Accounting Standards Board

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Dear Peter

IASB Discussion Paper 'Preliminary Views on Insurance Contracts'

This letter sets out the views of the UK Accounting Standards Board (ASB) on the above discussion paper ("DP").

The ASB has for many years been concerned that insurance accounting, both in the UK and internationally, has been based on detailed regulatory rules rather than on principles that are consistent with those underlying financial reporting in general. In recent years some steps have been taken to close this gap (for example, in the UK the move by the Financial Services Authority (FSA) towards 'realistic' measurement of life assurance liabilities, and the related issue of FRS 27 'Life Assurance', and internationally the limited improvements made by IFRS 4 'Insurance Contracts', and the market-consistent philosophy underpinning Solvency II), but the gap still remains.

The ASB therefore welcomes the issue of the IASB's DP as a long-awaited step towards applying general financial reporting principles to insurance businesses.

We fully support the IASB's move towards improved insurance accounting. That said, we do have some major concerns with the DP's proposals. These are set out more fully in the answers to the individual questions in the invitation to comment, set out in the appendix to this letter. In summary, these are as follows.

Consistency with general financial reporting principles

1. There may be aspects of insurance accounting where the IASB may decide that it is not possible to adopt fully those principles that would apply to general financial reporting; insurance business is complex and the rights of policyholders, the risks borne by insurers, and the extended time-scale of both long-tail business and life assurance gives rise to unique financial reporting problems. Where the IASB decides that special principles should apply, it should clearly justify this and emphasise that the conclusions reached in relation to insurance contracts are not intended to be applied elsewhere. Particular areas where such special principles may be needed are in relation to the definition of equity and liabilities (in particular for

life assurance) and the possible links to the measurement of pensions liabilities; revenue recognition; the recognition of future premiums; and the extent to which unbundling of financial components is required. We discuss these issues in more detail in our briefing paper 'IASB Proposals on Insurance Contracts – Implications for Other Business Sectors' which can be found on our website at http://www.frc.org.uk/asb/press/pub1378.html .

Suitability of exit value measurement model for insurance business

2. We are not convinced with the arguments for developing a non-entity-specific exit value measurement model for insurance business. As we commented in our response to the IASB's fair value discussion paper (dated 2 May 2007), we support the move towards greater use of current values, but do not believe that non-entity-specific exit values are necessarily the most appropriate version of current value in all circumstances. The DP's exit value model is based on the presumption that liquid efficient markets are available, and that the price that a market participant would contract at can be determined on a reasonably objective and consistent basis. We do not think that such markets exist for insurance contracts; such contracts are rarely transferred between insurers and the risks are often repackaged for the purposes of reinsurance transactions. It is therefore necessary to construct purely hypothetical transactions to determine this exit value. We do not see this as a fundamental objection to the DP's proposals, because in practice the lack of market transactions will mean that many inputs to the valuation (especially in relation to risk margins) will be based on entry price information. However, we think the proposals should be reworked so as to reflect this reality, and the IASB should give further thought to developing a model incorporating entity-specific and entry-price information rather than trying to narrow its approach into an exit value model.

Should you have any queries on the issues raised in this letter please do not hesitate to contact either Simon Peerless on 020 7492 2424 or me.

Yours sincerely

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Appendix – Responses to questions in the invitation to comment

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?

We agree with the IASB view expressed in paragraph 29 of the DP. The ASB also sees no reason why recognition and derecognition requirements for insurance contracts should not be consistent with those in IAS 39 for financial instruments. Insurers are already familiar with the IAS 39 requirements for financial guarantee contracts.

If the IASB does make changes to IAS 39, for example as a result of development of the recognition and derecognition principles in the conceptual framework project, the ASB would recommend that the IASB continues to ensure such consistency between the proposals for insurance and the requirements in IAS 39.

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 do you propose, and why?

