit in “current exit value” due to the nature of insurance contracts. We believe that the measurements that exclude entity credit risk are of most value to prudential regulators and are equally useful to investors. This is another reason to prefer “value in settlement”, rather than “current exit value”.
- (g) We believe that certain elements of with profits policies should be categorised separately as policyholder equity (rather than as shareholder equity or as liability), in order to reflect their characteristics. This is not a category permitted under current structures but consideration should be given to creating such a category.

Board for Actuarial Standards

1. Introduction

- 1.1. The Board for Actuarial Standards (BAS) welcomes the IASB's invitation to respond to its preliminary views on Insurance Contracts. The BAS was established in 2006 as the independent standard-setter for actuarial practice in the UK. We believe it is unique in the world in that it has been established by government (HM Treasury), not by the actuarial profession, and only 10% of its funding comes from the actuarial profession, the balance coming from the insurance industry and from pension schemes. There are 14 members of the Board, seven of whom are actuaries and seven lay members representing a wide range of stakeholders. The BAS is an operating body of the Financial Reporting Council, as are the Accounting Standards Board and four other boards; FRC staff supporting the BAS work alongside staff supporting the ASB and the other boards.
- 1.2. In carrying out its work, the BAS is committed to:
 - Working on the basis that well informed users are the best regulators;
 - Targeting the use of its powers, taking a proactive, risk-based and proportionate approach, and making effective use of Regulatory Impact Assessments;
 - Emphasising principles and clarity in its standard-setting; and
 - Being consultative - involving preparers, users of corporate and actuarial reports, the wider public and other regulatory organisations in its decision-making and allowing adequate time for consultation, without compromising confidentiality or its independence.
- 1.3. As explained in our response to the IASB's question 3, we expect that the measurement of the insurance liabilities will normally be carried out by actuaries and that once the IASB has finished its project on Insurance Contracts, the BAS will be developing standards to regulate how in detail any IFRS will be applied in the UK. We are extremely pleased to participate in the IASB's consultation, but there are certain questions posed by the IASB that relate to what we regard as technical accounting matters outside our domain as an actuarial standard setter, and so we have restricted our response to those questions we regard as falling within our scope.
- 1.4. The BAS believes that the measurement of insurance liabilities raises issues that go beyond the questions specifically asked in the Discussion Paper, and that it is important to keep those wider issues distinct for the purposes of analysis, and so we have started with a section setting out our views on those issues before moving on to address the specific questions. We hope this will make our views clearer and more focussed on the underlying objective and concepts (rather than on measurement difficulties), even though it means that our response falls outside the IASB's preferred structure.

2. Classes of information

- 2.1. The information provided on insurance contracts could fall into one of three separate classes that the BAS has used during development work, namely:
 - (a) "value" (the value for which goods would trade in the market)
 - (b) "value relevant information" (information provided on a good or entity, which markets can use to assess value)
 - (c) "prudential information" (information required by prudential regulators)
- 2.2. Even if underlying assets and liabilities are assessed on a fair value basis, financial reporting does not show the value of the entity in question (in other words, Balance Sheet Net Asset Value is not equal to Market Capitalisation and financial reporting as such does not represent "value"), but rather "value relevant information". This is not intended as a criticism, but once recognised, enables the debate to be widened to a consideration of the characteristics of information relevant to the market, rather than being unnecessarily constrained by the potential misunderstanding that accounts represent the value of the reporting entity. *{Paragraph 31 of the DP effectively recognises this point and states that "the IASB's objective is to select a measurement model that gives users useful information about the amount, timing and uncertainty of the future cash flows resulting from the contractual rights and contractual obligations created by insurance contracts", but it does not really go on to consider some of the issues involved}.*
- 2.3. The point made above could be approached differently as a unit of account issue and raises the question *{as discussed in DP paragraphs 183 to 202}* of whether the unit of account should be set at the lowest level (the 'atom' of reporting) or at the level of the entity, or indeed somewhere in between. In other words should an entity be accounted for based on the value of the whole entity or, as we believe, the sum of individual parts of the entity?

3. Comparison with Solvency II

- 3.1. We have compared and contrasted this discussion paper on insurance accounting with the European Solvency II development on prudential regulation. As outlined in 2. above, we have categorised the information required for each as separate types of information and in theory there seems no reason why they should coincide. Nevertheless (as noted in paragraph 8 of the DP), it would be desirable for the information reported to supervisors to be the same as the information reported in general purpose financial statements, given the costs associated with the production of (and the public availability of) both types of information. This is a pragmatic consideration rather than a conceptual reason, of course, but it does make a comparison of the two requirements worthwhile. We set out below our assessment of the comparison.

