Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

30 November 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Exposure Draft of *Insurance Contracts*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft (ED). Our responses to the questions raised in your ED are set out in the Appendix for your consideration.

Many insurers in Hong Kong are affiliated with regional or global insurance companies. We are aware that some of these insurers are concerned about the potential impact of the ED proposals on their regional or global operations and results. Whilst acknowledging these concerns, we have not attempted to capture all of them in this letter as we believe these industry participants will separately provide the IASB with comment letters outlining their views and concerns. Accordingly, our comments focus on the ED and the proposed measurement model in the context of the Hong Kong insurance market.

We generally support IASB in the development of a comprehensive measurement approach for all types of insurance contracts issued by entities (and reinsurance contracts held by entities), with a modified approach for some short-duration contracts. We also support a measurement approach that is based on the principle that insurance contracts create a bundle of rights and obligations that work together to generate a package of cash flows and that such a measurement approach uses the following building blocks: (a) a current estimate of the future cash flows; (b) a discount rate that adjusts those cash flows for the time value of money; (c) an explicit risk adjustment; and (d) a residual margin.

We also find application guidance at a reasonably right level of detail. However, we consider that additional guidance could be provided in areas such as incremental acquisition costs, the "maximum amount" included in the definition of risk adjustment, and “closely related” components of an insurance contract that would not require unbundling.

For contracts with discretionary participation features, we believe that specific additional disclosures are necessary, given the high degree of discretion involved, the unique and varying features of these instruments, and the different regulatory frameworks that apply to them in each jurisdiction.

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We believe that these areas for improvement must be addressed before issuing the final standard because sufficiently developed application guidance and disclosures are critical in ensuring the effectiveness of a principle-based standard for insurance contracts.

Further details of our views are set out in the Appendix to this letter in the form of responses to the consultation questions which you have raised. If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/IL/jn

Hong Kong Institute of CPAs

Comments on the IASB Exposure Draft of *Insurance Contracts*

Relevant information for users (paragraphs BC13–BC50)

<u>Question 1</u>

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?

In general, we consider the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions as this enhances the comparability and consistency in the financial statements of insurers.

Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)

<u>Question 2</u>

(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?

Yes, we 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. We further agree that insurance contracts should be valued using a fulfillment value, rather than an exit value, as this is the manner in which the majority of contracts will ultimately be settled.

(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

While we generally agree that the guidance on estimates of future cash flows is at a reasonably right level of detail, we consider that guidance in the following areas might be helpful:

(i) Clarification of "incremental" in the context of "incremental acquisition costs" - For example, whether profit commission specific to a contract is included, and generally how such profit commission is to be accounted for.
(ii) Accounting for non-proportional/facultative reinsurance – For example, how reinstatement premium is to be accounted for.
(iii) Recognition of a profit/loss at initial recognition of an outward reinsurance contract should a positive/negative residual margin arise. Please refer to Question 16(b) for more detailed discussions.
(iv) Inclusion of a statement that expected cash flows shall be measured at the amount expected to be paid or received using the legislation that have been enacted or substantively enacted by the end of the reporting period.

(v) For contracts with discretionary participating features, inclusion of a statement that cash flows shall only be taken into consideration to the extent that the performance of the specified pool of insurance contracts has been recognised as of the reporting period end.

Discount rate (paragraphs 30–34 and BC88–C104)

<u>Question 3</u>

(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

Yes, we agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability. We do not consider the assets backing non-participating contracts to be relevant to the fulfillment value of those contracts.

(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?

Yes, we generally agree with the proposal to consider the effect of liquidity as this reflects the substance that insurance contracts are illiquid instruments, however, we consider that the guidance on the magnitude of the effect of liquidity is not sufficient.

(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

We consider that own credit risk is not a relevant characteristic of a liability as the fulfilment value of the insurance liability does not change because of changes in the credit status of the insurer.

Risk adjustment versus composite margin (paragraphs BC105–BC115)

<u>Question 4</u>

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.

Identifying a separate risk adjustment and a residual margin as the IASB proposes may provide additional relevant information because:

(i) Separating into a risk adjustment and a residual margin provides more transparency in understanding the individual elements within an insurer's liability.
(ii) Including a separate risk adjustment reflects more accurately an insurer's view of

its obligations under the contract, in particular, for loss making contracts, this approach will lead to earlier recognition of losses.

(iii) A separate risk adjustment will provide useful information as regards the uncertainty of the insurer's estimate of future cash flows arising from its insurance contracts and the uncertainty and risk affecting different products. The “locked-in” nature of the residual margin for long term insurance contracts may provide useful information in the event that the insurer disposes of its business.

