



Chairmen

18 December 2007

Ref: 7/265

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

Dear Sir David

**Discussion Paper: Preliminary Views on Insurance Contracts**

On behalf of members of the International Association of Insurance Supervisors (IAIS) we are writing to comment on the Discussion Paper *Preliminary Views on Insurance Contracts*.

The IAIS is an international organisation comprising insurance supervisors from over 190 jurisdictions in nearly 140 countries, supervising insurers with approximately 97% of the world insurance markets. One of its main objectives is to promote the development of well regulated insurance markets. As this involves the implementation of high quality financial reporting standards, the IAIS has a keen interest in the work of the IASB. We have particular interest in those IASB proposals that will most influence the overall accounting model for regulated insurance enterprises in the interest of providing a meaningful, economically sound portrayal of these enterprises to the external markets.

Phase II of the Insurance Contracts Project is of crucial interest to the insurance industry and to insurance supervisors. Reflecting the importance of this project to the IAIS, in 2005 and 2006 we provided to the IASB two sets of observations on Phase II issues, as input into the insurance contracts project. We are now pleased to provide our comments on the discussion paper; in a number of areas our response draws upon positions discussed in further detail in those papers. These and other prior IAIS stated positions on valuation have also been consolidated in a paper *Summary of IAIS positions on the valuation of technical provisions* (October 2007), which is available on the IAIS website at [www.iaisweb.org](http://www.iaisweb.org).

The IAIS supports the IASB's efforts to develop a principles-based international financial reporting standard for insurance contracts, and has welcomed the publication of the discussion paper as an important step in the process. Nevertheless, a number of significant issues and questions will require further careful consideration before finalising the accounting model to achieve a solution which can be implemented and has widespread support, and the IAIS looks forward to continuing to provide input to and working with the IASB throughout the Phase II project.

## International Association of Insurance Supervisors

Comments on IASB Discussion Paper: Preliminary Views on Insurance Contracts

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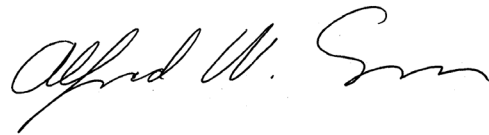
Finally, we should like to thank you very much for your letter of 1 November and the IASB's understanding on the deadline for submission of comments on the Phase II discussion paper. This has made it possible for us to hold a further round of discussions within the IAIS Insurance Contracts Subcommittee before finalising our comments and, we believe, to significantly enhance the quality of our response on the discussion paper.

If there is any way in which the IAIS can assist the IASB further, please do not hesitate to contact Rob Esson, Chair of the IAIS Insurance Contracts Subcommittee (tel: +1 816 783 8131; email: [resson@naic.org](mailto:resson@naic.org)) or Peter Cooke at the IAIS Secretariat (tel: +41 61 280 9196; email: [peter.cooke@bis.org](mailto:peter.cooke@bis.org)).

Yours sincerely



Michel Flameé  
Chairman, Executive Committee



Alfred Gross  
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## **I. General comments**

1. The International Association of Insurance Supervisors (IAIS) has been pleased to provide input to the Board during its considerations of the Phase II Insurance Contracts Project. Two prior papers, referred to colloquially as the first and second "Liabilities Papers",<sup>1</sup> were provided to the Board in May 2005 and May 2006 respectively. The Board will be aware that the IAIS has an overriding principle and aim:

*The IAIS believes that it is most desirable that the methodologies for calculating items in general purpose financial reports can be used for, or are substantially consistent with, the methodologies used for regulatory reporting purposes, with as few changes as possible to satisfy regulatory reporting requirements.*

2. While not commonly realised, Insurance Supervisors are one of the largest groups of users of general purpose financial statements for insurance enterprises, even in those jurisdictions where additional reporting requirements are imposed on the regulated entities. As such, the IAIS has a vital interest in the final insurance contracts standard.

3. The IASB will be aware from the prior work of the IAIS that the IAIS supports many of the Board's tentative conclusions, and many of the underlying directions of the insurance contracts project. In particular, the IAIS was – and remains – an early supporter of the use of some form of exit value as the measurement attribute for insurance contracts. We remain ready and willing, as we have stated in our prior commentary, to work with the Board, to enhance the dialogue between the IAIS and the IASB on these matters and work towards an objective of facilitating consistent regulatory and general purpose financial reporting.

4. The IASB has been working on the insurance contracts project with little respite for ten years. If it were easy, it would have been completed several years ago. It is not easy, and the project spreads its tentacles into almost every difficult area with which the Board is dealing. In many areas of the project, a theoretically pure answer on one aspect may work for that aspect, but then causes problems with others. As such, we are of the opinion that there is no perfect solution to the project, merely practical solutions that may go only 50, 70, 90% towards the theoretically pure answer in various aspects, which when integrated across the whole project provide the optimal practical solution at the expense of theoretical purity in some situations. As an analogy, we think that there are aspects of the project that are inter-related like a party balloon: squeeze any one part hard enough and it pokes out in another place.

5. Our recommendations are governed by this realisation. For example, we support the use of market-consistent measures to the extent possible. We also support the theoretical concept that it ought not to matter whether one measures at the individual contract or portfolio level. We believe as an important principle that similar obligations with similar risk profiles should result in similar liabilities. The problem is that these three notions – when pushed to the limit – become inconsistent with each other.

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<sup>1</sup> IAIS: *Issues arising as a result of the IASB's Insurance Contracts Project – Phase II: Initial IAIS Observations* (May 2005) and

IAIS: *Issues arising as a result of the IASB's Insurance Contracts Project – Phase II: Second set of IAIS Observations* (May 2006), available on the IAIS website at [www.iaisweb.org](http://www.iaisweb.org).

6. In all these cases, we believe that there will need to be a practical solution and that the Board will need to find a way to achieve a result that improves financial reporting in a cost effective manner.

7. One of our recommendations, which expands on a recommendation in the second Liabilities Paper, is to promulgate a common reference framework for modelling, until such time as insurance liabilities become directly observable in a deep liquid traded market. The lack of market observability for the vast majority of insurance liabilities causes many of the problems inherent in the project. If insurance liabilities were traded in a deep, liquid market (leaving on one side the significant legal obstacles to enable this to happen), then the exit price would be observable and akin to "level 1" fair value.

8. Clearly this is not the case, and hence the Board is recommending a proxy methodology – the three building blocks – to try to model or approximate the exit price. However, in particular, the risk margin component is particularly difficult to calibrate reliably, and there is little current guidance on how to do so in a manner that will promote consistency and comparability.

9. An example, but not necessarily the only one, would be to define a reference entity for the purpose of modelling, which might obviate some of the inter-related problems noted above and notably enhance comparability. For example, a large well-diversified AA-rated insurer would imply that the transfer notion would take into account a market level of diversification (an alternative being a non-diversified, mono-line insurer, which would not consider inter-risk diversification benefits). Additionally, the transfers could be modelled to an entity with a specified credit rating, and therefore standing, at a level that is likely to be practical. Some of the putative transfers under the concept of similar credit standing in the discussion paper would, quite simply, be illegal in the vast majority of jurisdictions. This common reference framework would solve these problems while more clearly reflecting the intended exit value concept.

10. The other area that we feel may help the project considerably would be a principles-focussed approach to the specification of cash flows, rather than the application of non-market constraints. This is a notion with which a number of Board Members seem uncomfortable, yet we believe that done correctly would improve the project. The key, it seems to us, is the correct interpretation of the wording of building block (a). The requirement in paragraph 34(c) of the discussion paper is to "incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations." Paragraphs 39 – 43 expand on this notion to clarify that this would require probability weighting of the cash flows under various scenarios. The IAIS agrees with these suggestions. However, there has been disquiet at the Board regarding where the contract begins and ends, and whether certain disaggregated cash flows meet the definition of an asset or liability when looked at in isolation.

11. We would suggest that, while the idea of disaggregating the cash flows appeared at first to be a promising approach, it has not met its promise and that a different way of looking at these ten-year old problems may be better. In particular, rather than trying to split up cash flows and define exactly where contracts in the abstract begin and end, we recommend looking at the difference between having a contract, and not having a contract. The things that arise in the one case that do not in the other constitute a fairly good definition of what the contract is all about. The Board seems almost to be wavering in its application of principles regarding recognition and measurement, and it seems to us, has "peeked ahead" in a number of cases.

12. An example would be discretionary participation features, which are an important part of the observable exit value of certain life contracts. It is as if the Board has agreed that there are contracts to be recognised, but has then peeked ahead to the measurement, and disaggregated the expected cash flows, because it feels that some cash flows would not meet the definition of a liability in isolation. In order to square the circle, it has then had to go back to reconsider the recognition criteria to exclude those cash flows from recognition in the first place. In our view, the better way would be to ask the question whether, in totality, there is a right or an obligation to be recognised as a result of the contract. If yes, then an artificial disaggregation of the product into particular cash flows that is known to be inconsistent with market behaviour does not seem to us to constitute a faithful representation of the measurement of the exit value of the contract.

13. We are fully aware that some are concerned about the possibility that using unconstrained cash flows in the measurement process may give rise to abuse, in particular where principles are at risk of being interpreted differently by different companies, which raises issues of comparability and faithful representation. We believe, however, that two factors should work to mitigate the potential problems. Firstly, cash flows to be considered may be further specified through clearer principles. Secondly, a true probability weighting of the cash flows would adjust them for all scenarios. The appropriate response to concerns about issues arising from the use of unconstrained cash flows is not to constrain the cash flows so as to ignore real world economic views, but to provide clear principles and guidance on appropriate probability weighting of cash flows to prevent the abuse in the first place.