	Item	IASB	Solvency II
(a)	Liability (Definition)	Based on all rights and obligations (including options and guarantees) arising from the contract (subject to guaranteed insurability)	Based on all rights, obligations and cashflows (including options and guarantees) arising from the contract
(b)	Measurement objective	Market exit value	Market exit value for hedgeable risks, (modified settlement for non hedgeable risks)
(c)	Context limitations	Entity risk is implicit in exit value	No entity risk "adjustment"
(d)	Entity State consideration	Going concern	Discontinuance

- 3.2. Our analysis above indicates that there is substantial agreement on the primary issues of the definition of a liability and the measurement objective (although some details appear unclear and we are aware that other commentators perceive differences). If this is the case then any emerging difference in information requirements must be due to the measurement process through which the objective is achieved, rather than for any conceptual reason. This is not to suggest that measurement is not without its difficulties and we will return to this later. We are aware that there may be detailed differences under the liability definition in respect of the treatments of future premiums and of participating contracts, and will also return to those details later.
- 3.3. Our analysis indicates a possible difference of approach in the allowance for the risk of the entity's own default, which we regard as a context limitation. Paragraph 232 (a) states that "if an insurer measures its insurance liabilities at current exit value, that measurement should reflect the liability's credit characteristics". Our reading of Solvency II is that it takes the same position as the IASB (Article 73, 1. of the Framework states that "liabilities shall be valued at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arm's length transaction. When valuing liabilities, no adjustment to take account of the own credit standing of the insurance....undertaking shall be made."). Solvency II's use of market prices for hedgeable liabilities appears to be consistent with this, since the market price of the financial instrument used to hedge the liability presumably incorporates its credit characteristics (albeit the default risk of the counterparty, not of the insurer). However, there is a lack of clarity in the Framework Directive and other commentators have different interpretations. It seems to us more useful to a prudential regulator to have information that does not incorporate the entity's credit characteristics (otherwise an insurer with inadequate assets to settle its liabilities in full would reduce the reported value of its liabilities on that account).

- 3.4. For the entity “value” class of information, it is important to incorporate the credit characteristics of insurance liabilities, but it is unnecessary for the class of “value relevant information”, as users of accounts can operate effectively with consistently produced information and certainty over the principles of its preparation. Recognising that it is unnecessary is important because, if convergence can be achieved, there would appear to be no conceptual (or residual) reason why the liabilities calculated for financial reporting should not coincide with those calculated for Solvency II. We discuss this issue further in our response to Question 14 below.
- 3.5. Solvency II distinguishes between hedgeable and non hedgeable risks and proposes a modified settlement approach for the latter, based on a best estimate of the settlement with the policyholder, plus a cost of capital. In practice this may lead to much the same calculations as those envisaged by the IASB’s proposed building blocks, but it does raise the question of whether the IASB’s proposals do in practice represent the concept of market consistent exit values.

Conclusion: The IASB’s definitions of liability and measurement objective are ones that could coincide with those of prudential regulators, and this does appear to be the case with Solvency II (except for the details noted above). The IASB should adopt a measure of liabilities that excludes credit characteristics, since it is unnecessary for users of accounts and is more likely to achieve convergence with the measures used for prudential regulation.

4. Retail and wholesale markets

- 4.1. As discussed in DP paragraph 99, insurance is transacted in individual retail, commercial and wholesale markets (inter insurance / re-insurance companies). The contract premiums will reflect the market through which the contracts were effected, but these are unlikely to be the markets through which “market exit” could be achieved. Although there is a second hand market in certain individual retail policies, this is not a complete market and this limits the application of this potential concept of “market exit”.
- 4.2. The alternative approach to “market exit” is the expected cost in the wholesale market between insurance companies. For such transactions there would be an unavoidable change in the insurance contract and the liability to a policyholder would change, from the current insurer to the wholesale buyer. This is unusual and the concept of a market exit price for goods and services is based upon a general implicit assumption that the goods in question are unchanged by the act of sale. Whilst we accept the comments made in DP paragraph 232, that such transactions are only practicable between insurance companies of similar credit ratings, the DP stops short of considering the implications of this. In our opinion the potential change in the characteristics of an insurance contract by a market transfer (combined with the limited circumstances in which a transaction could be expected to occur), raises two possibilities:
 - insurance contracts should be regarded as uniform (and somehow differentiated by limited markets), or

- insurance contracts should be regarded as separate contracts which are differentiated by the credit standing of the issuing entity.