In principle, the ASB agrees that measurement of any liability should involve estimates of future cash flows, the effect of the time value of money and a risk margin. We have the following comments on the three building blocks:

(a) The DP adds the qualifier 'unbiased' to the cash flows. We would fully agree that the cash flow estimates should not be biased in the sense of being systematically distorted (for example, biased towards an over-estimate rather than a best estimate). However we do not agree with the implication in the DP that cash flow forecasts from the entity's perspective should be regarded as biased. Instead we consider such cash flows to be equally unbiased but just presented from a different stand-point.

We find it confusing that the DP refers to the measurement of the *liability*, but the cash flows taken into account relate to all contractual rights and contractual obligations relating to the insurance *contract*. We think it would be clearer if the DP consistently referred to measurement of insurance contracts, rather than liabilities. This is particularly relevant to life assurance, where a transfer of the *liability* (as it stands at the measurement date) is very different from a transfer of the *contract*.

(b) We agree that the discount rates that adjust the estimated future cash flows for the time value of money should refer to the current market rates.

For our views on the inclusion of the insurer's credit characteristics in the measurement of an insurance liability see our answer to Q14.

(c) We agree with the notion of a risk margin but find it unclear what the different elements of the margin in the DP are intended to represent. Our discussions with preparers and auditors have led us to believe that there appear to be differing interpretations of these amongst commentators. We had particular difficulty in understanding what is meant by the service margin, and whether this is intended to be merely an additional risk margin relating to the provision of investment management services (representing future potential profits) or whether it is intended to include both a profit margin and the expected costs of providing the services. We believe that the first interpretation is intended, since the expenses should be included in the cash flow projections; but the reference in paragraph 88 of the DP to 'explicit service margins' seems to contradict this. We recommend that the IASB expand on the principle behind the risk margin, as noted in F3 of the DP, and provide a clear principle behind the service margins.

Having noted the above, we disagree with the proposal in the DP that current value of market rates and margins should necessarily be a non-entity-specific exit value. As mentioned in the covering letter, we believe that the nature of the insurance market is such that, in practice, many inputs to the valuation will be based on entity-specific and entry price information. The DP itself acknowledges this fact.

It is only because there is no market in insurance liabilities that it is necessary to develop a valuation model based on these three building blocks. Given that, the goal should be to achieve the most reliable measurement, based on the available evidence on pricing. In the absence of a secondary market in insurance liabilities we believe that the only reliable evidence on pricing is that provided by the transaction price and the entity's own forecasts of cash flows (including administrative and claims settlement expenses). We believe that this approach is the best measure of the burden the insurance liabilities represent to the entity.

We would therefore suggest that the proposals be reworked to reflect this reality and a current entry price model, which allows the use of entity-specific inputs, be

adopted. Please refer to our answer to Q5 for further discussion on the use of exit values when measuring insurance liabilities.

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?

The ASB does not favour including detailed rules in financial reporting standards. We firmly believe that accounting standards should provide the guiding principles and some rules that would be applicable to most users. Although detailed guidance on how cash flows and risk margins are to be determined is likely to be necessary, we consider that this is best left to the industry itself. We note that a similar process has worked well in the UK for a number of years where industry specialists produce Statements of Recommended Practice (SORPs) interpreting the accounting standards as they apply specifically to a particular industry. We would therefore recommend that the IASB only retain the overall principles in the final standard and any detailed guidance (such as that in appendices E and F), if absolutely necessary, is restricted to application guidance only.

For example, the main principles in Appendix E *Estimates of Future Cash flows* are contained in paragraph E2. This is supplemented by more detailed but principled guidance on various aspects of the estimated future cash flows, including paragraphs E4-E6 on *uncertainty and expected present value approach.* However, a number of other areas in the appendix contain simple tick lists of what may or may not be included, for example paragraph E24 gives a list of relevant cash flows that may be included in the calculation. We believe in providing such lists the IASB is in danger of providing a tick list of rules for constituents.

