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By email:commentletters@hkicpa.org.hk & post

Mr. Steve Ong
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Exposure Draft – Insurance Contracts

Dear Steve

We refer to your letter dated 2 August 2010 and would like to set out our comments on the International Accounting Standards Board's Exposure Draft – Insurance Contracts.

Our comments on the specific questions raised in the exposure draft are attached. We would be happy to further clarify or discuss any of the above points should you so wish.

Yours sincerely

Rita Liu
Secretary

Enc.

Chairman Standard Chartered Bank (Hong Kong) Ltd
Vice Chairmen Bank of China (Hong Kong) Ltd
The Hongkong and Shanghai Banking Corporation Ltd
Secretary Rita Liu

主席 渣打銀行（香港）有限公司
副主席 中國銀行（香港）有限公司
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根據條例第364章成立

APPENDIX

ED/2010/8 Insurance Contracts

Question 1 – Relevant information for users (paragraphs BC13–BC50)
Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

We agree that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions.

The "Current Fulfilment Model" reflects the insurer's intention to settle the obligation with the policyholder rather than transferring the obligation to an external party. The building block approach consisting of expected future cash flows, the time value of money, the recognition of a risk adjustment and a residual margin appears to be a faithful presentation of the underlying economic value of insurance contracts.

Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)
(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?

We agree that the insurance measurement approach should be based on the present value of contractual fulfilment cash flows. The Board proposals allow for explicit and robust estimates of future cash flows. The proposals also require that future cash flows should be unbiased and determined at a portfolio level which is consistent to how companies manage and measure their insurance business.

We note that acquisition costs and the residual margin are determined at an individual contract basis and we would like the Board to clarify why inconsistent levels of measurement are proposed in the Exposure Draft. We would propose a consistent unit-of-account, determined at a portfolio level, which is consistent to how insurers price and manage their business.

Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)
Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

We support the dual margin proposal in the Exposure Draft, as we believe such a model will provide more transparent and useful information, which is consistent with

current pricing practices. The dual margin separates two distinct elements of the insurance liability, namely the risk of uncertainty and the profit element of the insurance contract. The dual margin approach may allow for better comparability amongst these different elements as well as amongst insurers.

We acknowledge the FASB's single margin proposal as a pragmatic approach. Our concern with the FASB model is that the composite margin approach does not allow re-measurement on a regular basis, which is inconsistent with how insurers view their current insurance obligations.

Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

(a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?

We support the proposal to recognise such gains over the coverage period when the insurer is released from risk.

(b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?

We agree that if the result of expected present value of future cash outflows plus the risk adjustment, is more than the expected present value of future cash inflows, the difference should be recognised immediately in the income statement.

(c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?

We agree that the residual margin should be calculated only at a portfolio level. This is consistent with the measurement of the other building blocks and the residual margin is further a product of components that will be measured at a portfolio level.

(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?

The Board's approach of locking in the residual margin and systematically releasing it over the coverage period of the insurance contact only reflects the economics of the insurance contract on day 1 and we would prefer re-measurement of the residual margin consistent with the re-measurement of the other building blocks. However, the re-measurement should not cause the residual margin to become negative, which is consistent with recognising a loss when it occurs.

The adjusted residual margin should then be amortised over the remaining coverage period, with the difference treated as a change in estimate.

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)
Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

We support the proposal to include acquisition costs in the initial measurement of the insurance contract as contract cash outflows.

Acquisition costs are a necessary part of the fulfilment of an insurance contract. We are concerned that inconsistent treatment will result from only including incremental acquisition costs within the insurance liability best estimate calculation. By utilising different types of sales structures (e.g. commission based versus permanent staff), significantly different accounting outcomes for entities writing the same type of insurance business will occur.

This is particularly apparent for bancassurance entities - utilising an internal bank sales force to distribute insurance products, as well as utilising external providers for selling exactly the same product. At an insurance entity level, both costs will be seen as incremental, however at the bank's consolidated level, only the latter will be recognised in the insurance contract measurement. By booking all the internal bank sales force costs as upfront expenses, the bancassurers will lose competitive advantage due to bigger upfront losses.

