香港會計師公會
HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

By air-mail and e-mail <CommentLetters@iasb.org.uk>

Our. Ref.: C/FASC 31 October 2003

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

Dear Sir/Madam,

Exposure Draft
ED 5 *Insurance Contracts*

The Hong Kong Society of Accountants (HKSA) welcomes the opportunity to provide you with our comments on the Exposure Draft ED 5 *Insurance Contracts*.

We set out in the attachment our response to the questions raised in your Invitation to Comment.

The HKSA has a policy of converging Hong Kong Financial Reporting Standards with the International Accounting Standards Board's Standards. The standard setting due process applied in Hong Kong (details of which are available on the HKSA's website) acts to support this policy. The HKSA's Financial Accounting Standards Committee (FASC) issued an Invitation to Comment on the exposure draft with a comment period concurrent with that set by the IASB. Accordingly, the accompanying comments may reflect the views not only of members of the FASC but also of constituents in Hong Kong who provided comments to the HKSA.

If you have any questions on our comments, please contact our Deputy Director - Accounting, Mr. Simon Riley, in the first instance.

Yours faithfully

WINNIE C.W. CHEUNG
SENIOR DIRECTOR
PROFESSIONAL & TECHNICAL DEVELOPMENT
HONG KONG SOCIETY OF ACCOUNTANTS

WCC/SR/al

香港金鐘道八十九號力寶中心二座四樓
4th Floor, Tower Two, Lippo Centre, 89 Queensway, Hong Kong
Tel: 2287 7228 Fax: 2865 6603 / 2865 6776
http://www.hksa.org.hk E-mail: hksa@hksa.org.hk

Hong Kong Society of Accountants' comments on the IASB's Exposure Draft ED 5 *Insurance Contracts*

Question 1 – Scope

(a) Is it appropriate for ED 5 to apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs?

(b) Is the ED 5 proposal that weather derivatives should be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract appropriate?

Taking into account the fact that the IASB is developing the IFRS on Insurance Contracts in two phases, we consider that the scope proposed in the ED is generally appropriate.

We note in the Basis for Conclusions (BC 51) that accounting for insurance contracts by policyholders is to be addressed by the Board as part of Phase Two and we welcome that.

The general principle in ED 5 as regards scope appears to be that if the financial instrument is covered under another Standard then that other Standard should apply. This would include assets held to back insurance contracts, financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts – clearly IAS 39 would take first preference over the IFRS resulting from ED 5 when determining which Standard to apply to a given financial instrument. Because there is to be a separate IFRS on Insurance Contracts, at least for the foreseeable future, there is an unavoidable need for the clear demarcation between the scope of IAS 39 and the proposed IFRS resulting from ED 5. Scope exclusions aside, however, there is the potential for overlap between the subject matter of IAS 39 and ED 5 because both are relevant to financial instruments (ED 5 just happens to be relevant to a more specific category of financial instrument). We would recommend that, for the IASB's longer term (post 2005) project on financial instruments that consideration be given to subsuming the IFRS on insurance contracts into a more coherent and comprehensive IFRS on financial instruments so that any arbitrary distinctions as regards scope can be removed.

Question 2 – Definition of insurance contract

Is it appropriate for ED 5 to define an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary'?

We consider the definition to be generally appropriate. The fact that financial instruments such as financial guarantees are excluded (ED 5 paragraph 4e) from the definition by virtue of being covered under another Standard is indicative of the comment we made on question 1 above. Although the degree of risk obviously varies from one case to another, the principle of a financial guarantee arrangement is that the guarantor assumes the risk – at least a contingent liability – that a future outflow of economic benefits will occur should a specified event occur or not occur as the case may be. If the IASB does not plan, as part of its long term (post 2005) review of the financial instruments, to produce a single coherent and comprehensive IFRS on financial instruments, we would suggest that financial guarantee contracts should be brought within the definition of an insurance contract and excluded from IAS 39.

In response to our invitation to comment on ED 5, a number of commentators expressed confusion about whether letters of credit are caught within the definition of an insurance contract or not. We believe this stems in part from the inclusion of a reference to "letter of credit" in, for example, paragraph B17(g). Not all letters of credit contain the same terms – some may be with recourse, others without, and such differences may cause the instrument to be accounted for under IAS 39 or the IFRS that results from ED 5. We presume it is the Board's intention to include letters of credit, and the other specific types of financial instrument mentioned throughout the ED, as an insurance contract solely as a consequence of such instruments meeting the definition of an insurance contract (rather than as a result of what an instrument may be called). Consequently, we would recommend that paragraph B17(g) be further clarified in this respect.

Question 3 – Embedded derivatives

(a) Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate?