As noted in the answer to question 2, the margins are not widely understood across the insurance industry and have already resulted in extensive discussion amongst industry specialists. However, Appendix F only states the principle behind the risk margin in F2 and only provides further lists of characteristics by way of explanation. We would suggest that the IASB improve the explanation of the underlying principles in this area, provide an explanation of what it envisages the service margin to represent and avoid providing further guidance in the form of tick lists.

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why?

(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).

As referred to in the answers to question 2 above and question 5 below, the ASB notes that the DP's proposals, although described as 'exit value', are in fact a hybrid of entry and exit aspects. The question over calibration is one example of this.

We support option (b), as being the most reliable measure based on the available information. Although option (c) – that the transaction price is no more than one piece of evidence on which the entity estimates the price a market participant would arrive at – is logically consistent with an exit value model, in many cases the transaction price is the *only* verifiable information on which to base this estimate. Only in those rare cases where more reliable evidence on the burden of the obligation is available, should the entity override the transaction price as a basis for measurement of the liability.

As stated in the answer to question 2 above, we believe that the objective should be to make the best use of the available evidence in measuring the liabilities and at initial recognition, in most cases, the actual transaction price provides the only verifiable evidence. Although calibration to entry price moves away from the pure exit price attribute, we believe that calibration to transaction price should be the starting point for the valuation.

We also note that there might be cases where an insurer sells the same insurance contract through two different sales channels, either at differing premiums or at the same premium but one bearing higher acquisition costs than the other (e.g. through an agent to whom commission is paid, and directly). The insurer would therefore arrive at different values for identical liabilities; in such cases, the entity would need to balance the two pieces of evidence.

We are also concerned with the assumption in the DP that different market participants would all derive the same cash flows and discount rates, and that all variation in pricing can be attributed to the risk margin. We think this assertion needs further consideration.

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?

As already noted in the answer to question 2, the ASB would support development of a *current* measurement basis for insurance liabilities, based on the most reliable measurement of the burden to the entity of the insurance liability. However, we do not consider that the DP adequately makes the case that a current measurement basis should necessarily be an *exit* value basis.

As the ASB has previously noted in its response to the IASB DP *Fair Value Measurements*, current exit value is only one basis for current value. Current exit values give the most reliable measure of fair value where markets are liquid and efficient, i.e. high numbers of buyers, sellers and transactions, and where information flows are efficient and freely available to all. However, as soon as any one of these factors is limited, current exit values are no better estimates of fair value than some of the other measures available. For insurance liabilities, liquid and efficient markets cannot be presumed as these liabilities are hardly, if ever, transferred. The vast majority of insurance contracts contain some element of tailoring that could not be transferred other than in a fire sale and would need to be taken into account when arriving at the fair value. Given this, we question whether it is meaningful to attempt to determine current exit value based on a largely hypothetical market and transactions.

We have particular concerns over revenue recognition under the proposed model, which is based purely on the changes in assets and liabilities relating to the insurance contract. Firstly, the use of an exit value model that is not calibrated to transaction prices will give rise to 'day one' gains whose measurement is dependent on highly subjective estimates of the price the market would charge for risk and other factors. Secondly, even under the DP's calibration alternative, a gain is recognised at inception equal to the acquisition costs. Although a case may be made for recognising revenue to represent the services provided to the customer in setting up the contract, we find it difficult to accept that the revenue relating to these services should be measured solely on the basis of the costs incurred.

As noted above, we do not believe that the DP adequately makes the case for the current measurement basis to be an *exit* value basis. For example, paragraph 97 of the DP sets out three reasons for not using an entry price model as follows:

(i) The first in 97(a), that prices may be available only at inception and that subsequent prices are likely to be a theoretical construct, is no worse than the hypothetical third party transaction that the exit price model would require. Generally, insurers continue to hold themselves as willing to write new business for the same risks as their existing portfolio, and it seems to us that it will only be for specialised risks that entry prices will not continue to be readily available.