The potential utilisation of different distribution channels will lead to confusing financial results and the industry could see changes to product offerings and service agreements to obtain desirable accounting outcomes.

We would propose that acquisition costs should be determined at a portfolio level, instead of on an individual contract basis and should represent "directly attributable" costs rather than "incremental" costs. This will ensure consistent application with

other measurement building blocks and it is also consistent with insurers' pricing practices.

Question 11 – Definition and scope

(a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?

We agree with the principle that the new standard for insurance contracts should be focused on insurance transactions and not the accounting for insurance entities. We agree with the concept of combining all rights and obligations under the insurance contract when assessing the ultimate net obligation to the policyholder, which reflects the economic substance of an insurance contract.

(b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?

We agree with the scope exclusions except as set out below.

(c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

The existing scope exclusion for financial guarantee contracts (including letters of credit) with insurance risk characteristics should be retained. Many such contracts are issued in the normal course of banking business and their issuances are subject to credit assessment rather than actuarial calculation. We believe that the existing accounting requirements prescribed in IAS 39 is appropriate and should continue for such contracts.

Question 12 – Unbundling

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

We see the merit of unbundling contracts where components are not closely related; separate accounting treatment will better reflect the characteristics of such components and useful and relevant information will be provided. This will also allow better comparability amongst similar features. By unbundling components with different risk profiles, more transparent information will be available and this will be consistent with how insurers manage their business.

We would, however, seek further clarification from the Board on the application of the unbundling proposals. Our current interpretation of the account balance example is that all account balances should be unbundled. There are circumstances where account balances are closely related to other policyholder benefits and separating such

components firstly is inconsistent with the economics of the contract and secondly very difficult to perform. The examples in paragraph 8(a)(i) and (ii) are very prescriptive and we urge the Board to reconsider this against the framework of a principle based standard.

Question 13 – Presentation

(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?

We support the changes. The new summarised margin presentation proposal focuses on the drivers of profitability of insurance contracts, which is reflective of how insurers expect to earn income from providing insurance services to policyholders and investment returns. It also links directly into the Statement of Financial Position movement.

(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

For the disaggregation options, we would prefer to see such as required disclosure items only. This will allow the Statement of Comprehensive Income to only reflect main profit contributors with additional information, including volume indicators, to be disclosed by way of supplementary notes.

Question 17 – Transition and effective date

(a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?

We understand the Board's intention to take a pragmatic approach to the transitional rules; however the outcome will not reflect the economic position at transition, or for many years following initial application of the standard until contracts in force at transition have run off. We firmly believe that a residual margin does exist on the transition date and as such should be carried forward. By not allowing such a margin to be carried forward, insurers are prevented from recognising such profits in future and a lack of comparability between in-force and new business profit recognition will remain until such time that the in-force book (as at transition date) is fully run-off.

We would therefore urge the Board to consider the transition arrangements under IAS 8, which would require a full retrospective application or an application from the earliest date possible if a full retrospective application is impractical. Such determination should best be left for the insurer to determine. Full disclosure should be required from which period the transitional adjustment was made if a full retrospective adjustment was impractical.

By allowing a residual margin to be recognised on transition date, consistently with the other measurement building blocks, all components of the insurance liability will be calculated consistently at transition and on subsequent dates.

(b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?

The FASB approach also does not allow a residual margin recognition beyond transition date and for the same reasons as mentioned above (a), we would oppose such an approach.

The composite margin approach is only reflective of the risk adjustment element and the FASB proposal is to lock-in this amount with a systematic release to income. This approach is inconsistent with the IASB approach of re-measuring the risk adjustment at each reporting period and as mentioned in question 5, we would rather support the IASB approach.

(c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?

Please see below (d).

(d) Please provide an estimate of how long insurers would be required to adopt the proposed requirements.

We would not support a mandatory implementation date prior to at least three years following publication of the final standard. This is to allow sufficient time to implement systems and process changes necessary to apply the new standard.

We believe that insurers should be permitted to revisit elections previously made under IFRS 9 upon initial application of the new Insurance Contracts Standard.