We believe that the concept of market exit value is consistent with a view that the goods should be unchanged by the transaction, implying that there are distinct insurance contracts with separate credit characteristics, which themselves are traded in markets defined by those contracts. If this is the case, then credit risk becomes inseparable from the product and, under a market exit value approach, there should be no separate allowance for credit risk (and the conceptual challenge is replaced by the challenge of calibration).

4.3. We regard insurance premiums in the retail and wholesale markets as being set to cover the following costs:

Component	Sub Component	Nature	Comparative Wholesale Position
Pre Contract costs	Selling	Marginal cost	Absent
	Underwriting	Marginal cost	Absent
	Product design	Fixed cost	Absent
	Marketing	Fixed cost	Absent
	Organisational support	Fixed cost	Equal
	Pricing assessment	Fixed cost	Equal
	Legal contract	Fixed cost	Equal
Contract costs	Insurance risk	Marginal cost	Equal
	Services	Marginal cost	Equal
Profit Margin	Risk margin	Marginal cost	?
	Desired return on risk capital	Marginal cost*	Equal
	Desired return on franchise value	Marginal cost*	Equal
	Market adjustment (including marginal cost entity risk)	Marginal cost	Equal

* The two stated returns may be regarded as alternatives

“Equal” is used to signify that the components are present in both retail and wholesale prices and that there is no particular reason why they should differ.

“?” indicates that both components are present in both retail and wholesale prices, but that there are reasons why they should differ. The main reason is that from a demand perspective the purchaser of a retail product is obtaining risk diversification, which is already present in a wholesale portfolio of contracts.

Although insurers will express these components differently, they will generally be recognisable in the premium setting process.

4.4. In paragraph 99, the IASB states that “if insurers were collecting margins that significantly exceed those that would be likely in wholesale markets, presumably other insurers would lower their premiums to gain market share. Therefore, it seems unlikely that significant differences of this type could occur systematically for long periods.” However, our analysis above suggests that this assertion ignores the reality that the premium components and their

magnitude for retail insurance (the insurance company entry price) would be expected to be different from those for wholesale insurance (the insurance company exit price). These differences arise immediately and the extent of the differences can produce either gains or losses at inception. In general it should be expected that at inception the values of future premiums would exceed the future marginal costs from the contract as this excess is necessary to cover the pre contract costs of policy design, marketing and selling etc.

- 4.5. Regarding the “market adjustment” element of profit margin, we note that the price for insurance, like other goods, depends on the interaction between demand and supply. The componentary structures suggested by ourselves (in 4.3 above) and the IASB’s “building blocks” both provide an insight into supply (insurer) price considerations. However, they reveal nothing about the motivation of the demand (retail buyer or wholesale buyer) price, and price is the point at which supply and demand coincides.
- 4.6. It is arguable that the demand for insurance is reasonably constant and the price will therefore fluctuate with the variable element of the premium components, namely profit margin (and certainly the way in which price movements for insurance premiums vary with available capital suggests that this is a present feature). On this basis, and without a model of the inter-relationship between capital availability and profit margin (or market risk margin) the componentary model does not provide a solution to market consistent prices; this appears to be an unavoidable limitation, but one which we believe is acceptable provided users appreciate that it provides “value relevant information” rather than value (see 2.1 above).
- 4.7. Of course, many insurers have experience in setting competitive premiums in their own markets, and each insurer’s own experience could be used as a proxy for determining the “market adjustments” for exit price. However, not all reporting entities actively write new business and, furthermore, the “market adjustments” in the retail market may not be the same as those prevailing in the wholesale market for a number of reasons. Possible reasons are that the risk diversification sought (and hence price motivation) by the individual retail buyer is very different from the risk diversification involved for a wholesale transaction, and secondly that perfect markets are a theoretical concept which is not necessarily borne out in practice.
- 4.8. In this regard we note that the marginal price of retail insurance contracts is an unreliable guide to both the likely wholesale portfolio market prices and the rational actions of retail insurance companies. For example, marginal retail insurance premiums may be low (a soft market) because an individual insurer is willing to acquire a limited quantity of that business on those terms (e.g. to maintain market share). However, the insurer would not be able to sell its portfolio of insurance contracts at those prices in a wholesale transaction. To use such a price as the basis for financial reporting would appear to misrepresent the financial position. Likewise, when retail premiums are high (a hard market) the insurer would not want to pay those prices to sell its portfolio of liabilities. In both hard and soft markets a settlement construction appears to be more appropriate.