(ii) The second in 97(b), states that insurers might not reflect changes in interest rates in their pricing and therefore entry prices would not be updated to reflect these changes. We do not understand why an entry price model should not require best estimates of cash flows and current market rates for observable market inputs such as interest rates, to derive an entry price risk margin.

(iii) The third in 97(c), that the insurer's current prices might reflect an unwillingness to take on further specific risks because of an already skewed portfolio, has greater validity. However, this would result in a poorly diversified portfolio being measured at a higher amount than a fully diversified portfolio; something that might in fact provide better information for users than a purer approach of excluding diversification benefits from the measurement.

That said, we note that the DP's proposals already include certain entry value elements (both in implementation A, as explained in paragraph 98, and in the acceptance that in practice the only way an insurer will generally be able to hypothesise the exit value transaction will be to build on its own pricing methodology). We think that an entry value model could have the following benefits:

(i) it would avoid the issue of recognising 'day one gains' based on purely hypothetical and subjective measurements (although the issue of 'acquisition costs' would remain, as would the question of whether it is appropriate to recognise an initial profit equal to the acquisition costs incurred).

(ii) it would avoid the need to exclude 'entity-specific' cash flows; we think it is unhelpful to attempt to measure liabilities on the basis of how a different insurer might settle them, rather than based on the best estimate of how the reporting insurer will settle them.

(iii) It would remove an inherent contradiction in the exit value concept, that whilst the objective is to determine what a third party would value the insurance contract at, the cash flows that are valued exclude future premiums (not meeting the criterion of 'guaranteed insurability') that a third party would nevertheless include in its assessment.

In our view, therefore, the IASB should give further thought to developing a model incorporating entity-specific and entry-price information rather than trying to narrow its approach into an exit value model.

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?

Accounting treatment of expected cash flows from beneficial policyholder behaviour in the insurance industry

The ASB agrees that conceptually the expected future premiums may be regarded as some form of intangible asset, although not meeting the recognition criteria in current standards. This might be regarded as a customer relationship asset, or a 'constructive right' to future cash flows. Principles for the possible recognition of such assets should be developed within a wider intangibles project rather than simply for insurance contracts.

However, in the absence of such an intangibles project, a short-term solution is necessary for insurance contracts. We also note that ignoring the likely continuation of long-term insurance contracts would fail to provide a useful representation of the insurer's business (with the recognition of initial losses on business that is expected to be profitable). Accordingly, we would support the DP's proposals solely as a pragmatic solution to the problem.

Within this pragmatic approach, these cash flows can be seen as part of the measurement of the insurance *contract* rather than the insurance *liability*, and can then be properly included in the measurement of the contract that a third party would assume in a hypothetical transfer.

Therefore, under a current exit value measurement basis favoured by the DP, the solution presented in (b), that these be incorporated as a reduction in the current exit value of insurance liabilities, is the most appropriate. We also note that (b) would also be appropriate under a current entry value measurement basis.

The DP does not address the question of whether it is permissible, under this pragmatic approach, for contracts which result in a net asset to be offset against other contracts with a net liability; or whether the insurer needs to show that the 'net asset' contracts are in fact related to the liabilities on other contracts against which they are netted.

Consistency of accounting treatment to other industries

We are concerned, however, with the potential implications of this proposal for financial reporting of similar types of intangible assets in other industries. Many types of business incur costs with a high expectation of future cash flows that are not contractually enforceable, or where there are long-term contractual arrangements where future receipts are not recognised. For example, investment managers, providers of mobile telephone services, internet connection services, and similar arrangements may incur substantial set-up costs that will only be fully recovered if customers renew or extend the contract beyond the minimum non-cancellable term; but such businesses are willing to incur such costs because these renewals or extensions are highly probable based on previous customer behaviour. Customer payments beyond the minimum term are not usually recognised as an asset as the customer can decide to discontinue premium payment by cancelling the contract. Operators of infrastructure assets under service concessions may also have future cash flow expectations that are highly likely but not contractually enforceable, and current guidance does not allow the recognition of such future cash flows.