14. Such true probability weighting of cash flows would also, we believe, help with the issue of policyholder behaviour. Insurance policies are not treated like fungible financial instruments by policyholders, whether efficient markets theory dictates they should be or not. Consequently, a real world economic view of insurance contracts should take into account reasonable expectations of policyholder behaviour. We believe that these are all part of a true probability-weighted valuation of cash flows. While not necessarily harmful, we do not believe that the construct of a "policyholder intangible asset" is necessary if the cash flows are weighted on the basis of true economic expectations. The end result, which we believe the Board supports, would be financial reporting for insurers that would reflect their true economics in a decision-useful manner.

**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?**

15. We see no good reason in theory for the recognition and derecognition requirements for insurance contracts to be inconsistent with those for financial instruments in the current version of IAS 39, which we see as rooted in the general asset-liability model.

16. However, we believe that further awareness of the practical application of the recognition and derecognition requirements to insurance contracts is necessary. In particular, there is a question of when there actually is an insurance contract, which may necessitate reconsideration of the insurance contract definition under IFRS 4.

### *Recognition*

17. Paragraph 27 of the discussion paper quotes from IAS 39 (paragraph 14) as follows: "An entity shall recognise a financial asset or a financial liability when, and only when, the entity becomes a party to the contractual provisions of the instrument." In the Board's preliminary view, that requirement is also appropriate for insurance contracts. In other words, an insurer would recognise rights and obligations created by an insurance contract when it becomes a party to the contract.

18. We note that the application of these recognition criteria to insurance contracts would imply a material change to current practice. In many jurisdictions insurance liabilities are recognised from the date of contract inception, ie from the date on which the insurance cover starts. However, insurance contracts are commonly entered into before that date. For example, an insurer might enter into a contract on 1 November (the binding date), for coverage to commence on 1 January (inception date). We assume that the IAS 39 criteria imply that the rights and obligations arising from the insurance contract should be recognised from the date that the insurer becomes bound to the contract. This should be made explicit in the paper.

19. A change to current practice would have wider consequences than just the requirement to measure the rights and obligations under the contract during the period from binding to inception. Revenue recognition and the calculation of certain performance indicators are interrelated with current practice for recognition of the liability. These would have to be reconsidered in light of the changes to current practice regarding recognition. Such changes would also have a knock-on effect on the measurement of reinsurance contracts (insurance assets), for which measurement issues do not currently generally arise until the start of the period of coverage, cf. question 12 (b) (iii).

20. In some cases, entering into a contract before inception is only binding for the insurer, while the policyholder has the option to withdraw from the contract, for example simply by not paying the premium. The existence of such cases highlights the need for including options and maybe also other derivatives on insurance contracts in the scope of the standard in order to ensure consistent measurement between such derivatives and the underlying contract.

21. All in all, the IAIS doubts that the benefit of the theoretically pure approach to recognition in accordance with IAS 39 would be sufficient to outweigh the costs and practical issues surrounding such a significant change to current practice. If the Board agrees and therefore ultimately concludes that there is no need for such a significant change, it is important to note however that insurers should still be expected to recognise onerous contracts immediately upon binding.

### *Derecognition*

22. Paragraph 39 of IAS 39 states: "An entity shall remove a financial liability (or part of a financial liability) from its balance sheet when, and only when, it is extinguished – ie when the obligation specified in the contract is discharged or cancelled or expires".

23. We agree in principle with the IAS 39 approach and also believe that current practice is largely consistent with this approach, but would add the following additional comments in respect of insurance contracts.

24. The period of risk exposure under insurance contracts is usually well defined, and should have a clear expiry date. However, in many cases it can be difficult to establish whether the liability in respect of the risk exposure is extinguished because valid claims can emerge long after the risk period has expired. In noting the above, we do not see the issue as a matter of principle but as one of implementation.

25. We also note that it is possible for a liability to be extinguished by transfer to another insurer, but the more usual arrangement for transferring risk is reinsurance. In a reinsurance transaction the liability is not extinguished but is retained by the original insurer.

## **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?**

26. The IAIS has previously stated that for insurers it believes that a current economic valuation of assets, obligations (liabilities) and risk exposures is necessary to provide sufficiently relevant and reliable information about the financial position of an insurer. The IAIS also recognises the need to assess the overall financial position of an insurer based on consistent measurement of assets and liabilities. In this regard, the IAIS supports the concept of current economic valuation as it will enhance consistency in the valuation of assets and liabilities.

27. Insurance liabilities, in general, should be measured at observed market prices if available and relevant. Where prices can be observed in a deep, liquid market, then such inputs would achieve the measurement objective without the need to use the building block approach. However, as such prices are not available for insurance liabilities in most cases, a proxy methodology is required. The IAIS therefore believes, in principle, that the three building blocks approach provides an appropriate methodology for the measurement of those elements of insurance liabilities that are not measured in deep, liquid markets.

28. We assume that the notion of "contractual cash flows" encompasses all cash flows stemming from the contractual relationship between the insurer and the policyholder not excluding, for example, optional or discretionary cash flows. Failure to capture all appropriate cash flows can result in significant distortions in the results.

29. Where elements of the liability are not measured in deep liquid markets, building blocks (a) and (c) require the current estimate and the margin, respectively, to be "explicit", and we encourage the IASB to include requirements for separate disclosure of the current estimate

and the margin. As the discussion paper does not consider disclosure requirements it is unclear to us what is meant by "explicit" within the above context, and we encourage the IASB to clarify on this. We agree that the building blocks approach implies that the cash flows, the discount rates and the margins are assessed separately. Furthermore, when disclosure issues are put on the agenda, we will support that there are requirements to disclose the present value of the cash flows, the size of the margins and (in some circumstances, such as for outstanding claims) the size of the effect of discounting. Such separate disclosures help to promote understanding of an insurer by both (potential) policyholders and other market participants, as well as market discipline by insurers.

30. Reference to market assumptions is appropriate only for data that is reliable, easily accessible and covers aspects/characteristics of insurance that are clearly identifiable and sufficiently "homogeneous" on a reference market. Excluding too widely and strictly evidence of the company's own experience in managing a portfolio may lead to difficulties in terms of relevance and faithful representation and thus be inappropriate in many circumstances. Consequently, the IAIS believes that, where reference to market assumptions is not appropriate, the entity's own cost structure would be used as a proxy. In such situations, the transfer notion inherent in the discussion paper would imply a transfer to an entity providing the same level of service at the same cost.

31. Regarding building block (a), we note (and support) the guidance in Appendix E (paragraph E21) which indicates that cash flow scenarios should be sensitive to future inflation rates.

#### *Discount rate*

32. Regarding the discount rate, paragraph 47 of the IAIS's first Liabilities Paper reads as follows:

*The IAIS believes that, when a deep liquid market of appropriate term exists, a risk free rate is appropriate, except where benefits are dependent on the performance of the underlying assets, and that discounting should utilise the entire yield curve, rather than an average rate. When a deep liquid risk free market of appropriate term does not exist, reference should be made to the highest quality and deep liquid markets that do exist such as swap or other derivatives markets, markets for long term utility debt, markets for high quality long term corporate debt etc.*

33. In short, the IAIS believes that estimated cash flows should, in principle, be discounted by risk free rates corresponding to maturities of the cash flows used in the measurement of insurance liabilities.

34. The IAIS fully supports the Board's preliminary view that all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations should be reflected in insurance liabilities. Under the three building blocks approach, the IAIS understands that the cash flows are estimated in first building block, the price of uncertainty of the estimated cash flows is considered in the third building block, and only the factor of the time value of money is in the second building block. In other words, the estimated cash flow should, in principle, be discounted by the risk free rates in the second block.

35. Consequently, the IAIS does not believe that asset earning rates should be used for discounting (except implicitly for unit linked contracts and where appropriate for participating contracts, where the cash flows from liabilities perfectly or symmetrically link with those from the underlying assets).



36. Additionally, while paragraph 69 of the discussion paper suggests that the discount rate applied to liability cash flows should perhaps be adjusted for their liquidity, we are concerned that the practical implementation of this may be difficult and that if an adjustment is necessary it may be addressed better by other means.

*Service margin*

37. IAIS members – as well as other commentators – are unsure of what is intended by the "service margin" referred to in building block (c). IAIS members are concerned over the prominence given to the service margin. We discuss this issue further, in more detail, in our response to question 4.

38. The IAIS is currently of the view that the costs of providing services, and the uncertainty around those costs, are dealt with in the cash flow estimates (building block (a)) and risk margin (building block (c)), respectively. In other words, the element included in the current exit value described in the discussion paper as "service margin" could be dealt with in building block (a) under the assumption that the service components in the contract are outsourced.

**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?**

39. The Board has indicated its intention to develop a principles-based standard. There are also several areas in the discussion paper where the Board indicates that it does not intend to provide detailed guidance (eg approaches to determining risk margins and discount rates). Factors such as the discount rate and risk margin may have a significant impact on the balance sheet. Small differences in such factors may have a large impact upon the measurement.

40. An appropriate level of guidance will help to promote comparability in the application of the Phase II standards worldwide. At the same time, products vary from jurisdiction to jurisdiction (due to differences in legal environments, markets etc.) which may give rise to a need for additional guidance at the national or local level.

41. The IAIS believes that significant guidance will be required on both estimating future cash flows and calculating risk margins. Neither Appendix E nor Appendix F provide the level of guidance that will be necessary for consistent worldwide implementation and application. However, it might not be practical or necessarily appropriate for the full extent of the guidance to be provided as part of the Phase II standard; detailed guidance in the standard would not be consistent with a principles-based approach (which the IAIS supports). The subjects of insurance cash flow estimation and risk margins are also highly technical and an area of ongoing study and practice development by the actuarial profession.