- 4.9. Pre contract costs (acquisition costs) can be viewed on different bases and hence can also cause confusion. During the development of a new product, an insurer incurs the fixed costs shown in the table in 5.3. At any reporting date some of these costs have accumulated and others will continue to accumulate (such as marketing) in the future. These costs are not related to individual policies and the insurer needs to estimate the expected sale volume and apportion these costs accordingly, in order to convert the fixed and marginal costs into an average cost charged.
- 4.10. This apportionment of overheads is logical, but has the result that the “surplus” over marginal cost released on the sale of a marginal product is simply the allocated allowance for fixed costs, and has no direct relationship with the total amount of pre-acquisition costs.

Conclusion : The componentary structure of liabilities needs to be modified to reflect the additional components detailed in this section and recognise the differences between retail and wholesale markets.

5. Market consistency

- 5.1. Achieving the measurement objective of market exit value will be difficult in practice. The first practical difficulty is that (as noted in DP paragraph 93) the current exit value of an insurance liability is not observable, and insurers will need to estimate the price at which such hypothetical transactions would take place.
- 5.2. In this process the measurement objective assists little (except simply that it indicates consistency with the market). Whilst we question the wisdom of hypothecating market prices where these are not verifiable, we do not discuss that issue here except to note that the measurement problems for assets that arise from applying marginal prices to quantity trades are just as great (i.e. the price achieved for the last marginal transaction in the stock market will not necessarily hold for a large quantity purchase or sale).
- 5.3. The only observation we make here is that the unit of account for assets (effectively the marginal stock level) is different from the unit of account for contracts (namely the portfolio level). However we can rationalise this difference by the differing nature of the markets and by the fact that a wholesale market appears the appropriate one for insurance contract measurement.
- 5.4. Although financial reporting is concerned with output (i.e. the content of financial reports and the principles underlying financial reporting), the lack of observable reference data means that objectivity cannot be achieved directly through the output. Hence the output (the liability) has to be derived through a process based approach, and the extent of control is limited to that achievable through controls on the process.

- 5.5. The primary measurement objective (market consistent exit value) implies that the measurement objective is equivalent to the wholesale market premium for insurance liabilities and that we need to consider firstly how such premiums are likely to be determined and then how we can specify a process for such measurements for reporting purposes. The result of a process is not necessarily an entry value, an exit value or any other value, but simply the result of a process. The process will not fulfil a particular objective unless componentary structure and the determination of each component in combination produce the required measurement objective (in other words even if the objective is clear, the process will not necessarily achieve the solution).

For example, if we take the simplest componentary model and state that market price P is equal to cashflows C times a risk discount factor D then $P = C \times D$.

Now, if we know C , for example $C = 100$, we can solve the equation for P or D if we know one or other of the other variables. However, P by definition is unknown (or there would be no need for a componentary model) and D is also unknown as it can only be derived from knowledge of C and P . The result is that we cannot achieve market consistency for $P = C \times D$.

If we do not know D , the greatest extent of discipline that can be achieved is through the determination of a consistent componentary structure (which may well be $P = C \times D \times E \times F \times G$) and a clear explanation of the determination of each component. Even with this approach it is only through a process of back testing that the validity of the approach can be judged, and even then only for past prices.

6. Risk and profit margins

- 6.1. The measurement of liabilities needs to allow for risk aversion and profit. Insurance companies are no different from any other companies and seek to produce and sell goods at a sale price that exceeds their cost of production (thus making a profit). The only difference from other companies is that the sale involves obligations that extend beyond the point of sale (although even this is not perhaps as great as it would seem, as many goods are sold subject to guarantees or a legal requirement for reasonable durability).
- 6.2. The costs of production for an insurance product (the contract costs) are an element that can be assessed (to a certain degree) by insurance companies who will use this as a starting point for the determination of price. Insurance companies have a vested interest in producing profitable policies and none in loss-making policies. This is as equally true for wholesale as retail business. *{DP paragraph 80 (b), which states that "in some cases, an insurer expects a contract to be unprofitable (or perhaps insufficiently profitable) because of, for example, the state of the insurance cycle, government or regulatory restrictions on price changes, or underpricing to buy or maintain market share", may appear to challenge this, but we would regard this phenomenon as relating to our "market adjustment" component of our "profit margin"}*.