Examples used in the DP

We are also concerned that the analysis of this proposal in the DP is based on a very simplistic example (paragraphs 129 to 131). In our view, in this example the policyholder in the first year is acquiring both life cover for one year, and a guaranteed right (or option) to life cover for a second year at a fixed price. This option is, in this example, clearly valuable – a policyholder who becomes unhealthy by the end of the first year is entitled to acquire life cover for the second year which has a 20% chance of paying CU 10,000 (ie an expected payout of CU 2,000) for a premium of only CU 575.80. For the second year, however, a healthy policyholder is paying the same premium for life cover with an expected payout of just CU 500 (5% of CU 10,000). In the example, therefore, the insurer is undercharging for the risks assumed in year 1, in the expectation of recouping the loss from higher charges in year 2 from healthy policyholders who renew (and who could be expected to be able to find cheaper cover for the second year). The IASB's proposed accounting, recognising future premiums, obscures this underpricing of the first year contract. Whilst this simple example may not be representative of actual insurance business, we consider that more careful analysis of this issue is necessary before conclusions are reached on whether recognition of future premiums is in fact appropriate.

Similar concerns arise in the other area mentioned in the DP where future premiums may be recognised. For example, contracts where significant acquisition costs (often commission to intermediaries) are incurred that are expected to be recovered out of future premium income which is expected to arise but which the insurer is not able to enforce.

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 modifying significantly 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).

As noted in the answer to Q6, the ASB cannot find any principles that would support the recognition of cash flows arising from beneficial policyholder behaviour and sees the inclusion of these cash flows as part of the measurement of the insurance contract. As such, it is difficult to see why the 'continuing insurability' test is relevant, as asserted in (a) above.

However, as also noted in the answer to Q6, ignoring the likely continuation of long-term insurance contracts would fail to provide a useful representation of the insurer's business (with the recognition of initial losses on business that is expected to be profitable). Therefore, we would suggest that in the context of the model in the DP the cash flows that should be taken into account are those that relate to the contract being measured, and which would be taken into account by a hypothetical transferee. However, a distinction must be made between the cash flows that relate to the contract and those that relate to the wider customer relationship, which should not be included.

The practical implication of this is that option (b) would be adopted; however, no cash flows resulting from beneficial policyholder behaviour should be recognised separately. We would distinguish new from existing contracts on the basis of whether any further action was required by the insurer, or further acquisition costs incurred, in order to receive the future premiums.

Question 8

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

In the ASB's view, an argument can be made for capitalising these costs, since they represent the acquisition by the insurer of a valuable intangible – the customer relationship and the expectation of future cash inflows. Whilst we would support the development of principles for the recognition of such an intangible, we believe that the DP's alternative – writing-off these costs and, at the same time, recognising an offsetting gain arising from the initial measurement of the liability – is in the shorter term an acceptable pragmatic alternative.

However, whichever approach is taken, it is essential to define clearly which costs meet the definition of acquisition costs. We also note that many other types of business have similar initial cost structures and expected but not contractual future income, and it is important that the IASB is clear on the reasoning for any different treatment for insurance.

Question 9

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

Accounting treatment of excess consideration

The proposed treatment of a portfolio transfer proposed in the DP is different to that under a business combination. In a business combination goodwill comprises the excess consideration paid. By contrast, the DP proposes that in a portfolio transfer any such excess will be taken to the income statement. However, the DP does not elaborate on the distinction between the two types of transfers to justify such different treatment.

Exit price fair value

As the DP notes, the IASB intends to do further work before concluding whether current exit value described in the DP is the same as fair value as currently described in IFRS. The proposals on the measurement of liabilities in the DP are similar, in theory, to the current exit value model. However, in practice entity-specific inputs will more likely be used when measuring these liabilities due to a lack of deep and liquid markets in insurance liabilities. In this respect, the model proposed in the DP is not fair value as defined in the SFAS 157 context, hence a more detailed comparison between them would be justfied. If such a review results in material differences, the IASB would need to explain any exemptions allowed in the measurement of insurance liabilities under the new proposals.