42. For this reason the IAIS believes that the actuarial profession has a significant part to play in developing guidance for actuaries to use in measuring insurance liabilities in accordance with the forthcoming standard. The IAIS has encouraged the International Actuarial Association (IAA) to continue its work this area, and we anticipate that the output will provide an important contribution to the development of actuarial guidance. Such

actuarial guidance at the international level would help to promote worldwide consistency in application. Local features may require that national actuarial standards provide more specific guidance.

43. We understand that if application guidance involves the removal of options within IFRS, provided there is appropriate disclosure, this does not create non-compliance with IFRS. It would be helpful if this were acknowledged in the Phase II standard.

**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).**

44. As an opening comment on this question, we would note the strong interrelationship between the issues above and those which the IASB's Revenue Recognition project will cover. It is clearly preferable that the results emerging from the Phase II and Revenue Recognition projects be as consistent as possible. The latter project is still at an early stage. The IAIS will be commenting on the output from that project in due course. As more conclusions and insights come out of the Insurance Contracts, Revenue Recognition and other projects, some Members' views may evolve. Their stated positions below should not therefore be taken as immutable.

45. We would be interested in receiving further information on the costs contemplated within "relevant acquisition costs" and the rationale for deducting these.

46. The IAIS has found it necessary when considering the calibration of margins to give further consideration to the issues surrounding profit on inception.

47. The IAIS's second Liabilities Paper includes the following principle: "An exit model is preferable but profit on inception should be recognised only where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities." IAIS Members' views differ on how this can best be achieved.

48. While IAIS Members are unanimous that losses on inception should be recognised immediately, they differ regarding situations where a profit on inception might possibly arise.

49. Three broad approaches have emerged at this stage, which are best illustrated by a diagram of premium calibration.

50. Approach I calibrates the margin in accordance with alternative (c). Profit on inception which arises would be dealt with through the income statement.

51. Approach II is similar to Approach I, except that the calculated profit would be deferred as a liability and released to the income statement over the life of the contract.

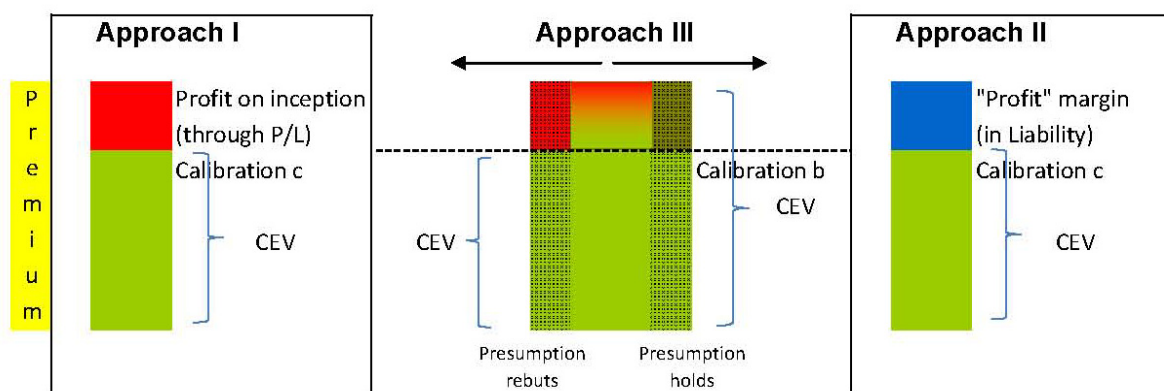
52. Approach III calibrates the margin in accordance with alternative (b) (rebuttable presumption that the margin is implied by the actual premium). As a result

- where the presumption holds the total amount – representing a current exit value (CEV) – is treated as an insurance liability (similar to Approach II except that there is no deferred profit element).
- where the presumption rebuts, calibration defaults to alternative (c) and initial profit arising is treated in accordance with Approach I.

53. In the discussion which follows, it is regarded that there is no need for an explicit service margin for the reasons given in paragraph 38.

**Diagrams of building blocks**

(Service components are presumed to be included within the cash flows and the margin)



*Approach I*

54. Insurance supervisors from the following jurisdictions support Approach I: Belgium, Canada (OSFI),<sup>2</sup> Denmark, France, Guernsey, India, Japan,<sup>2</sup> Spain, the UK.

55. Members supporting Approach I believe that calibration (c) is most appropriate. They believe that the premium may provide evidence of the margin that market participants would require but has no higher status than other possible evidence. If a significant profit or loss appears to arise at inception, further investigation is needed in order to ensure that proper internal controls, and proper governance around the calibration as well as the use of reliable models are in place. Nevertheless, if the insurer concludes, after the above procedures, that the estimated market price differs from the price implied by the premiums that it charges, any difference between the premium and the current exit value should be recognised in the income statement as profit or loss.

56. Recognising this difference within liabilities would not be in line with the measurement attribute (current exit value). Consequently, the supporters of Approach I believe that the difference should not be recognised in the liabilities as it is not part of the insurance obligations nor does it represent any further obligations to the policyholder.

*Approach II*

57. Insurance supervisors from the following jurisdictions support Approach II: Australia, Germany, Italy, Poland, Switzerland.

58. Supporters of Approach II are persuaded, by market evidence and the contractual nature of financial services contracts, that the value of insurance contracts encompasses more than just the amount required by market participants to take on the underlying insurance obligations. Applying the building block approach, this additional component would not constitute part of the current exit value, even with full allowance for all relevant cash flows and an appropriate and sufficiently reliable risk margin. In the absence of an alternative accounting treatment this would lead to significant gains at inception which are likely to exceed the level which many may have previously anticipated.

59. They believe that the additional component should be addressed by the inclusion within the total liability for the insurance contract of an additional “profit” margin calibrated to achieve nil profit at inception after allowing for the value of all relevant cash flows, allowable acquisition costs and a sufficient and reliable margin for risk. This “profit” margin should be released over time in an appropriate pattern to reflect the realisation of the value inherent in the additional component.

60. They consider that this approach is consistent with the treatment under other accounting standards for other financial services contracts, and so avoids accounting arbitrage. They consider that it is better to adopt an approach for insurance contracts that is consistent now and change it in due course as the other standards evolve: it would set an unnecessary precedent for the insurance industry to jump ahead of other accounting developments.

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<sup>2</sup> For Canada (OSFI) and Japan, Approach III would be acceptable as a transitional and practical solution to the extent that profit on inception derives from the miscalibration of current estimates and risk margins.

61. This approach, they believe, would also address the concerns held by many about the impact of allowing the potential recognition of significant profits at inception, particularly given doubts in some quarters as to the reliability of measurements involving “level 3” (ie modelled) inputs, which would inevitably be the case with a pure current exit value measurement.

62. They conclude that the “profit” margin does not meet the current definition of current exit value, being an amount that an acquirer would require as compensation in order to take on the obligations (assuming that the cash flows included in the calculation of current exit value include the full, unconstrained amount of future premiums). They consider that the risk margin and the “profit” margin are fundamentally different in nature and it would be inappropriate to treat them the same. This should not be regarded as a retreat from the principles of current exit value: it merely represents an acknowledgement that there is something more outside of the current exit value which is needed to fully account for the entire insurance contract.

63. They therefore see the liability for the insurance obligations alone (measured at current exit value) as being distinct from the liability for the insurance contract as a whole, which includes the additional “profit” margin to deal with the additional component, ie the value of the additional component should be explicit and transparent and be disclosed separately.

64. To align with a risk based solvency regime, those who support Approach II believe it is important that the current exit value is not tainted by margins which are not risk based. They believe that a current exit value determined as above achieves this.

65. Under this approach it is most appropriate if the impact of any subsequent changes in either the non-financial estimates of future cash flows or the assumed risk margin is not recognised immediately as a profit or loss at the time of the change. This is because such changes implicitly lead to a change in the value of the additional component under the contract. It follows that the “profit” margin should be recalibrated at that point, consistent with the manner of calibration at inception, rather than allow the change to be released to the income statement.

66. They see this approach as having the additional benefit of neutralising many of the as yet unresolved issues in relation to accounting for insurance contracts (eg when to recognise the contract and any associated up-front profit, allowance for relative efficiency or diversification, allowance for beneficial policyholder behaviour and future premiums, inconsistencies with other accounting standards and the need for unbundling, profit recognition for participating contracts, etc.).

### *Approach III*

67. Insurance supervisors from the following jurisdiction support Approach III: USA.

68. Supporters of Approach III believe that the appropriate calibration in practice would be effectively equivalent to alternative (b). However, their reasoning is slightly different to the wording of 4(b).

69. They believe that the correct principle for calibration is to utilise a current exit value, and that the total liability should equal the current exit value. However, they recognise that there are uncertainties inherent within the estimation processes in modelling, including particularly in this instance insurance loss modelling.

70. Consequently, they believe that unless the current exit value is very clearly significantly below the amount implied by the actual premium less acquisition costs, great care is needed

before recognising a profit on inception. They believe that neither discounted cash flows nor margins are computable to a high degree of exactitude and that the margins, in particular, will tend to be a range of values rather than one single figure.

71. Hence, when an estimation of the profit on inception is within a reasonable range of the possible measurement error of the current exit value, they believe that it is better to calibrate the margins based on the observed market transaction price. However, they also believe that when the implied profit on inception is outside this range, it should be recognised.