6.3. A market consistent price can therefore be broken down as follows:

Price (market consistent) = pre contract costs + contract costs + profit margin

where pre-contract costs include both marginal and allocated fixed costs, and contract costs include insurance risk, contract administration costs, claims payment costs & service costs, allowing for the time value of money.

6.4. The risk and profit margins both have a significant impact on price and it is important that they are allowed for in the measurement. Risk and profit margins may be assessed either by an adjustment to the discount rate or by a specific addition to cashflows (a certainty equivalent adjustment factor). The two approaches are equivalent, but the adjustment to the discount rate is more readily understandable and is perhaps preferable for this reason. The risk and profit margins will then be automatically allowed for in the assessment of market consistent exit prices for contracts of all outstanding durations.

6.5. The deduction of the profit margin from the discount rate used for the liabilities is sensible, as it would be included in a market exit price for the business. It also releases the profit on the insurance broadly in line with the release from insurance risk (and this was the concept underlying the use of the "net premium method" at an artificially low discount rate for participating policies in the UK). However, there would also be an initial release of "margin" at the inception of a policy representing the difference between an insurance company retail entry price for the contract and the immediate wholesale exit price. This margin is effectively the repayment of the pre contract selling costs of the insurance company. Ignoring any changes in profit margins between the inception date of the retail contract and the wholesale transaction date, the profit at inception may be regarded as follows:

profit at inception = insurance company pre - pre contract costs
contract entry costs in a market exit price

We therefore believe that option (a) in question 4 should not be adopted; there should be no constraint such that the insurance company would recognise zero profit at inception.

Conclusions:

- **We support measurement using a componentary model.**
- **Its reliability and consistency will depend on the accuracy of the componentary model and the standards for determining each component. Such standards should best be set by independent actuarial standard setters.**
- **We would normally expect profits at inception.**

7. Practical Difficulties

- 7.1. Problems arise in moving from the concepts of premium construction to their application in practice.

The contractual cashflows (probability weighted) are uncertain and there is no such thing as a market consensus for such items. In the event of an exit price being sought, a potential buyer would make his own assessment of the cash flows and would not necessarily agree with the estimates of the insurance company's management. However, until such time as a real deal is arranged the only information available for the cashflows would be management estimates of these figures.

- 7.2. Likewise the profit margin, (which should include a risk margin, an allowance for profit and an adjustment for market prices) is not readily available on an objective basis. Furthermore, even if two insurers were able to agree on the market price for a contract this would not mean that they both agreed on the component parts. For example, one insurer's estimate of the cashflows (probability weighted) may be greater but its risk margin lower than another insurer, whose estimates of the cashflows (probability weighted), are less but whose risk margin is higher, thus resulting in an identical view of market price.

We agree with the Board's view (paragraph 37 of the DP) that "measurements are more relevant and reliable if they are consistent with observed market prices", but we believe verifiable exit values for insurance contracts/portfolios cannot be readily obtained, nor can verifiable information relating to many of the separate components of a market exit value.

- 7.3. This lack of observable prices is not ideal and as a result it is unavoidable to rely heavily on management estimates for such information. As indicated above, since management estimates have to be used for many components, we prefer the use of management information for all components (except the time value of money) as a combination of information from separate sources could actually make the result less reliable. In other words, management have experience in operating within the market and setting premiums with the result that they are likely to be capable of combining the separate components to obtain a reliable entry price for the sale of contracts. However, whilst insurers will have experience of retail prices, this will not necessarily provide a reliable estimate of wholesale prices.

Conclusion : Management estimates will provide the best information, but may still lack overall market consistency for wholesale exit prices.

Responses to Questions

Question 1

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

Whilst we believe in the principle of consistency, we suggest that while there remains a lack of clarity over contractual conditions (e.g. renewal premiums), it is better to leave open the possibility that further analysis of the features might reveal aspects unique to insurance contracts that would require different treatment.

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)?*

If not, what approach would you take, and why?