Question 10

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

The ASB considers that in general (and other than as stated in our response to Q17 below) there should be no special treatment for assets held to back insurance contracts. These assets should be accounted for in accordance with the requirements of other IFRSs that govern their treatment.

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?

In principle, the risk margin should be that applicable to the individual contract and should not take into account diversification benefits. However, in practice, the determination of the risk margin will need to be made on portfolios of contracts with similar risks as that reflects more closely the economic realities of the way management run insurance businesses.

In theory, if deep and liquid markets with perfect information flows exist, there are no differences between the valuation of an individual contract and that of a portfolio i.e. no arbitrage or diversification benefit is possible. However, as mentioned earlier ,the market in insurance liabilities cannot be defined as deep and liquid and therefore some diversification benefits within and between portfolios are expected. However, the ASB would not advocate the recognition in the risk margin of the diversification benefits between portfolios. Such diversification benefits arise as a result of the management's stewardship of the business and affect the profits and position of the business as a whole. It is therefore more appropriate to provide explanations of how such benefits arise in the management commentary.

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.

In answer to (a) above, we disagree that the cedant should measure reinsurance assets at exit value. As noted in the DP, the main reason a cedant is prepared to pay more than current exit value for reinsurance is that it pays out precisely when the cedant most needs the money i.e. when it has suffered a loss. Furthermore, reinsurance contracts are often non-transferable. Exit value will apply a market perspective to the valuation thus ignoring this entity-specific nature of the reinsurance contract. However, we are unconvinced by the analysis in the DP (paragraph 209) that the exit price for the reinsurance contract is that in a hypothetical transaction in which both the reinsurance and the reinsured risks are transferred together. We see no justification for combining two separate items in this way (and note that the reinsured risks may be a portion of the risks of a portfolio of contracts, which might not be separately transferable).

We consider that current entry price for reinsurance contracts may provide a better measure of the fair value of the contract and is also likely to cater for this entity-specific element. For example, under an entry price model the consequences referred to in Q12(b) are no longer contentious:

(i) On a current entry price model, the greater the risk covered by the reinsurance, the greater the price the entity is prepared to pay for it.

(ii) The entry price of the reinsurance contract will reflect the expected claims to be made under the contract.

(iii) The current entry price would reflect the value of a right to obtain reinsurance.

Question 13

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

The ASB believes that the argument for unbundling is strongest in those cases where there is a clearly separable savings element in a contract (although practical concerns may arise). In such cases the ASB would support the unbundling of the deposit element and accounting for it as a financial instrument. However, in doing so, the IASB needs to bear in mind the practical cost benefit implications of such rules and perform thorough field testing prior to proposing such a scheme.

We do, however, question the assertion, in paragraph 220 of the DP, that all insurance contracts with premiums paid in advance contain a deposit element. In

our view, an insurance contract is a contract for services (the bearing of risk) by the insurer on behalf of the policyholder, and does not represent a repayable deposit. This is different from the premiums paid under a long-term savings-type life assurance policy where repayment of premiums, plus investment earnings less charges for mortality and management costs is an essential part of the contract, and where the parallels to a deposit-type savings account are much closer.

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?

We are aware that there remains considerable disquiet about the requirements in IAS 39 regarding the inclusion of credit characteristics in the fair value measurement of a liability, and consider that this is a key aspect of that standard requiring further consideration. In our view, the IASB has not yet made a convincing case for this approach.

In principle, we cannot see any reason for taking a different line for insurance contracts on this issue than for financial instruments, where the credit rating of the instrument is taken into account in the fair value measurement. However, we do not consider this to be a major issue for insurance accounting, since insurers generally need a high credit rating to continue in business (and a significant deterioration in their credit rating would often lead to a cessation of the business).

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?