However, there are some concerns with this approach, including the following:

(i) The separation of a risk adjustment and a residual margin is potentially overly technical and theoretical and its costs may outweigh the benefits obtained (after all, these margins, whether separate or composite, will be amortized at the end).

(ii) A requirement to separate may be particularly burdensome for those smaller size insurers who may not have the capabilities and the experience to work out the margins separately.

(iii) The split between a risk adjustment and a residual margin is sensitive to subjective assumptions on uncertainty and, as a result, the amount amortized each reporting period is potentially subject to manipulation.

Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)

<u>Question 5</u>

(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?

We consider "maximum amount" is not clearly defined. We find it hard to pin down the intended meaning of "maximum amount" as in many transactions, it is difficult to conclude whether the amount paid is the maximum or not, and the same would be true of the notional transaction on which this margin is based.

We suggest that the definition of "risk adjustment" could be reworded by deleting the word "maximum" such that it simply refers to the amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. While this would more reasonably imply an amount that a willing buyer/seller will accept, the wording would also be consistent with the wording proposed in the IAS 37 *Measurement of Liabilities* project.

(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?

Whilst we agree to the use of the three techniques set out in ED to measure the risk adjustment, we do not agree that it is necessary to limit the measurement to these techniques.

Prescribing specific techniques would seem to be rather rule-based. IASB should aim to develop a principle so as to allow for the use of techniques that are proved to result in more relevant information, including those that may be developed in the future. The principle could be accompanied by disclosure about the methodology used in determining the risk adjustment including why it meets the measurement objective.

This would also provide more flexibility for short-term insurance contracts, smaller insurers and certain jurisdictions (e.g. in emerging markets) where the regulator may have set up its own techniques.

(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not? Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

A key objective of the insurance contracts project is to improve consistency and comparability of insurance accounting. If a separate risk margin is required, there may be considerable diversity in practice in the methods used by insurers to measure the risk margin. This diversity is likely to arise because the risk adjustment cannot be determined directly from actual transactions nor from observable market data, and instead will be implied based on the financial, economic and/or statistical theory chosen by the insurer, and the assumptions made each period under that chosen theory. Whilst it may be appropriate to give current management of the insurer some latitude in determining the best theoretical model to apply, users of the financial statement should be given sufficient information to enable them to compare the level of conservatism applied by different insurers (note: imposing requirements for full comparability of the risk margin may not be practical). Of the three methods identified in the exposure draft, the confidence interval method, measured at the portfolio level, is a more widely understood and applied method in the insurance industry, and would therefore appear to be the most appropriate method for this purpose.

An additional comment regarding the confidence level is that we would maintain that a change in the confidence level is a change in the accounting policy and therefore requires restatement. This reasoning is consistent with that applied in the current IFRS 4, in which paragraph 26 clearly regards the level of prudence applied to measurement of insurance contracts liabilities as a matter of accounting policy. If this is the case, we suggest that the wording of the final sentence of B79 in the ED be revised to clarify that, although the relative margin may need to change over time, the confidence level should remain consistent from period to period.

(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (i.e. a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

Yes, if a risk adjustment is required or disclosed, we agree that an insurer should measure the risk adjustment at a portfolio level of aggregation. Insurers generally manage the risks of insurance contracts at a portfolio level, and the effects of diversification and concentration within such portfolios are relevant to their value to the insurer.

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

We consider the application guidance in discussing the techniques is excessive in details when compared to the guidance on how the risk adjustment is operated and defined and what the objective is in calculating the risk adjustment. We consider that more guidance in these latter areas could be added.

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

<u>Question 6</u>

(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?

Yes, we agree that an insurer should not recognise any gain at initial recognition of an insurance contract. We do not consider the initiation of an insurance contract represents the completion of an earnings process.

(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?

Yes, we agree that an insurer should recognise a loss at initial recognition of an insurance contract immediately in profit or loss if there is a negative residual margin. We do not support the concept of deferring loss to later periods.

(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?

Yes, we agree that an insurer should estimate the residual or composite margin at a portfolio level, by similar date of inception of the contract and by similar coverage period. We consider that the addition of the date of inception and coverage period to the grouping requirements is necessary as the residual or composite margin will be amortised using these variables.

Further, if a residual margin were determined by grouping current-issue loss-making policies with in-force profitable policies, a company could defer a loss on issue by eroding the residual margin of existing policies.

(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)?

We agree that the residual margin should be released in a systematic way that best reflects the exposure from providing insurance coverage.