72. In this regard, the work of Messrs. Borio and Tsatsaronis *Risk in financial reporting: status, challenges and suggested directions* is, they believe, relevant; in particular, the item labelled "measurement error" in their BIS paper:<sup>3</sup>

*Measurement error information designates the margin of error or uncertainty that surrounds the measurement of the variables of interest, including those that quantify risk. The need for this type of information arises whenever these variables have to be estimated. For instance, measurement error would be zero for first-moment information concerning items that were valued at observable market prices and for which a deep and liquid market existed. But it would be positive if, say, such items were marked to model and/or traded in illiquid markets, since a number of assumptions would need to be made to arrive at such estimates.*

*The margin of error, in turn, can derive from two sources. There may be intrinsic uncertainty about the measure, arising from imperfect "modelling" of the variable – what one may call "model error". Or whoever is the source of the information may intentionally misreport it, giving rise to what one may call "reporting bias error". (...) instances of the former include the margin of error associated with predictions about future cash flows used to calculate the current value of a loan (first-moment information) or the parameters used in calculating VaRs (risk information(...)). Instances of the latter include the uncertainty surrounding the reporting of a profit or VaR figure over which the reporting entity has some discretion and that could give rise to a gain if not reported truthfully. For instance, profit figures could be purposefully inflated if the compensation of the manager was tied to short-term share performance, as painfully revealed in the aftermath of the recent equity market bust.*

73. This measurement error is outside the explicit taxonomy of the building blocks, and hence implies a potential variability in the current exit value derived from those building blocks: it is for this reason that they believe that utmost diligence is required in the recognition of a reliable profit on inception.

74. Under this approach the impact of subsequent changes in estimated cash flows or the assumed risk margins would be recognised in the income statement at the time of the change. Supporters of this approach would not believe it appropriate to move estimates to a different part of the reasonable range of estimates, absent persuasive evidence, for the reasons stated in paragraph E16 of the discussion paper.

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3 Claudio Borio and Kostas Tsatsaronis: *Risk in financial reporting: status, challenges and suggested directions*, Bank for International Settlements (2006), available at [www.bis.org/publ/work213.htm](http://www.bis.org/publ/work213.htm).

**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?**

75. In response to (a): The IAIS believes that the measurement attribute described is an appropriate measurement attribute for insurance liabilities. The attribute is based on the notion of transfer. The IAIS believes that the notion of transfer would be strongly influenced by the settlement obligations that the transferee would undertake upon acquisition. In other words, any transfer would need to be made to an entity capable of accepting the transfer, which, in the case of a regulated industry like insurance, implies that the transferee would also need to be regulated and capable of settling its obligations to the claimant/beneficiary in accordance with the original insurance contracts. This implies that the exit value would, in any case, be the expected present value (ie appropriately adjusted for the time value of money) of the ultimate settlement cash flows, including the appropriate margin for uncertainty. We also refer to our comments to question 4 above proposing that the risk margin should be sufficiently robust.

76. In response to (b): Regarding the best label for the measurement attribute, we are unable to answer this question pending the outcome of the work on fair value measurements. SFAS 157 defines fair value in terms of a current exit value model. The Board will be aware from the IAIS's comments to the recent discussion paper on Fair Value Measurements that there are certain aspects of this model that we believe are inappropriate for the measurement of liabilities in level 3 of the hierarchy (such as the use of own credit characteristics in the measurement and the lack of deep, liquid markets for insurance liabilities). If these aspects are not addressed in the work on fair value measurements and yet the two terms remain similar, then the IAIS would urge the IASB to use a different label for insurance contracts.

**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?**

#### **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).**

77. The IAIS supports the approach of alternative (b) in question 6. Future premiums do not exist in isolation, but only exist in conjunction with the obligations under the rest of the contract. Moreover, the separate identification and measurement of beneficial policyholder behaviour is often arbitrary. Therefore, we believe that contractual cash flows arising from beneficial (as well as unfavourable) policyholder behaviour should be included in the liability measurement as mentioned in our introduction.



78. We refer to our introductory comments in which we argue that an insurance contract should be considered as a whole, rather than disaggregated into separate components which are then assessed individually against specific recognition criteria. Paragraphs 81-82 of the IAIS's second Liabilities Paper discuss this issue as follows:

81. *The problem appears to arise from the view that, because of the insurer's inability to enforce payment of future premiums under a long term contract, such premiums must be treated separately and differently. The practical reality is that future premiums are part of a single common contract, and are integral to the fulfilment of the obligations under that contract. Neither the company nor the policyholder is able to deal with one without simultaneously dealing with the other. To recognise one, the other must also be recognised.*

82. *If it is accepted that the obligation as a whole should be recognised, measurement of the obligation then requires consideration of all of the associated cash flows, including the contractual, long term premium inflows. To the extent that there is any uncertainty surrounding those cash flows it should be reflected through the application of an appropriate probability assumption, consistent with the probability assumptions applying to other cash flows. This is consistent with the measurement of financial instruments involving cash inflows as well as cash outflows.*

We continue to support the above comments.

79. Some examples may help. In the first (simplified) example, there is a ten year endowment policy<sup>4</sup> which is evaluated using three different scenarios (in reality, more would be used to allow for different times of death and surrender or lapse). Nonetheless, the scenarios may help illustrate our point regarding the cashflows. The three scenarios are that the policy is maintained for the entire ten years and matures; the policy is surrendered after 3 years; and the policyholder dies after seven years. The expected cash flows consist of the premiums less acquisition costs in each case and the payments for surrender, death or maturity, as appropriate. Appendix I includes the numeric examples used for the graphs.

80. The graphs show the cash flows in each case. Another way of looking at the IAIS contention that

*future premiums are part of a single common contract, and are integral to the fulfilment of the obligations under that contract. Neither the company nor the policyholder is able to deal with one without simultaneously dealing with the other*

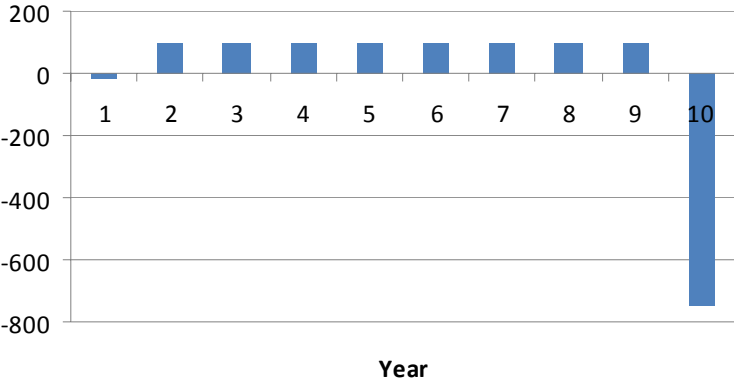
is that the negative cash flows in the examples (which are what give rise to the liability) can only exist as part of each individual scenario – in the case of the matured contract, if the policyholder stopped paying premiums at year three, then the maturity cash flow would never happen, and instead there would be a surrender, or lapse, at year three – as in the second scenario. So, in order for the negative maturity cash flow to occur, one must assume the corresponding prior positive cash flows from the premiums. In the same way, in the death example, for the death benefits to be paid in year seven, one must assume (for this scenario) that the policyholder has paid the corresponding prior premiums – because if he or she did not, there would be no death benefit, merely a prior surrender or lapse.

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4 Endowment Policy - A life insurance policy which pays a sum of money after an agreed period of time, or on the death of the life insured, whichever happens first. Source: Association of British Insurers, Glossary of Insurance Terms (2005), available at [www.abi.org.uk/](http://www.abi.org.uk/).

81. It is the scenarios, complete with their positive and negative cash flows, that need to be probability weighted to attain a proper evaluation of building block (a).

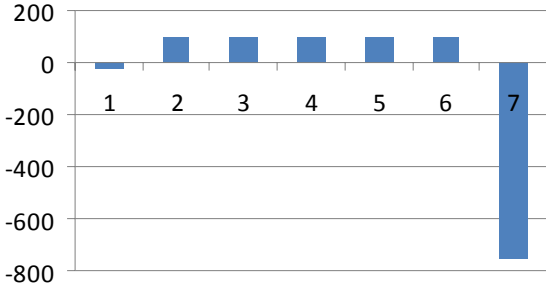
Scenario 1 – policy remains in force for 10 years and then matures



Scenario 2 – policy lapses or is surrendered at year 3



Scenario 3 – policyholder dies at year 7



82. We note that the IASB appears uncomfortable with the consequences of an exit value that represents a true probability weighting of all cash flows. Such cash flows would include probabilities for various different scenarios – both outflows and inflows such as future premiums. By excluding future premiums the Board finds itself having to propose the recognition of a customer relationship asset in order to achieve an economically sensible result. The IAIS believes that this would be a serious conceptual error and quite unnecessary. It is confusing to look at different parts of the cash flows as constituting different types of assets or liabilities such as a "customer relationship asset". The IAIS stresses that the objective is to measure the contract as a whole and not a group of separate assets and liabilities artificially extracted from the contract. If the proposal of alternative (a) in question 6 were to go ahead, the IASB should at least ensure that the recognition of any such customer relationship asset is not artificially constrained.