We believe that whilst the “building blocks” approach provides a useful structure for insurance liabilities, this will not achieve a market-consistent exit value, for the following reasons:

- As discussed in 4.5 above, we regard it as impractical to try to estimate the risk margin and service margin that market participants require, because the only variables that are observable are premiums that are influenced as much by the interaction of supply and demand and by the availability of capital as by the insurers’ desired margins.
- As described in 4.3 above, this structure excludes important components that would be present in market exit values, such as the recovery of infrastructure costs. Omission of such elements increases the risk of mis-measurement. Under (a) there is no market consistency to the contractual cashflows, which generally arise from the contractual terms.

Nevertheless, we agree that the “building blocks” provides a useful start to providing value relevant information (see 2.1(b) above),

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?

We agree that it is at an appropriate level of detail for IASB guidance. However, since the results cannot be verified against external reference data (as explained in 5.4 and 5.5 above), the only effective control over the measurement of the various components is through clear process controls. As a result, more detailed guidance over the process is required, but since most of the factors involved concern actuarial measurement, the best sources of further detail are likely to be actuarial standards (rather than IASB guidance).

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 recognise 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 should 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 recognise a profit or loss at inception.*
- (d) Other (please specify).*

We believe the actual premium charged has no role to play in the calibration of margins (and therefore do not support any of the alternatives presented). Whilst the actual premium charged determines the contractual income, it is irrelevant to current market conditions and hence to the “current exit value” approach. Equally, the hypothetical premiums that would currently be charged by the insurers cannot be relied on as they would produce a retail entry price rather than a portfolio (wholesale) exit price. Rather, the best result will be obtained by using information on the components used by the insurers to calculate entry prices (as described in 4.3 above), but adjusting the components to allow for differences in portfolio (wholesale) exit prices. However, this approach still has limitations as we have explained in section 4.5 above.

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?*

We believe "value in settlement" is more appropriate than "current exit value", because it is more useful to use the insurer's own servicing costs and because measurements (such as "value in settlement") that exclude entity credit risk are of most value to prudential regulators and are equally useful to investors. Moreover, we believe that the going concern principle is best represented by a Settlement approach, based on measuring solely the contract costs detailed in 4.3 above and the time value of money, and that in this respect a settlement approach will result in a more consistent basis of financial reporting across all industries, including insurance under current accounting frameworks.

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 recognised 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 recognise them? Why or why not?*

All cashflows arising under a portfolio of insurance contracts should be recognised in the same way as it would by market participants for such business (based on the existing, but not new contracts). Hence we support (b), i.e. we believe an insurer should incorporate policyholder behaviour, both beneficial and adverse, on a best estimate basis in the value of liabilities.

Question 7

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

- (a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those*

premiums). 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 (ie 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).

(a) We believe questions 7 (future premiums), 11 (unit of account) and 13 (unbundling) are closely connected and in order to minimise the risk of inconsistency, we are answering them together. For the purpose of determining risk margins, the IASB has taken the portfolio level as the unit of account and we agree with this, because insurance operates based on the pooling of risk, and the risk margins charged would not apply if this were not the case (as explained in section 4.5 above). However, the corollary of this is that the measurement objective and the relevant cashflows should also be determined at portfolio level, rather than the lower level of granularity (such as the individual contracts) implied by the question.

If certain cashflows that would normally be included in a market exit value are excluded, this produces an artificial level of granularity.

For this reason we find it unnecessary to rely on the concept of guaranteed insurability to define the scope of the cashflows. The portfolio itself is defined by market participants who trade such portfolios, and in practice it includes allowance for all cashflows expected to arise under the portfolio including both future premium receipts and bonus payments. Any alternative construction is both unnecessary and artificial.

It seems to us that the arguments (in DP paragraphs 191 – 199) as to why a portfolio might have a different expected value from the sum of the individual contracts have no force under the definition of “current exit value”. However, we agree with the argument (in DP paragraphs 200 – 201) that if current exit value is to be independent of the entity that holds the liability, then the diversification between portfolios and negative correlations between portfolios (for the entity) is irrelevant to a market exit price.