(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?

Yes, the proposed method(s) of releasing the composite margin is simpler to apply, with no re-measurement and no accretion of interest.

(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

We do not agree with the accretion of interest on the residual margin as this will add complexity in its calculation and confuse the users of financial statements. Moreover, the residual margin does not represent an obligation and so we do not believe that accretion of interest is appropriate.

Acquisition costs (paragraphs 24, 39 and BC135–BC140)

<u>Question 7</u>

(a) 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?

Yes, we 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.

Premium allocation approach

<u>Question 8</u>

(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?

We believe that the Board should permit but not require a modified measurement approach for the pre-claims liabilities of certain short-duration insurance contracts as this provides a pragmatic short-cut approach to certain insurers while leaving the option to those insurers which are capable to apply the full methodology. In our view, the modified measurement approach represents a reasonable proxy for the full measurement methodology, though the full methodology will provide a more accurate result.

(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

We consider that the definition of "short-duration" and the scope permitted to use this modified approach is not clear. There is no guidance on whether contracts like multi-year contracts and reinsurance contracts on risk attachment basis fall under the definition of "short-duration contracts" and there is scope for uncertainty and manipulation at the margin. We suggest that the Board should provide more guidance in this respect to ensure consistency of practice across the insurers as well as to reduce structuring opportunities for insurance contracts.

Contract boundary principle

<u>Question 9</u>

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

Yes, we support the proposed boundary principle. However, we consider guidance is not sufficient. We suggest the Board including in the application guidance some illustrative examples regarding specific insurance contracts in order to ensure consistent application in practice.

Participating features

<u>Question 10</u>

(a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?

We generally agree that the measurement of insurance contracts should include participating benefits on an expected present value basis, because these are integral to the contract.

We note that the Board does not propose to limit the cash flows included in the measurement of the liability for participating benefits to those for which a legal or constructive obligation exists. We understand one of the underlying rationales is that it is exceptionally difficult to determine whether an insurer is paying participating benefits because it believes it is obliged to do so, as these are generally set in the policyholders' expectation at the date insurance contracts are made. The insurer will normally pay distributions unless performance ultimately is considerably worse than expected. Therefore, it is appropriate to include those distributions in the measurement of cash flows.

Despite the Board's explanation in BC71 (from the view of the insurance contract as a whole rather than looking at one component of a contract), we are still not fully persuaded that participating benefits meet the definition of liability under the Conceptual Framework, given the unfettered nature of the insurer's discretion to pay or withhold participating benefits and so it could be extremely difficult to make a reasonable estimate of how much would ultimately be enforceable. These are economically similar to a non-controlling equity interest issued to external stakeholders by a subsidiary of the insurer where the management of the insurer has an absolute discretion to declare or pay dividend of any amount and at any time to these stakeholders and therefore should be dealt with by the insurer as a component of equity instead of being recognized as a liability. We recognize that this raises a more fundamental conceptual issue regarding the definition of liability, and which is beyond the scope of the Insurance contracts project.

We suggest that the Board should give more guidance on what constitutes "payments to current or future policyholders as a result of a contractual participation feature" in paragraph B61(j). In our view, we believe that either (i) policyholder dividends as shown in published dividend illustrations at the date insurance contracts are made; or (ii) policyholder dividends in line with current management (e.g. Board of Directors) expectation and approved dividend policy, would have both pros and cons.

- For (i), while the amount is more objective and less subject to opportunity for manipulation by management, it may not accurately reflect the actual potential obligation to the insurer.

- For (ii), there is also the opportunity for management's manipulation as the management can decide on the level of policyholders' dividends. Constant changes in management expectation may lead to undue volatility in the measurement of cash flows and results. However, it may provide more accurate predictive information on future cash flows as compared to (i).

To reduce the potential for abuse by management of the change of policyholder dividend policy in order to determine the liability, we suggest that disclosures should be required in respect of changes in the expected dividend policy and its impact on the results or the liability if the insurer follows the dividend illustrations when the contract is issued. The latter also serves as a measure of the gap between policyholders' expectation and the current management expectation.

(b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?

Yes. The discretionary element of these instruments may in some cases share similarities with a non-controlling equity interest in an insurer (or a fund/business component of an insurer) and may not meet the definitions of either a financial liability or an insurance contract. However, given these instruments are generally unique to the insurance industry, we consider it practical to include theme within the scope of the insurance accounting standard.