83. Market participants evaluate insurance portfolios based on those unconstrained probability-weighted cash flows for building block (a). However, they then adjust the result with building block (c) (the risk margin) for the uncertainty surrounding such things as

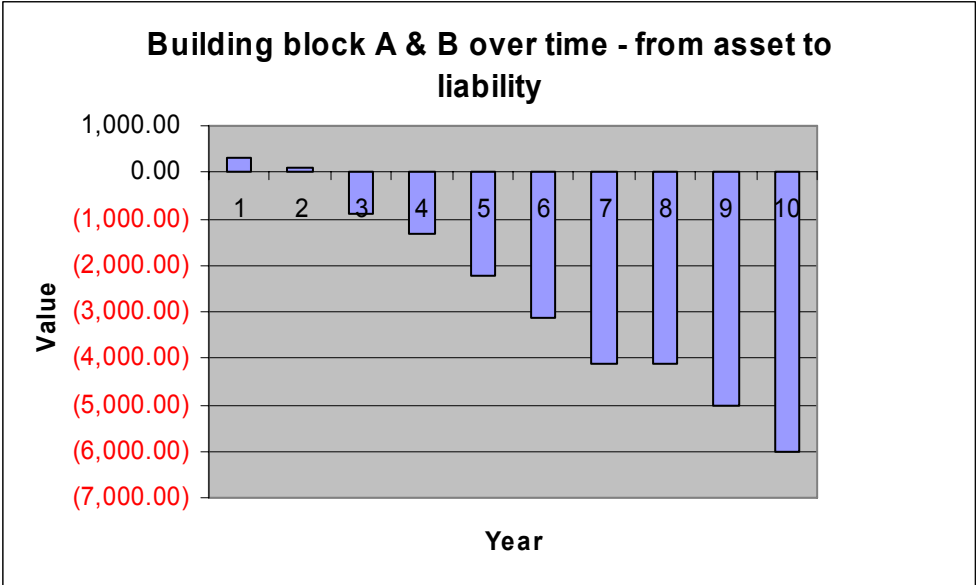
discretionary participation features, or the level of expected future premiums (which also ought to be part of a set of consistent lapse and persistency scenarios within the probability-weighted cash flows). The point here is that although certain expectations about future cash flows are built up by the market, they are also discounted within the risk and uncertainty factors. As with the allowance for probability, uncertainty is dealt with by refined adjustments to the measurement, not by crude, binary inclusion or exclusion of material cash flows. In the arguments for discounting, paragraph 66 (b) of the discussion paper states, inter alia, that "if it is true that some insurers underestimate claims liabilities, the appropriate response is to improve the methods used to make those estimates, not to compensate for those underestimates by excluding an economically relevant factor from the measurement." The appropriate response to concerns about issues arising from the use of unconstrained cash flows is not to constrain the cash flows so as to ignore real world economic views, but to provide clear principles and guidance on appropriate probability weighting of cash flows to prevent abuse.

84. Reiterating comments from our second Liabilities Paper, "the IAIS believes that the principle of allowing for probability in the measurement of insurance liabilities is fundamental to achieving sensible and meaningful financial reporting for insurance contracts." We feel that the notion of beneficial policyholder behaviour may be approaching the question in the wrong way, and that the focus should be on appropriate probability weighting of the scenarios giving rise to the cash flows and risk margins, consistent with the measurement model set out in the discussion paper.

85. As stated above, the IAIS believes that all future cash flows under an existing insurance contract should be allowed for in its measurement, to the extent that they are integral to the fulfilment of the obligations under that contract, and we believe that this approach would encompass the contract's commercial substance.

86. Following on from the example above, we also have a more realistic example of contractual cash flows for such a policy (it does not change the substance of the prior example). No renewals are assumed. The actual numeric example is included in Appendix II.

87. This example illustrates how the evaluation of such an insurance contract results in an "asset" answer in the years at the beginning of the policy, and a "liability" answer in future years as premiums are received and the future obligations outweigh the future inflows. Of course, at that stage there will be corresponding invested assets resulting from the receipt of the prior years' premiums less acquisition costs.



88. As shown, the recognition and measurement of the contract as a whole results in an asset in the early years simply as a result of a consistent measurement basis using the building blocks. There should be no further challenge to the recognition of the resulting asset. The IAIS therefore does not believe that the concept of a customer relationship intangible is necessary or useful in this circumstance.<sup>5</sup>

89. Within the context of an overall principle of commercial substance, in the interests of enhancing consistency and avoiding the potential for abuse, we recognise the desirability of some form of guidance as to which cash flows form part of an existing contract.

90. The IAIS understands the concept of "guaranteed insurability" put forward in the discussion paper as an attempt to differentiate future premiums under an existing contract from future premiums in respect of new contracts with similar characteristics, and to establish the boundaries around the contract. However, we are concerned that this concept might introduce an artificial and unnecessary constraint on the recognition of cash flows, and thus be inconsistent with the proposed measurement attribute. It also seems clear that market participants do not, in fact, utilise this criterion when valuing existing insurance contracts. Without further clarification the concept is likely to produce differences in application, potentially unnecessarily restricting the recognition of future cash flows in some circumstances and possibly allowing the recognition of future cash flows that are not part of the contract in others.<sup>6</sup> We believe that any criteria which the IASB develops as guidance on

5 As we stated in paragraphs 85 and 86 of the second Liabilities Paper:

85 There would seem to be little value effectively to "gross-up" a balance sheet by separately recognising related cash inflows and outflows that are both essentially contingent on the same event – i.e. existence of the contract. The tangible linkage is the contract itself, and hence it is appropriate to value the total package of rights and obligations under the contract as a whole – offsetting the cash inflows and outflows.

86 While in most cases the value of the cash outflows will exceed the value of the cash inflows this need not always be the case, particularly just after the contract's inception if acquisition costs have been fully expensed and future premiums include margins to recover them. Acceptance of the potential for what would normally be a liability to be negative (i.e. represent a net asset) is consistent with a prospective approach to measurement and reflects the reality of the business.

6 The types of business for further consideration might include guaranteed investment contracts (within an insurance wrapper), stepped premium risk business, and insurance where there is a guarantee by the government, such as workers' compensation and health.

which cash flows form part of an existing contract should consider all the expected contractual cash flows. The IAIS also recognises that there are particular issues with flexible premium products.

91. Some IAIS members (insurance supervisors from Australia, Canada (OSFI), Singapore, USA) would be satisfied with a statement of a principle of commercial substance within the Phase II standard, and would expect further elaboration to be covered outside of the standard, perhaps within future actuarial guidance.

92. Other IAIS members (insurance supervisors from Belgium, France, Germany, Guernsey, Italy, Poland, Switzerland, UK) would prefer further elaboration on a guaranteed insurability principle within the Phase II standard. They see promise in criteria that would provide parameters in determining which cash flows should be considered as part of an existing contract.

93. The IAIS will endeavour to provide further input to the Board on these issues.

#### **Question 8**

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

94. The IAIS believes that acquisition costs should be recognised as an expense when incurred. This is consistent with a prospective approach to valuation (which would apply under both a "current exit" and "current entry" model) in which the recovery of acquisition expenses requires no further separate consideration if the measurement attribute is based upon building block (a) with no additional constraints other than those noted in our response to question 7.<sup>7</sup>

#### **Question 9**

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

95. The measurement of insurance contracts will generally require modelling. However, where they are acquired in a business combination or portfolio transfer they may have an observable (or allocated) value at the point of transaction. We anticipate that there may be differences between the consideration upon transfer and the liability measure adopted for insurance obligations. The balancing item, being goodwill, would represent a difference between fair value on acquisition and the Phase II measurement attribute of current exit value. We would note that portfolio transfers take place for different reasons, for example to provide a customer base for future business, or for run-off and settlement of a portfolio. In the latter case, the portfolio transfer value is likely to be the current exit value. We would also note that portfolio transfers can take place in distressed situations, which would explain a difference.

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7 See also paragraphs 87-89 of second Liabilities Paper.

**Question 10**

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

96. In this regard the IAIS recognises, in principle, the need to assess the overall financial position of an insurer based on consistent measurement of assets and liabilities, which would include, in the event of such designation, assets held for the purpose of backing insurance liabilities. The IAIS generally supports a market-consistent approach to valuation. We believe that such valuation of assets, obligations (liabilities) and risk exposures is necessary in order to provide sufficiently relevant and reliable information concerning the financial position of an insurer.

97. Just as it should be helpful for the market to have insurance liabilities presented using current exit value, it would also appear to be helpful for the market to have other financial information presented in a manner that reduces accounting mismatch. For an enterprise with insurance liabilities this would mean that assets that back insurance liabilities should be capable of being measured at fair value when fair value measurement is the appropriate measurement attribute for the asset. If this is adopted, a one-time redesignation provision should be allowed. We note the transitional provisions included in paragraph 45 of IFRS 4 regarding the redesignation to fair value of assets held to back insurance liabilities, and recommend that a similar transitional provision should be made available. Inconsistent reporting can occur through the use of the fair value option where some enterprises elect to use the option and others do not. Whilst this potential area of mismatch requires urgent consideration by the IASB within the context of financial assets, we would urge the Board also to address the potential for accounting mismatch in relation to non-financial assets. We would note that non-financial assets, as well as financial assets, are used to back insurance liabilities. We believe that the principle of reducing accounting mismatches should not be specific to enterprises issuing insurance contracts but is a general principle when developing and revising accounting standards. We recognise that there may be instances where a particular measurement attribute is appropriate for a certain class of financial or non-financial assets or liabilities (other than insurance liabilities) and as such it may not be possible or appropriate to eliminate an accounting mismatch in all cases.

**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?**

98. In response to (a): In the first Liabilities Paper the IAIS argued that “the Board should consider measurement criteria that can result in answers at the individual contract level that are consistent with those obtained when those contracts are measured at the portfolio level.” We therefore agree that “the unit of account does not affect the expected present value of the future cash flows.”<sup>8</sup>

99. Whilst the measurement criteria are theoretically applied to the individual contract, we agree that in practice the risk margin will be determined for a portfolio of contracts, since insurance contracts are managed as portfolios in practice. We believe that the definition of portfolio in IFRS 4 seems to be appropriate for this purpose.