As to unbundling (DP paragraphs 220 - 228), we believe that current exit value has no meaning for the components of a contract, as separate components cannot be transferred to another insurer, and that the unit of account should not be smaller than the individual contract. We also believe that the price another insurer would pay to transfer all rights and obligations would take account of both unfavourable and beneficial policyholder behaviour (DP paragraphs 121 – 160), and hence that beneficial policyholder behaviour should be included in current exit value. In particular, we believe that the transfer price would include all future premiums (allowing for the best estimate of the probability of early surrender), which is consistent with taking the whole contract as the unit of account.

Question 8

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

We see this as a matter of accounting convention and insurance should be treated consistently with other industries. Our preference is to recognise them for practical reasons. It is difficult to determine how acquisition costs that result in positive benefit could be reliably distinguished from those that prove to be abortive.

Question 9

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

No special considerations should apply.

Question 10

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

Market values are preferred but, as explained in 4.2 above, the effective unit of account (i.e. marginal prices) is inconsistent with that for the liabilities (i.e. the portfolio). There is no ready solution to this issue.

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) As explained in our response to question 7, we agree that the portfolio is the appropriate unit of account. As explained in section 3.3 the use of market exit

values will automatically incorporate all factors, including risk, reflected in market prices.

- (b) The second part of the question deals with the effect on liabilities/price of portfolio diversification. However, once market consistent exit price has been adopted as the measurement objective, this automatically captures all factors that affect market price. The insurance market consists both of insurers who provide many types of business (“multi line” or “composites”) and those that provide only a single type of business (“single” line), with multi line being the predominant group. The result of this is that it would be unrealistic to attempt to hypothecate the market prices that would prevail in the absence of “multi line” providers. However, the concern is that the question glosses over the risk that a portfolio may be too small to achieve adequate risk reduction. As the primary statements do not measure risk, this issue will not arise there, but may arise in the disclosures.

Since it is not possible to “unbundle” the benefits of inter-portfolio diversification from market premiums, we believe those benefits should be disregarded in the determination of the risk margins.

Question 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.*

Reinsurance assets should be measured consistently with the liabilities to which they relate. As discussed in question 5 above, we do not support the market exit value approach and favour a Settlement basis, in which case reinsurance should be considered based on the underlying cashflows (with allowance for potential default). If, nevertheless, liabilities are measured at current exit value, then reinsurance assets should be measured consistently.

As discussed in section 3 above, the consequences of the risk of the entity’s own default are that it may be applied to the reporting entity, but not to reinsurance counterparties (whose risk of defaulting must be allowed for), resulting in the following position:

	Treatment of Entity Risk	
	Settlement Basis	Market Exit Price
Insurance liabilities	Ignored	Entity risk is inherent in market exit price
Reinsurance assets	Reinsurer entity risk allowed for	Entity risk is inherent in market exit price

Question 13

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

No. As explained in our response to question 7, we do not believe in unbundling as we support the portfolio unit of account. However, the treatment of the portfolio needs to be consistent with the range of contract types that it contains, i.e. the variables used in measuring the portfolio must be determined at a sub-portfolio level at which the contracts have reasonably similar characteristics.

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?*

This question seems to us to be posed from the wrong perspective. We believe it is more helpful to consider instead whether or not insurance contract portfolios are differentiated by the strength of the insurer, with the result that the insurance market consists of otherwise similar products differentiated by levels of credit risk.

The question of the homogeneity across producers is easier to illustrate in terms of other goods such as cars, where it is obvious that not all cars are the same and that different manufacturers may make cars of different quality, which is a factor reflected in their market value. Once a car has been manufactured, its characteristics (e.g. manufacturer and model) cannot be changed by the subsequent purchase or sale of the car, but if a portfolio of insurance contracts is sold, the primary characteristics of the insurance policy (i.e. the security provided by the insurance company) is changed. If, therefore, market exit value is the measurement objective, it is necessary to clarify the nature of the market through which such exits could be achieved.

In practice insurance transfers do not happen between insurers of different credit ratings, which leads us to the view that insurance products are credit risk differentiated. This implies that credit risk considerations are inherent in a market exit price, but what is not clear is whether the consideration of entity credit risk should be removed if we adopt the "value in settlement" basis.