The ASB's views on a number of the inconsistencies noted in appendix B of the DP have already been noted in the answers to the questions above. In particular, the ASB would like to reiterate that it does not support inconsistencies between recognition and measurement requirements for insurance assets and liabilities and those for financial and long-term assets and liabilities. Furthermore, the revenue recognition principles and requirements across the various industries should be consistent.

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?

We think this is a very difficult question that needs more detailed analysis than that given in the DP. In principle, the definition of a liability (including constructive obligations) should be the basis for determining which cash flows are included in the measurement of the liability on a participating contract. However, in practice the precise obligations on the insurer are often unclear (and this varies from one jurisdiction to another – e.g. in recent years the FSA's rules have incorporated a much more explicit obligation to pay a 'fair' return to policyholders than was previously the case).

In addition, deciding how much the insurer is obliged to pay to policyholders in varying scenarios is complicated by the fact that some of these payments are contingent on receipt of future premiums from policyholders, and also on the actions taken by management in each scenario, e.g. to switch from one investment category to another in reaction to market volatility.

This question assumes greater importance if the surplus in the life fund is treated as a form of equity rather than (as is currently the case in the UK) as a separate item within liabilities (the 'fund for future appropriations') since increase or decreases in the policyholder liability then become more prominent.

We do not, therefore, think that the guidance in the proposed amendment to IAS 37 will result in consistent interpretation of what constitutes a constructive obligation in the case of participating contract liabilities, and consider that this issue requires more fundamental analysis and development of clear principles.

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).

In principle, the ASB agrees with elimination of mismatches that may arise. However, in practice this can lead to often complex adjustments for a relatively small portion of the balance sheet. In particular,

(a) We think that the theoretically correct answer is that the insurance liability contains a derivative on the insurer's own shares that should be separated and included in equity, matching the treatment of the treasury shares. However, this would be a complex adjustment for what (in most cases) is likely to be a relatively small proportion of the investment portfolio and linked liability. Therefore, on pragmatic grounds, we would be prepared to see treasury shares recognised as an asset in these limited circumstances.

We note that if the insurer were to unbundle the unit-linked assets and liabilities and treat as deposits rather than insurance contracts these will become off-balance sheet and the treasury shares will no longer need to be reported as an asset on the insurer's balance sheet.

(b) A similar approach is allowable in the UK under FRS 27 *Life Assurance.* It may be argued that the measurement of the goodwill in the subsidiary must be capable of being made reliably – otherwise the insurer will not be able to determine the amount at which the linked liabilities are to be settled.

(c) Since the insurer will settle the unit-linked liabilities based on market valuation, the valuation must be reasonably reliable and it may therefore be justifiable to treat these assets as at fair value through profit and loss.

(d) We believe that excluding from the current exit value of a unit linked liability the differences between the carrying amount of the assets held to back such a liability and their fair value will result in the liabilities being misstated. The approach, as described, amounts to netting-off of assets and liabilities and is not a principled approach.

We do not agree with the argument in paragraphs 283 and 284, that the exit value of the liability can be taken as excluding the value of the unrecognised assets. First, this violates the principle that the measurement of the liabilities should be independent of the assets to which they relate. Nor do we agree that the transfer of the liabilities without the related investments is 'inconceivable', even if, in practice, this might be more usual. Since the exit price is based on a hypothetical transaction, we cannot see why this should not hypothesise the transfer of the liabilities alone. Finally, if it is assumed that the assets and liabilities must be transferred together, this merely establishes an exit value of nil for the combination; it could equally well be argued that the exit value of the assets should be 1000 (in the example in paragraph 284) to equal that of the liabilities, than to argue that the exit value of the liabilities should be 950.

Question 18

Should an insurer present premiums as revenue or as deposits? Why or why not?

As mentioned in our answer to Q13 above the deposit element should be accounted for as a financial instrument in accordance with IAS 39. Apart from this, we do not consider that insurance premiums are deposits, since the payment of claims is not the return of the premium (the claim paid to a specific policyholder will often be substantially greater than the premiums paid by that policyholder).