100. In response to (b): The second Liabilities Paper includes the principle that “similar obligations with similar risk profiles should result in similar liabilities.” At first glance this might be taken to imply that benefits from inter-portfolio diversification or negative correlation between portfolios would not be included in the liability measurement. However, this question is closely related to the concept of the reference market – the market participant to whom the business might be transferred in determining a current exit value. In theory valuation should be based upon the assumptions about the level of diversification of the market participant. If the market participant is considered to be well diversified, perhaps inter-portfolio diversification benefits should indeed be taken into account in the liability measurement, consistent with the assumptions about the market participant. This then raises the question of the treatment of an insurer's relative diversification compared with the market participant. The IAIS would prefer differences in diversification from those which would be expected to be obtained by a market acquirer to be addressed not in the liability measurement but through capital requirements.

101. Paragraph 52 of the second Liabilities Paper discusses the issue as follows:

*Pooling and inter-portfolio offsetting across risk types can give rise to a benefit to be reflected in the measurement of the liabilities, only to the extent that they are recognised in market transactions. To the extent that the market does not reflect such benefits, or to the extent that the insurer achieves greater or smaller pooling or offsetting benefit than the market, the effect is company specific, and the IAIS believes this should be included in the solvency capital requirement rather than in the insurance liabilities.*

102. If diversification at the level of a typical market participant is not included in the liability measurement, this may have reporting consequences. For instance, a large, diversified insurer may decide to pass some or all of the benefits of diversification on to its customers through its pricing. However, because of the inability to reflect sufficient diversification in the liability measurement, it would potentially report a loss at inception on the business. It would subsequently release profits equivalent to other less diversified insurers. However, because of its capital efficiencies those profits would represent a higher return on capital than the market would ordinarily require for the risk.

## **Question 12**

**(a) Should a cedant measure reinsurance assets at current exit value? Why or why**

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8 Discussion paper, paragraph 186.

**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.**

103. In response to (a): Yes. The IAIS believes that the measurement of reinsurance assets should be consistent with the measurement of the corresponding liabilities in the cedant's books, ie current exit value.

104. In response to (b) (i) – (ii): Yes. These logically follow on from (a) above. However, we note that whilst the expected loss model for reinsurer defaults will include impairment, the impairment provided for by the reinsured should not result in a reduction in the liability measurement by the reinsurer.

105. In response to (b) (iii): We agree that a contractual right to obtain reinsurance for contracts that have not yet been issued exists from the date at which such contractual rights are obtained. We refer to our response to question 1 in which we note the costs and practical issues surrounding a significant change to current practice regarding recognition. We recommend that the Board ensures that the outcome on this issue is consistent with the ultimate outcome regarding recognition.

### **Question 13**

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

106. We agree with the Board's view (paragraph 228 (a) of the discussion paper) that if the components are so interdependent that they cannot be split other than on an arbitrary basis, then the Phase II standard should apply to the whole contract. We also agree with the Board's view, as set out in paragraph 228 (b), that if the components are not interdependent, then the Phase II standard should apply to the insurance component, and IAS 39 to the deposit component.



107. However, we do not agree with the Board's view regarding interdependent but measurable contract components where the entire contract would be measured in accordance with the Phase II standard, but with the IAS 39 amount split out. This approach would lead to inconsistencies where, for example:

- it may not be mandatory to measure the deposit component at fair value under IAS 39
- the measurement of the deposit component under IAS 39 might be affected by a deposit floor
- the measurement of the deposit component might imply a different treatment or quantum of acquisition costs than under Phase II (IAS 39 only allows incremental costs to be deferred).

108. As a result, if the whole contract were measured in accordance with the Phase II standard and the deposit component then unbundled under a different measurement attribute under IAS 39, then what remained would no longer be measured in accordance with the Phase II standard and would not provide meaningful information.<sup>9</sup>

109. To address this issue, we believe that a more principles-based approach to unbundling contracts in the circumstances described in paragraph 228 (c) would be firstly to measure the entire contract using the Phase II model, then to measure the deposit/service components using the Phase II model and deduct these from the total. This leaves the insurance component being measured on a consistent Phase II basis. The deposit/service components would then be remeasured separately in accordance with IAS 39 and IAS 18, as appropriate.

110. However, we emphasise that there are cost/benefit considerations which may need to be taken into account. The IAIS also believes that if there were significant practical difficulties in unbundling a contract into separate components, then measurement should be in accordance with paragraph 228 (a).

**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?**

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<sup>9</sup> As an example let us consider an accident insurance policy with accumulation. Such a product would fall into the "interdependent but can be measured separately" category. For such products, an insurer pays (i) insurance claims (not death benefit) where a policyholder is injured during the period of insurance cover, and (ii) proceeds at maturity. In this case, in general, the premium corresponding to maturity proceeds could be regarded as a deposit component and it would seem appropriate to apply IAS 39 to this component. However, were the policyholder to die during the period only death benefits would be paid and maturity proceeds not. This means that the value of the deposit component, measured separately in accordance with IAS 39, is effective only where the policyholder does not die during the period of insurance cover. In other words, the deposit component does not exist independently of the insurance component and neither component can be measured separately where both components are interdependent. (This would be consistent with paragraph 11 of IAS 39 (measurement of embedded derivatives).) Therefore, it would not be possible to measure each component separately in isolation in cases where both components are interdependent.

111. In response to (a): No. The IAIS believes that credit characteristics are generally irrelevant to the measurement of insurance liabilities and most other liabilities.

112. In response to (b) (i) & (ii): No.

113. The Board will be aware from the first and second Liabilities Papers that the IAIS considers that allowing for own credit worthiness in the measurement of insurance liabilities would be inconsistent with the valuation of insurance liabilities in a going concern. The IAIS considers this unacceptable not only for prudential purposes but also for general-purpose financial statements, as we believe this will result in information which is not useful and could be misleading.

114. This is an extremely important issue for the IAIS, and we provided substantive comments on this to the Board in our response to the Fair Value Measurement discussion paper. These are attached in Appendix III. We note that the only justification in FAS 157 for considering an entity's credit risk in the measurement of a liability is that the holder of the obligation as an asset would consider it in determining the amount that they would be prepared to pay. This justification is based upon a presumption of symmetry of assets and liabilities which is itself breached in many places in current IFRSs and the current discussion paper.

115. The IAIS is aware of the research on this issue, and would note that it does not disagree that – to the extent that credit standing may be inferred in a level 1 price – such effects appear to occur in level 1 of the fair value hierarchy. However, the reason why it works in level 1 is because it is actually the asset that is traded that is then able to cancel out the liability. We therefore strongly disagree with such effects being an explicit part of the measurement attribute for liabilities in level 3 of the hierarchy.

116. Consistent with other exit value considerations, it is the credit characteristics of the market participant (or reference entity) which determines the value, since they are the ones whose credit standing is ultimately relevant to a market-consistent approach to measurement in the absence of a deep and liquid market for trading insurance liabilities.

#### **Question 15**

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

117. The IAIS believes that a theoretically correct model would eliminate differences between IAS 39 liabilities and the accounting model for insurance contracts. We agree that the Board should continue to work towards eliminating unnecessary differences between the models but believe that until further work is completed it would be premature to conclude that the differences should necessarily be eliminated. We understand that the longer-term intention of both the IASB and the FASB is to move towards "fair value through profit and loss" for all financial instruments. The IAIS understands that this intention may help solve some of the issues of inconsistencies and agrees that continued long-term investigation in this area is needed, but we still believe there are many outstanding issues to address before

any move to full fair value is appropriate. We also note that there are differences between insurance contracts and financial instruments which mean that full consistency in the treatment may not be appropriate in all circumstances. See also question 21 for our comments on surrender values.

**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?**

118. In response to (a): The IAIS has stated as a position that

*amounts relating to future policyholder distributions in respect of both the guaranteed and discretionary elements of participating contracts should be treated as liabilities based upon the expected future cash flows.<sup>10</sup> To treat them as equity would misrepresent the financial position of the company.*

119. The IAIS believes that the accounting model for insurance contracts, including participating contracts, should reflect their economic substance. As indicated in our comments above, we support the measurement attribute described as current exit value (question 5) and the building block approach to achieving this (question 2). Discretionary benefits under participating contracts do have an observable exit value – in a portfolio transfer of participating contracts – and hence economic substance as part of the liability measurement. In the case of participating contracts, it is the contract as a whole that creates an obligation to pay dividends to policyholders. The issue is one of measurement of the liabilities under the contract rather than recognition. We believe that the building blocks approach set out in the discussion paper addresses the measurement.

120. Building block (a) describes the current estimate as an "explicit, unbiased, market-consistent, probability-weighted and current estimate of the contractual cash flows". We believe that this principle should be applied in measuring the full liability in respect of a participating contract. We believe that the approach to the measurement of the liabilities arising from the obligations under participating contracts should be consistent with the overall measurement objective, and that separate consideration of different components of the contract is an artificial disaggregation which may result in liabilities which do not reflect the economic substance. Constraining cash flows artificially is also not consistent with the measurement attribute. We therefore urge the Board to adopt an approach for participating contracts which is fully consistent with the current exit value measurement attribute, without

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<sup>10</sup> The IAIS second Liabilities Paper sets out discussion on the nature of discretionary elements of participating contracts. The IAIS also notes the wide variety of participating contracts and legal frameworks for those contracts in Member countries and intends to do more detailed work on the resulting treatment of discretionary elements going forward. Our response is not intended to pre-empt future work in this area.

artificial constraints on the cash flows, and believe that this approach would enhance financial reporting of the economic substance of the liabilities under participating contracts.

