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Mr. Steve Ong
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Hong Kong Institute of Certified Public Accountants
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Dear Steve,

IASB Exposure Draft on Insurance Contracts (the "Exposure Draft")

I refer to your letters dated 16 September 2010 on the above Exposure Draft to our Mr. Charles Li and Mr. Mark Dickens which have been passed to me for my attention.

We have completed our review of the Exposure Draft and our views are set out in the paragraphs below.

General

The Exposure Draft proposes a single comprehensive measurement model for all types of insurance contracts which would replace IFRS 4 – Insurance Contracts. The IASB proposes that an insurer should measure insurance contracts using a model based on the present value of the fulfillment cash flows plus a residual margin.

Although we agree with the intended objective of the Exposure Draft, we have concerns that the proposed measurement model differs substantially from the principles included in the current Conceptual Framework and will be too complex for layman users of financial statements to understand the financial position and performance of an entity that enters into insurance contracts.

Our detailed comments are discussed further below.

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Conceptual issue and Present obligations vs. Future commitments

Paragraph 17(a) of the Exposure Draft proposes that an insurer should include in its measurement of an insurance contract *"the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract, ..."* Paragraph 23(a) of the Exposure Draft requires that *"Estimates of cash flows for a portfolio of insurance contracts shall include all incremental cash inflows and cash outflows arising from that portfolio, ..."* Paragraph 24 further explains that *"At initial recognition, an insurer shall include in the measurement of the insurance contract an estimate of all cash flows that will arise as the insurer fulfils the insurance contract over the life of that contract."*

The proposals introduce a new concept of "netting" where both cash inflows and outflows relating to an insurance contract are considered together. This is a new accounting concept which we believe will be unique to insurance contracts and raises the question of whether a similar approach will be permitted for other non-insurance contracts and if not, why not. We also note that the proposals appear to be inconsistent with the proposed new approach taken by the IASB for revenue recognition where the proposed principle is to look at the separate performance obligations of a contract.

We consider that the "possible" future cash outflows arising from a claim on an insurance contract are not "present" obligations under the current Conceptual Framework, that is, a liability, but represent a commitment to make cash outflows but only in the event of a valid claim. The commitment would only become a "present" obligation when the insured event happens and the policyholder provides adequate evidence to support his claim.

We believe that it is vital to distinguish a "present obligation", that is, a "liability" from a future commitment or an obligation which may not necessarily result in the outflow of resources. Under the current Conceptual Framework only liabilities are recognised in financial statements. Commitments or future responsibilities to make cash outflows are not recognised but are normally only disclosed. We believe that when the current Framework was developed the word "present" was intentionally added to distinguish present obligations from future obligations and commitments and paragraph 61 of the Framework stresses and draws a distinction between a present obligation and a future commitment.

The existence of a present obligation by definition means that there is a liability, and there will be an outflow of resources. There is no issue concerning whether there will be a probability of the outflow of resources, as this is a given. In contrast, estimates of future claims payable represent "provisions" for "possible" future liabilities.

We believe that long term insurance contracts, such as life insurance, provide a commitment but not an unconditional obligation of the policyholder to pay future insurance premiums. The insured can opt out at any time and the consequence is a loss of his insurance coverage and forfeiture of his premiums.

We therefore do not agree with the proposed measurement of an insurance contract at the present value of fulfillment cash flows and further conceptual discussion should be held on whether "an estimate and netting of <u>all</u> cash inflows and outflows that <u>may</u> arise over the life of that contract" is appropriate.

<u>Current value</u>

The proposals introduce a new concept of "current value" which is not included in the current Conceptual Framework or in other existing accounting standards. Paragraph 22(a) expands on paragraph 17(a) of the Exposure Draft and further explains that the present value of the fulfillment cash flows constitute *"an explicit, unbiased and probability-weighted estimate (ie expected value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract"*.

We do not support the proposed measurement of insurance contracts at their expected present values, i.e., the probability-weighted average of the present values of the future cash outflows less future cash inflows that <u>may</u> arise as the insurer fulfils the insurance contract. We consider that this approach, which conceptually requires identification of all possible outcomes and allocation of probabilities to each possible outcome, is complex and will be costly to preparers.

Paragraph B39 in the Exposure Draft attempts to address this concern and provides some guidance. It states that *"When considering all possible scenarios, the objective is not necessarily to identify every possible scenario but rather to incorporate all relevant information and not simply ignore data or information that is difficult to obtain."* It therefore allows an entity to "select" some "scenarios" but does not explain or provide any guidance on how to "select" the scenarios, which are also required to be "unbiased". We consider that the guidance in paragraph B39 needs to be further expanded. In addition, we believe that to enable a reader to understand how an insurer measures its insurance contracts, which relies heavily on assumptions and estimates made by management, there should be a need to disclose adequate details of the assumptions, scenarios and probabilities together with any changes, and not just the amount so determined.

We therefore believe that the proposals will be too complex and costly to preparers and will not provide useful information to layman users of financial statements.

Risk adjustment

Paragraph 17(a) of the Exposure Draft proposes that the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract should be *"adjusted for the effects of uncertainty about the amount and timing of those future cash flows"*. Paragraph 35 of the Exposure Draft states that *"The risk adjustment shall be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected."*

Paragraph B68 explains that *"The risk adjustment conveys information to users of financial statements about the effects of uncertainty about the amount and timing of the cash flows arising from an insurance contract."* Paragraph B70 of the Exposure Draft further states that *"The risk adjustment shall be included in the measurement in an explicit way. Thus, the risk adjustment is separate from estimates of future cash flows and the discount rate that adjusts those cash flows for the time value of money; it cannot be included implicitly in those two other building blocks."* Paragraph B73 of the Exposure Draft proposes that *"An insurer shall use only the following techniques for estimating risk adjustments: (a) confidence level; (b) conditional tail expectation; or (c) cost of capital."*

We consider that the uncertainty about the amount and timing of the cash inflows and outflows arising from an insurance contract would have been taken into account in determining the expected present value of cash flows of the insurance contracts.

We do not feel comfortable with this new concept of a "risk adjustment" as it appears in substance to be a sensitivity analysis. However, it is described as a value for "selling" the insurance risk and is also required to be measured separately and taken into account in measuring the carrying value of an insurance contract. The Exposure Draft does not clearly explain or demonstrate how the risk adjustment could be separately considered and we agree with the opposite views set out in BC111 of the Exposure Draft that the techniques required by the Exposure Draft for estimating the risk adjustments will be difficult to understand by layman users of financial statements. Therefore, we would suggest that IASB should further explain and clarify what the "risk adjustment" is intended to represent and whether there would in fact be double-counting of the risk.

Although we appreciate the efforts made by the IASB to accommodate the past practices of insurance companies, the IASB may wish to consider whether the proposed standard amounts to issuing an industry specific standard which we understand the IASB has in the past attempted to avoid. We are unclear why insurance contracts are not regarded as "financial instruments" and why the other existing accounting standard on making provisions for possible future liabilities or insurance claims, namely, IAS 37 "Provisions, Contingent Liabilities and Contingent Assets", could not be applied for insurance contracts.

We hope that the above comments are useful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited

Colin Chau
Senior Vice President
Listing Division

CC/CRC/el

c.c. Mr. Charles Li – Chief Executive
Mr. Mark Dickens – Head of Listing