In general, the BAS view is that we favour the exclusion of entity credit risk for the following reasons:

- entity risk is not diversifiable by the entity itself. It's a bit like throwing a dice: although the average outcome over many throws may be 3½, this is not a possible number for a single throw. Likewise for insurers, there is no ability to average entity credit risk and an entity will either default or it will not.
- an entity cannot readily achieve the market expectation for its own default in respect of the insurance contracts (through market transactions), as there is no complete market in which it can buy back its own insurance contracts. In this respect the contracts are distinct from corporate debt in which there is an active traded market.
- the insurance contracts produced by the entity represent assets owned by others. If these products were detachable from the entity and capable of open market trading, then there is merit in adjusting the value to reflect expected default. However, the contracts are not detachable and, hence, any adjustment made for default would not be priced by the market itself but estimated by the entity anticipating its own default.
- In our opinion, reducing the value of the liabilities for own credit risk potentially undermines the usefulness of accounting information, as it implies that an entity's liabilities should be reduced for reporting purposes to the level of its ability to pay. For example, if an entity with £100m of insurance liabilities and £1m assets, reported on its financial position as £1m liabilities and £1m assets, then the position would not be transparent and an entirely separate metric would be necessary to convert the 'credit adjusted liability' to the full contractual amount.
- The current situation for combining the necessary information is in fact the reverse of this. Financial Reporting produces "value relevant information" (which is largely ex credit risk) and investors use judgement and other information (e.g. credit rating agency assessments) to convert contractual amounts to market values.

From a practical perspective the credit risk for insurance contracts is different from that of insurance company debt and, although both credit ratings and market ratings are available for the debt, only credit ratings are available for claims paying ability, i.e. there is no market rating for the credit risk of the insurance contracts.

Our conclusion from the above is that there is no compelling logical or practical reason for the entity risk to be allowed for in the financial reporting by an entity on issued insurance contracts. However, entity risk is inseparable from market consistent exit values and hence cannot be excluded; under a Settlement approach the issue again becomes relevant.

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?

We regard this as a technical accounting matter that is outside our domain as an actuarial standard setter.

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?*

(a) No, we do not believe the cash flows should be required to satisfy a legal or constructive obligation.

Participating policies give rise to issues that are in many ways unique and do not to our knowledge have an equivalent in other industries or under other types of contracts.

The nature of insurance companies is that they are required to hold a minimum level of regulatory (or solvency) capital. This can be regarded as having two effects:

- the capital is invested in physical assets that earn a return
- policy premiums are set so that they are sufficient to provide a return on the capital held (which may exceed the minimum regulatory capital)

In this structure the capital may sensibly be regarded as shareholder equity. However, whilst the business is a going concern, it effectively represents funds that cannot be realised and distributed to shareholders.

For participating policies in the UK the position is different and the company constitution (together with other regulatory constraints) will often specify that the excess of assets over liabilities must, if distributed, be divided between policyholders and shareholders in a given distribution proportion (for example 90% to policyholders and 10% to shareholders). For this reason the surplus monies (assets less liabilities) cannot reasonably be classified as shareholder equity, as there is no realistic prospect that they will receive it, even allowing for the passage of time. Furthermore, although the surplus monies could conceptually be attributed to shareholders and policyholders based on the distribution proportions, it would be incorrect to regard the policyholder share as a policyholder liability because, for a going concern with profit fund, the surplus is never capable of full release whilst the fund continues to be open to new business.

A growing participating fund will require increasing amounts of regulatory capital. This “capital” will have to be provided by either shareholders or policyholders. In effect policyholders on an ongoing basis are making a contribution to the accumulation of regulatory capital either through the premium charged or through the distributed profits being lower than the underlying earnings. This position would continue unchanged until such time as the fund closes, from whence forth the accumulated regulatory capital could be distributed as the insurance liabilities reduce.

Although a proportion of the regulatory capital could be regarded as due to policyholders, it could not practically be distributed to them whilst the fund is ongoing, as the act of distribution would give rise to the need for additional regulatory capital on the distributed monies. For this reason the regulatory capital would appear to be neither shareholder capital or policyholder liability. The most appropriate categorisation would appear to be that of policyholder equity (even though this does not fit ideally into a normal conceptual framework).

(b) We do not accept that these amounts should be classified as liabilities.

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 recognise 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 recognise 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).*

We regard this as a technical accounting matter that is outside our domain as an actuarial standard setter.

Question 18

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

We regard this as a technical accounting matter that is outside our domain as an actuarial standard setter.

Question 19

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

We regard this as a technical accounting matter that is outside our domain as an actuarial standard setter.

Question 20

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

We regard this as a technical accounting matter that is outside our domain as an actuarial standard setter.

Question 21

Do you have other comments on this paper?

See introduction.