121. In response to (b): We understand that at its July 2007 meeting the Board decided not to go beyond the scope of IAS 37 in defining constructive obligations, and therefore we would not necessarily expect the definition within IAS 37 to be extended to participating insurance contracts. We also prefer not to respond to this question in view of the fact that the IAS 37 reconsiderations are still ongoing.

**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).**

122. We refer to our comments to question 10 which support the elimination of accounting mismatches to the extent possible. We would also note that the above types of issue apply more broadly than just to unit-linked contracts (for example, index-linked and participating contracts), and we believe that the solution should be compatible with the overall model.

**Question 18**

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

123. We believe that the presentation of premiums as revenue or deposit should be consistent with the unbundling of components of the contract for liability measurement (see our response to question 13). To the extent that unbundling is possible, and subject to

cost/benefit considerations, this should result in premiums relating to insurance risk being treated as revenue.

**Question 19**

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

124. The IAIS believes that consideration should be given to aligning the presentation in the income statement according to the quality of the inputs used in the measurement, for example distinguishing information which is directly observable in the financial markets from the inputs which are derived from modelling. The IAIS also believes that in many cases the current national reporting practices for non-life insurance provide useful information to users of the financial statements for calculating key performance indicators (eg loss, expense and combined ratios). The IAIS believes that meaningful information of this nature should continue to be reported on the face of an insurer's income statement.

125. We note that work is ongoing at the IASB on Phase B of the Financial Statement Presentation project. Developments on that project will interrelate strongly with the above question and the consideration of presentational issues within Phase II. In that context we urge the Board to ensure that adequate input is obtained from the financial services sector (through the Financial Institutions Advisory Group), and that this occurs at a sufficiently early stage in the project.

**Question 20**

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

126. Yes. The IAIS believes that all changes in the value of insurance liabilities should be included in the income statement when they occur.

**Question 21**

**Do you have any other comments on this paper?**

*Surrender values vs demand deposits*

127. We wish to make it clear that if an insurance contract grants the policyholder the right to surrender it for a cash payment, the surrender value, even if guaranteed in the contract, is not a deposit component. The payment of the surrender cash value is a compensation by the insurer to the policyholder for the release of the risks and obligations which the insurer had undertaken, and which is extinguished upon surrender. On surrendering an insurance contract, the policyholder forgoes insurance coverage for the remainder of the policy term as well as, for some contracts, the right to renew the contract on terms which are beneficial to

the policyholder and may be unfavourable to the insurer. As such, the surrender value is the transaction value of the whole contract and not of a distinct part of it. The surrender value cannot be measured separately from the rest of the contract as payment of this value results in the whole contract becoming void.

128. The second Liabilities Paper includes the following principle: "The IAIS believes that there is no necessity for the application of a surrender value floor to the measurement of insurance contract liabilities for general purpose financial reporting." We reiterate below the paper's discussion of this issue (paragraphs 73-78):

73. *Some see the surrender value under an insurance contract as bearing some relationship to the deposit value under a financial instrument. They might therefore be inclined to advocate the application of a surrender value floor on the measurement of an insurance contract liability, similar to the application of the deposit floor under IAS 39.*

74. *[However], the issue should not be confused with the application of a surrender value floor in setting total financial resource requirements for prudential purposes. In that context it remains the case that some form of surrender value minimum is appropriate, to provide protection in the event of a high level of surrenders.*

75. *The IAIS is considering whether, in the interest of market transparency, insurers should be required to disclose aggregate surrender values. Certain jurisdictions may require such a disclosure.*

76. *It is helpful to consider the multiplicity of obligations that may exist under an insurance contract, and the effects of policyholder behaviour, when considering the application of surrender value floors to insurance contract liabilities for general purpose financial reporting.*

77. *The approach of examining each component separately highlights the inappropriate consequences of a surrender value minimum applied in aggregate. However, there remains the practical measurement difficulty of consistently reflecting policyholder behaviour across all components at the one time. [...] applying a surrender value floor on one component may be inconsistent with prudent policyholder behaviour on another component.*

78. *The practical solution to this issue, as reflected in traditional actuarial valuation approaches, is to apply lapse assumptions consistently across all components of an insurance contract – valuing the contract as a whole, with the lapse assumptions chosen attempting to balance the competing influences on policyholder behaviour – e.g. by increasing lapse assumptions around points where guarantees are likely to apply. More recently, stochastic approaches and option pricing overlays have been applied to deal with the derivative aspects of some contract features, but the concept of a common underlying lapse assumption for the whole contract still applies, albeit that it might be stochastically varied depending on other influences, such as the extent to which a guarantee is in or out of the money.*

Comments on IASB Discussion Paper: Preliminary Views on Insurance Contracts

<b>Life policy example - simplified</b>										
Premium	100	per annum								
Maturity/death benefit	850									
Acquisition costs	120									
Surrender value at yr 3	175									
Flat yield curve	4%									
Scenario 1 - policy matures										
Year	1	2	3	4	5	6	7	8	9	10
Inflows	100	100	100	100	100	100	100	100	100	100
Outflows	-120									-850
Net	-20	100	100	100	100	100	100	100	100	-750
NPV of net	\$121.48									
Scenario 2 - surrender at year 3										
Inflows	100	100	100							
Outflows	-120		-175							
Net	-20	100	-75							
NPV of net	\$6.55									
Scenario 3 - death at year 7										
Inflows	100	100	100	100	100	100	100			
Outflows	-120						-850			
Net	-20	100	100	100	100	100	-750			
NPV of net	(\$161.11)									
Probability weights										
		NPV	Weighted							
Scenario 1	70%	\$121.48	\$85.03							
Scenario 2	20%	\$6.55	\$1.31							
Scenario 3	10%	(\$161.11)	(\$16.11)							
Expected cashflows			\$70.23							
Margin under implementation b			(\$70.23)							
Profit on inception			\$0.00							
<p><i>In each case, the cash outflow at the end of the policy - generally giving rise to a liability - cannot occur without the prior cash flows, many of which are inward, having also occurred. Hence each scenario should be evaluated as a whole.</i></p>										
<p>Scenario 1 Matures after 10 years</p>										
<p>Scenario 2 Surrenders after 3 years</p>										
<p>Scenario 3 Dies after 7 years</p>										

Note: the negative cash flow at year 10 **cannot** occur contractually unless the incoming premiums in years 1 through 10 have occurred, so evaluating it without considering the prior cash inflows is meaningless (i.e. the entire scenario must be evaluated, rather than merely single directional cash flows)

Comments on IASB Discussion Paper: Preliminary Views on Insurance Contracts

The scenarios are the same as in appendix I, but the numbers have been adjusted to reflect actual mortality tables etc. The scenarios have been probability weighted, and the net present value of the resultant cash flows is shown.

Although the cash flows in this example are based on a realistic example, for the sake of simplicity they use only building blocks (a) and (b). Risk margins have not been included – it is not expected that they would make a difference to the result that the cash flows may evaluate in total both positive and negative at different stages in the life of the policy.

Relatively realistic example		
10 Year Endowment (Insurance)		
Sex		Male
Issue Age		55
Mortality Table		2001 CSO
Commission		35%
Renewal Commission		10%
Expense per Policy per Year		\$50
Other Acquisition Expense per Policy		\$500
Interest Rate		5%
Capital		5% of reserves
Face Amount		\$10,000
Scenarios		
1. Lives to year 10 and cashes out		
2. Dies at end of year		7
3. Surrenders at end of year		3

Policy Year	Mortality Rate	Gross Premium	Face Amount	Per Policy Expense	Commission Expense	Other Acquisition Expense	Withdrawal Rate	Investment Rate	Statutory Reserve	Cash Value	Capital	Total Expenses	Total Death Benefits	Total Withdrawals	Total Outgo
1	0.00219	1,178.90	10,000	50	35%	500	5%	5%	546.56	1,000	27.33	960.51	21.90	49.89	1,032.30
2	0.00302	1,178.90	10,000	50	10%	0	5%	5%	1,455.51	2,000	72.78	167.38	30.20	99.70	297.28
3	0.00377	1,178.90	10,000	50	10%	0	5%	5%	2,352.79	3,000	117.64	167.26	37.70	149.43	354.39
4	0.00438	1,178.90	10,000	50	10%	0	5%	5%	3,239.24	4,000	161.96	167.15	43.80	199.12	410.08
5	0.00501	1,178.90	10,000	50	10%	0	4%	5%	4,163.96	5,000	208.20	167.05	50.10	199.00	416.15
6	0.00586	1,178.90	10,000	50	10%	0	3%	5%	5,146.60	6,000	257.33	166.91	58.60	178.95	404.45
7	0.00703	1,178.90	10,000	50	10%	0	2%	5%	6,206.80	7,000	310.34	166.71	70.30	139.02	376.03
8	0.00843	1,178.90	10,000	50	10%	0	1%	5%	7,365.93	8,000	368.30	166.47	84.30	79.33	330.10
9	0.00987	1,178.90	10,000	50	10%	0	1%	5%	8,559.08	9,000	427.95	166.23	98.70	89.11	354.04
10	0.01166	1,178.90	10,000	50	10%	0	100%	5%	0.00	10,000	0.00	165.93	116.60	9,883.40	10,165.93
NPV @ t=0		9,103.12													9,484.04