Further consideration should be given to the recognition of revenue. The implication in the DP is that revenue is simply the change in value of the insurance liability. We consider that revenue should reflect the recognition of premiums over the period in which the insurer is bearing risk.

Question 19

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

We believe that this should be addressed as part of the IASB's project on the presentation of financial statements.

Question 20

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

Yes; the ASB believes that some disaggregation of income and expense arising from changes in insurance liabilities would be beneficial to the users. However, the IASB would need to decide between the elements that should be disclosed on the face of the income statement and those that should be disclosed in the notes.

Question 21

Do you have other comments on this paper?

The ASB considers that insurance accounting should follow the same principles as general financial reporting, unless there is a specific and identified reason for taking a different approach. As mentioned in the covering letter, the ASB has concerns that the principles developed in the DP might have significant consequences if adopted in other non-insurance areas of financial reporting. These are discussed in detail in our briefing paper 'IASB Proposals on Insurance Contracts – Implications for Other Business Sectors', which can be found on our website at the following address http://www.frc.org.uk/asb/press/pub1378.html. A number of these concerns are summarised below.

Consistency with recognition of non-financial liabilities

In an insurance context, in some cases – particularly for with-profits life assurance – there is considerable uncertainty in determining which future bonus and other payments represent contractual or constructive obligations of the insurer and which are at the discretion of management (even though there may be compelling commercial reasons for payment). Discretionary payments of this kind do not generally arise in other types of life assurance and general insurance, but there are still issues as to the timing of recognition of potential claims, and whether arrangements such as no-claim discounts, premium refunds etc give rise to liabilities. Development of further guidance on the recognition of liabilities in these circumstances could have implications if extended to apply consistently to non-insurance businesses. This could have significant implications for the timing of recognition of provisions of all types.

The 'expected' basis also differs from the 'incurred loss' basis currently used for recognising impairment of financial assets such as loans and advances in a banking entity.

Liabilities and equity

The IASB is currently considering the definition of liability and equity as part of its conceptual framework project. For life assurers, the question arises as to how the surplus held within the life fund should be classified – that is, the amount in excess of the constructive obligations to policyholders that will be recognised as liabilities. This surplus falls within the current definition of equity; however, only part of this surplus may be distributed to shareholders; the remainder would be distributed to current or future policyholders.

However, if discretionary with-profits bonuses were to be treated as liabilities, a similar approach might apply to profit-sharing arrangements in non-insurance businesses, including for example participating preference share dividends.

Pensions accounting

Many issues relating to the measurement of insurance liabilities (and in particular those arising from life assurance contracts) are similar to measurement issues for pensions liabilities and would need to be considered simultaneously with the insurance proposals to ensure consistency of approach. Such issues include:

(a) the appropriate discount rates for uncertain long-term liabilities, and whether the expected investment return on assets held to meet the liabilities is relevant to the measurement of the liabilities;

(b) the incorporation of risk factors into the measurement; and

(c) the measurement of liabilities where there is an element of discretion in the amounts to be paid.

Capital Disclosures

The DP addresses accounting for insurance *contracts*, not insurance *entities*, and as such does not discuss capital disclosures (which relate to the entity as a whole). In developing FRS 27, the ASB concluded that it was essential that a life assurance business provided full details of its capital position – both the regulatory capital targets it was required to meet, and the capital available to meet those targets. The ASB considers information on the extent to which capital held in one part of a group is available, or not, to meet capital requirements imposed on another part of the group to be particularly important for insurance entities. IAS 1 (as amended in 2005) requires disclosures relating to capital that are in broad terms similar to those of FRS 27, but because these are applicable to entities generally, and not specific to insurance entities, they do not address specific insurance-related issues and do not result in the same level of detailed disclosure. The ASB would recommend that such disclosures are incorporated in any future proposals the IASB develops for insurance entities.