Typically, there will be a high degree of management discretion over the cash flows and the measurement of these instruments. Further, the features of these instruments and the regulatory framework governing them vary considerably across different insurers and legal jurisdictions. As a result of these factors (and as referred to previously under our response to part (a)), we believe that disclosures should be required to enable users to fully understand:

(i) the terms of these instruments (e.g., the aggregate present value amount of “non-guaranteed” future cash flows that were presented to policyholders at point of sale and subsequently, the nature of any contractual commitments to share profits between the insurer and its policyholders);

(ii) the regulatory framework governing these contracts (e.g., whether a profit split is mandated by laws and regulations, such as 90:10 policyholder:shareholder, and how it is determined);

(iii) the key judgments made by the insurer in classifying these instruments as those having discretionary participation features and the amounts included in the financial statements for such contracts; and

(iv) the key judgments made by the insurer in measuring the estimated future cash flows (e.g., the extent to which the measurement uses cash flows that fall below or above those previously illustrated to policyholders and/or required by regulatory limitations).

These disclosures should be specific to discretionary participation features and should be made in addition to the more general disclosure requirements that apply to all insurance contracts and other financial instruments.

(c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?

Yes, we agree with the proposed definition of a discretionary participation feature.

(d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

Yes, we agree with paragraphs 64 and 65 which modify some measurement proposals as they are effective in making them suitable for financial instruments with discretionary participation features.

Definition and scope

<u>Question 11</u>

(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?

Yes, we agree with the definition of an insurance contract and related guidance. The guidance makes clear how an insurance contract is defined and this definition is consistent with our view of what is insurance.

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

Yes, we agree with the scope exclusions in paragraph 4. Those situations are adequately covered elsewhere in the IFRS literature.

(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?

Yes, we agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts, though we understand from a practical perspective, this may create additional burden for banking and some other non-financial institutions industries.

Unbundling

<u>Question 12</u>

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?

Yes, we consider it is appropriate to unbundle a component of an insurance contract if that component is not closely related to the insurance coverage specified in the contract and the insurer shall apply other IFRS to account for that component as if it were a separate contract.

However we consider that the meaning of "closely related" is not clear and it is unsatisfactory to give examples rather than criteria. Ambiguity may arise, if the examples are seen as prescriptive rather than exemplary. We consider that example (a) in paragraph 8 is particularly prone to ambiguity as it may be read as including two tests constituting the criteria. Moreover, the examples in paragraph 8 given are not necessarily "most common" everywhere, and others may emerge that become more common. On the other hand, it would be helpful if the following examples are provided:

- an example from the field of financial reinsurance; and
- an example addressing the case of the common policy rider of accidental death and dismemberment insurance attached to a life insurance contract.

Based on the above, we consider that the examples provided by the Board are too selective, specific and incomplete which make paragraph 8 appear rather rule-based. We recommend that the Board should state clearly in paragraph 8 the guiding principles on what should be unbundled or excluded from the insurance contracts, or in other words, to provide further elaboration on what is meant by "closely related". The Board should then remove the list of the specific examples from paragraph 8 and put them under the Application Guidance as well as adding there more examples to provide more guidance to insurers.

Presentation

<u>Question 13</u>

(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?

Yes, we agree that the proposed summarised margin presentation would be useful to users of financial statements. The presentation clearly identifies the sources of insurance earnings.

(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?

Yes, we agree that an insurer should present all income and expense arising from insurance contracts in profit or loss.

Disclosures

<u>Question 14</u>

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

Yes, we agree with the proposed disclosure principle.

(b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?

Yes, we consider the proposed disclosure requirements will meet the proposed objective.

(c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

We suggest the following additional disclosures which would be useful:

(i) discretionary participating benefits calculated using dividend illustrative assumptions at the contract issuance date and additional disclosures in relation to financial instruments with discretionary participation features (Please refer to Question 10 for details);
(ii) the type and amount of expenses that have been included in the incremental acquisition cost for measurement of insurance contract cash flows; and
(iii) in addition to those disclosed under paragraph 87(g), the date when a portfolio transfer occurred; and also guidance on what the business context is that constitutes a portfolio transfer for this purpose (bearing in mind that reinsurance treaties frequently incorporate "portfolio transfers" between treaty years, on which an insurer's share may vary).

Unit-linked contracts

<u>Question 15</u>

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

Yes, we agree with the proposals on unit-linked contracts.

Reinsurance

Question 16

(a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?

Yes, we support an expected loss model for reinsurance assets as long as it is consistent with the final impairment model to be promulgated by the Board on its project on Financial Instruments: Amortised Cost and Impairment of Financial Assets (the Project). However, we have raised significant concerns with some conceptual and practical implementation aspects of the expected cash flow model as proposed in the Board's ED on the Project issued in November 2009. Please kindly refer to our comment letter to the Board regarding this exposure draft dated 6 July 2010 for details.