## Comments on IASB Discussion Paper: Preliminary Views on Insurance Contracts

1. Lives to year 10 and cashes out		Probability weighting:		70%							
Cash Flows	1	2	3	4	5	6	7	8	9	10	
Premium	1,178.90	1,178.90	1,178.90	1,178.90	1,178.90	1,178.90	1,178.90	1,178.90	1,178.90	1,178.90	
Investment Income	28.69	76.41	123.52	170.06	218.61	270.20	325.86	386.71	449.35	0.00	
Expenses	962.61	167.89	167.89	167.89	167.89	167.89	167.89	167.89	167.89	167.89	
Death Benefits	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Withdrawals	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	10,000.00	
Net Income	244.98	1,087.42	1,134.53	1,181.07	1,229.61	1,281.20	1,336.86	1,397.72	1,460.36	(8,988.99)	
Net cashflow excl inv inc	216.28	1,011.01	1,011.01	1,011.01	1,011.01	1,011.01	1,011.01	1,011.01	1,011.01	(8,988.99)	
NPV of future cashflows	910.71	739.96	(234.05)	(1,256.75)	(2,330.60)	(3,458.13)	(4,642.05)	(5,885.16)	(7,190.42)	(8,560.95)	
2. Dies at end of year		Probability weighting:		10%							
Cash Flows	1	2	3	4	5	6	7	8	9	10	
Premium	1,178.90	1,178.90	1,178.90	1,178.90	1,178.90	1,178.90	1,178.90	0.00	0.00	0.00	
Investment Income	28.69	76.41	123.52	170.06	218.61	270.20	325.86	0.00	0.00	0.00	
Expenses	962.61	167.89	167.89	167.89	167.89	167.89	167.89	0.00	0.00	0.00	
Death Benefits	0.00	0.00	0.00	0.00	0.00	0.00	10,000.00	0.00	0.00	0.00	
Withdrawals	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Net Income	244.98	1,087.42	1,134.53	1,181.07	1,229.61	1,281.20	(8,663.14)	0.00	0.00	0.00	
Net cashflow excl inv inc	216.28	1,011.01	1,011.01	1,011.01	1,011.01	1,011.01	(8,988.99)	0.00	0.00	0.00	
NPV of future cashflows	(2,013.63)	(2,330.60)	(3,458.13)	(4,642.05)	(5,885.16)	(7,190.42)	(8,560.95)	0.00	0.00	0.00	
3. Surrenders at end of year		Probability weighting:		20%							
Cash Flows	1	2	3	4	5	6	7	8	9	10	
Premium	1,178.90	1,178.90	1,178.90	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Investment Income	28.69	76.41	123.52	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Expenses	962.61	167.89	167.89	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Death Benefits	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Withdrawals	0.00	0.00	3,000.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Net Income	244.98	1,087.42	(1,865.47)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Net cashflow excl inv inc	216.28	1,011.01	(1,988.99)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
NPV of future cashflows	(595.17)	(841.21)	(1,894.28)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Probability weighted cashflows	216.28	1,011.01	411.01	808.80	808.80	808.80	(191.20)	707.70	707.70	(6,292.30)	
NPV of future cashflows	317.08	116.65	(888.52)	(1,343.96)	(2,219.96)	(3,139.76)	(4,105.54)	(4,119.62)	(5,033.30)	(5,992.67)	

**Extract from IAIS comments on IASB Discussion Paper on Fair Value Measurements****Q16 Do you agree that the risk of non-performance, including credit risk, should be considered in measuring the fair value of a liability? If not, why?**

The IAIS disagrees that own credit risk should be included in the measurement of insurance liabilities and most other liabilities, and believes that to do so will result in information which is not useful and could be misleading.

Generally speaking we have no doubt that, where the holder of an obligation is able to trade the related liability in a deep, liquid secondary market (ie level I), then to the extent that non-performance risk may be assumed to be included in the price (**even though itself unobservable**),<sup>11</sup> any reduction in the liability due to increased credit risk of the holder of the obligation may be accessed by it and should therefore be included in the measurement. However, attention should be paid to the fact that most liabilities are not within level I of the hierarchy.

We set out below a number of reasons why we believe that including credit risk in the measurement of insurance liabilities is inappropriate. Many of the comments below may also apply to non-insurance liabilities.

*Settlement obligations a strong influence on transfer notion*

The IASB will be aware from the IAIS's Second Liabilities Paper, and from our response to question 9, that we believe that the measurement of an insurance liability should be based upon the cash flows relating to full settlement with the claimant or beneficiary. Reiterating paragraph 11 of the Second Liabilities Paper, the IAIS believes that "any transfer would need to be made to an entity capable of accepting the transfer which, in the case of a regulated industry like insurance, implies that the transferee would also need to be regulated and capable of settling the obligation to the claimant/beneficiary. Accordingly, the IAIS believes that any transfer notion would be strongly influenced by the settlement obligations that the transferee would undertake."

*Can impact of changes in credit standing be accessed?*

Where the issuer of a liability is able to access the market and trade in it, it may be able to take advantage of any reduction in its potential ability to perform. This would happen in one of two ways:

1. By buying back the corresponding asset at a distressed price. This presumes that the corresponding asset exists in a tradable form, and that the entity is actually permitted to trade in that asset. For financial services entities, particularly insurers, that is not normally the case as it would amount to a unilateral cancellation and/or a bypassing of the termination provisions of the contract.
2. By transferring the obligation to a third party who is able to benefit from the reduced credit worthiness of the issuer. This presumes that:
  - the obligation in some way remains dependent on the likely performance of the original issuer rather than the third party who "owns" the obligation when it comes to be settled; and

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<sup>11</sup> Many misunderstand this statement upon first glance, as it is commonly held that it is observable. In fact, it is only inferable. No quote comes with a flag saying that today's price is, for example, 98¼ and 22.738% of this is due to credit characteristics.

- there is a market of independent buyers and sellers who represent “the market” and who establish the price of such obligations having regard to the likely performance of the original issuer.

However, for many obligations, including insurance contracts, the above does not hold. If a third party decides to take over the obligations they will be subject to all the original conditions, including all regulatory requirements. In fulfilling the obligations they will not be able to claim some concession simply because of the parlous state of the original issuer. In the case of an insurance liability the potential acquirer is likely to be stronger than the original issuer, and will be subject to regulatory constraints and expectations of their own creditors and shareholders. Hence, to the extent that a market exists, the fair value in that market will be the price demanded by the potential acquirer, not the seller – ie it depends not on the performance and credit standing of the original issuer, but on that of the acquirer or transferee. Consequently, an acquirer would not accept a reduced value for the liabilities knowing that they will have to settle the obligations in full.

Another way of looking at this is as the impact of a reduction in own credit standing representing an option on some form of asset which offsets the liability. The option is controlled (as an asset) by the party entitled to benefit from the obligations, not the party required to meet those obligations. Consequently, this "asset" would not meet the definition of an asset for the purposes of recognition, from the perspective of the obligor. The potential decision on the part of the holder of the asset to consider the credit risk and possible partial impairment of that asset should not and does not reflect the economic reality that the liability still exists at its full value. The holder of the liability does not control the option on the part of the holder of the asset to accept a settlement at less than 100%.

Paragraph C39 of the Basis for Conclusion to SFAS157 states: "For a liability, a fair value measurement assumes that the liability is transferred to a market participant at the measurement date and that the nonperformance risk relating to that liability [...] is the same before *and after* its transfer" (emphasis added). This clearly indicates that the valuation of the liability after transfer is a key factor in measuring the liability prior to transfer (unless the paper is suggesting that a market participant who is willing to assume a liability would consider whether he himself intends to default on the liability). Within a transfer-based approach to measurement, for most liabilities – including insurance liabilities – the theoretical transfer of an obligation would sever the link with the previous holder of the obligation and the previous holder's credit standing would therefore become irrelevant to the measurement of the liability.

#### *Apparent contradiction with Concepts Statement 7*

The Basis for Conclusions to SFAS 157 refers to Concepts Statement 7. In particular, in the discussion on the reporting of an entity's efficiency relative to the market, paragraph C41 quotes from paragraph 33 of Concepts Statement 7 as follows:

If the entity measures an asset or liability at fair value, its comparative advantage or disadvantage will appear in earnings as it realizes assets or settles liabilities for amounts different [from] fair value. The effect on earnings appears when the advantage is employed to achieve cost savings or the disadvantage results in excess costs. In contrast, if the entity measures an asset or liability using a measurement other than fair value, its comparative advantage or disadvantage is embedded in the measurement of the asset or liability at initial recognition. If the offsetting entry is to revenue or expense, measurements other than fair value cause the future effects of this comparative advantage or disadvantage to be recognized in earnings at initial measurement.

The above appears to argue that entity-specific attributes should not be considered in measuring liabilities. We would argue that non-performance risk is entity specific and that therefore the "comparative advantage or disadvantage [should] appear in earnings as [the entity] realises assets or settles liabilities for amounts different [from] fair value."

*Asymmetry of assets and liabilities*

It seems to us that the concept of allowing for credit risk in the measurement rests on a belief that there should be symmetry in measurement between assets and liabilities. Indeed, SFAS157, paragraph C42, uses symmetry as its very argument for recognising non-performance risk: “Those who might hold the reporting entity’s obligations as assets would consider the effect of the entity’s credit risk in determining the prices they would be willing to pay. Therefore, this Statement clarifies that a fair value measurement for a liability should consider the effect of the reporting entity’s own credit risk (credit standing) on the fair value of the liability ...”. While attractive, we do not believe that this symmetry is an appropriate economic recognition of the real world. Moreover, the Standard itself is not consistent in requiring this symmetry. For example, the mere acknowledgement that fair value may differ in different markets would imply that the fair value of one side of a transaction in one company may not be the same as the fair value of the other side of the same transaction – in other words, the asset and liability will not be symmetrical.

In summary we feel that, unless the holder of an obligation can access the benefits of a reduction in the liability arising from changes in its credit standing, there is no economic gain and it is inappropriate to include own credit risk in the measurement attribute for liabilities, including insurance contracts. To do so will result in information which is less meaningful and could be misleading.