(b) Do you have any other comments on the reinsurance proposals?

The drafting of the proposals may have made overly simplistic assumptions that the outward reinsurance terms are identical to those of the direct business. This may underlie the proposed way in which the residual margin should be deferred or recognized as set out in paragraph 45, to perfectly mirror or offset the residual margin deferred or recognized under the direct business as set out in paragraph 17.

Theoretically, it is expected that an immediately recognized loss under the direct business could be offset by a profit recognized on the outward reinsurance. On the other hand, a residual margin deferred due to a gain at inception on the direct business could be offset by a residual margin deferred due to a loss at inception on the outward reinsurance. Nevertheless, even in proportional treaty reinsurance, this may not be true. For non-proportional treaty or facultative reinsurance, we believe this would add further difficulties to achieve the matching as discussed above.

At the end, this may result in mismatching and a net Day 1 gain (after reinsurance) being recognized in the profit or loss.

We suggest that an insurer could only recognize a gain on outward reinsurance in the profit or loss to the extent this can be identified as arising from the losses recognized on the underlying direct insurance contract. In other circumstances, contracts should be deferred as residual margin and amortised.

Transition and effective date

Question 17

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

No. We do not agree with the proposal to set the residual margin to zero for insurance contracts reported at the transition date. Such treatment prevents insurers from reporting a potentially significant component of profits on existing contracts through profit and loss and reduces comparability between the results on existing and new business. Upon transition, profit arising from the release of the residual margin would only relate to insurance contracts entered into after the transition date. If the terms of new insurance contracts sold after transition date are similar to the terms of pre-transition insurance contracts (which will often be the case), historical financial information that is predictive of future performance is lost, and post-transition financial reporting may not fairly reflect the performance of the insurer. These transitional rules may reduce the usefulness of financial statements for many years in the case of long-term insurance contracts.

We understand the Board's concern that a residual margin on existing contracts may be costly to recreate. However, the Board should not deprive insurers the option of full retrospective application if they are capable to do so.

We consider the most costly and time consuming aspect of a full retrospective valuation lies in the setting of assumptions as at the issue dates of all contracts in-force at the time of adoption. Many insurers could find a short-cut retrospective application, based entirely on assumptions as at the date of first adoption, which would produce considerably more meaningful and useful financial statements.

We suggest that the Board should give an option of full retrospective or short-cut retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Estimates and Errors.* Only where both of these retrospective applications are impracticable may insurers may opt for the proposed transition requirements. Insurers could then assess whether they are able to apply the provisions of the new standard retrospectively or not, considering the whether the costs outweigh the ongoing benefits to users.

(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)?

We do not consider that the composite margin approach will put an insurer in a significantly different position to the Board's transition proposal, as it would be set equal to the risk adjustment determined under the Board's approach. Moreover, we support that a risk adjustment should be subsequently re-measured. Therefore, we do not agree with the FASB 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?

We consider it is preferable that the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9. The two IFRS are complimentary, and introducing one before the other could result in financial statements over a short period of time which are comparable to neither the current ones nor the ones subsequent to adoption of both standards.

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

In our capacity as a standard setter, we are unable to comment of how long insurers would be required to adopt the proposed requirements.

Other comments

<u>Question 18</u>

Do you have any other comments on the proposals in the exposure draft?

We do not have any other comments on the proposals in the exposure draft.

Benefits and costs

<u>Question 19</u>

Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

Currently IFRS 4 allows insurers to keep using pre-existing accounting policies for their insurance contracts. The financial impact of these policies is included in IFRS financial statements. This means that some entities use local or another set of accounting standards such as US GAAP and some international groups may even use different local GAAPs. This significantly impedes the comparability of companies within the insurance sector. We consider that a consistent and comprehensive IFRS for insurance contracts is urgently needed.

For publicly traded entities or other entities where stakeholders require general purpose financial statements in order to assess historical performance and assist in evaluating the future prospects of an insurer in making their investment and capital allocation decisions, we e believe that the benefits are likely to exceed the costs of the implementation of this standard. However, given that insurance is a highly regulated industry and that in most jurisdictions, local regulatory reporting frameworks for insurers are already well-developed for solvency and other regulatory purposes, the benefits of an additional (general purpose) financial reporting framework for non-publicly traded insurers are far less likely to exceed the costs of the proposed accounting standard for those entities.

~ End ~