We consider that it is appropriate for those derivatives embedded within an insurance contract, that themselves are not insurance related, to be accounted for under IAS 39.

(b) Is it appropriate to exempt certain embedded derivatives from fair value measurement in phase I of this project?

We can appreciate the IASB's pragmatic approach to developing the Insurance Contracts IFRS in two phases given the distinct lack of global convergence on insurance contract accounting. But, in principle, we are not in favour of the IASB addressing any project, including Insurance Contracts, in a 'multi-phased' fashion in part because it gives rise to questions such as whether one particular aspect of a project should be dealt with in one phase or the other. Even if we answered the above question in the negative, and had a very good reason for doing so, we feel that the IASB, by virtue of having issued ED 5, has already pre-determined that those matters to be dealt with as part of phase II will be dealt with then and not any sooner.

(c) Are the proposed disclosures about the embedded derivatives described in question 3(b) adequate?

Yes.

Question 4 – Temporary exclusion from criteria in IAS 8

(a) Is it appropriate for the draft IFRS to grant exemption from the criteria in paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to insurance contracts?

(b) Is it appropriate, despite the temporary exemption from the criteria in [draft] IAS 8, for the draft IFRS to:
- **(i) Eliminate catastrophe and equalisation provisions;**
- **(ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies; and**

(iii) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets?

We concur with the above proposals.

Question 5 – Changes in accounting policies

Appropriateness of the draft IFRS proposals in relation to:

(a) Requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts.

(b) When an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss.

We recognise that paragraphs 14 and 15 would apply in the interim before more comprehensive (and mandatory) measurement requirements than those appearing in paragraphs 10, 11, 12 and 16 are developed.

Subject to the following comments on paragraph 15, we believe the proposals in question 5 are appropriate. First, if an insurer "shall show that the change (in policy) brings its financial statements closer to meeting the criteria in [draft] IAS 8", this would appear to equate with a disclosure requirement. If it is the Board's intention for such a disclosure to be made, then that should be reflected either in paragraph 35 or in the disclosure section of the IFRS. We do not believe that such a disclosure is necessary, however, and would recommend that the paragraph be rewritten without the word "show". Second, the other operative phrase in paragraph 15 refers to the fact that any individual change in a policy need not require the entity to change other accounting policies in order to achieve conformity with paragraph 14. We would recommend rewording the last two lines in paragraphs in paragraph 15 to read, "… meeting the criteria in [draft] IAS 8, but that any such change individually need not necessarily result in full compliance with those criteria".

Question 6 – Unbundling

Are the draft IFRS proposals that an insurer should unbundle (i.e. account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet, appropriate?

In principle we agree with the requirement to unbundle the deposit component of an insurance contracts and we particularly agree with the Board's conclusion in BC35. Clearly this is one area where the appropriate financial reporting in an individual instance is reliant on a clear statement of principle in the IFRS and on the professional accounting skill and judgement of the financial statement preparer and auditor.

Where a 'bundled' product contains at least one distinct insurance-related element and at least one distinct deposit-related element, we believe there is a rebuttable presumption that the pricing for such a product takes into account the respective actuarial assumptions (for the insurance component) and the outright liability being assumed by the insurer for the deposit component. The risks assumed by the insurer are distinctly different as between the insurance and deposit-related components of a bundled product, as are the financial reporting requirements that would otherwise apply to the financial instruments if they were sold

separately. One test that the Board may wish to consider adopting as a first preference to unbundling, taking on board the IAS 14 approach to segment recognition, is the policy and pricing methods applied by the insurer in developing the bundled product.

We are concerned about the apparent lack of guidance in ED 5 on the unbundling of deposit elements. The approach proposed in ED 5 is that the "cash flows from the insurance component do not interact with the deposit component". We would question whether, in the case of a traditional endowment policy, which can be unbundled into a term and pure endowment policy, unbundling would be required. We would also question why the test in paragraph 7 of the ED should be expressed as a ' one-directional' test (the cash flows from the insurance component not affecting the cash flows from the deposit component) when we believe the test could well (and, arguably, should well) apply in both directions.

We would recommend that the requirement for unbundling be expressed in terms of there being "no interaction between the deposit and insurance elements".

Question 7 – Reinsurance purchased

Are the proposals in the draft IFRS to limit reporting anomalies when an insurer buys reinsurance appropriate?

We concur with the proposals in paragraphs 18 and 19 of the draft IFRS.

Question 8 - Insurance contracts acquired in a business combination or portfolio transfer

IAS 22 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 *Business Combinations* proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement.

We concur with the proposition in question 8.

Question 9 – Discretionary participation features

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments. The Board intends to address these features in more depth in phase II of this project. Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?

We refer to our comments on question 3 (b) above. We have no changes to suggest for phase I of the Insurance Contracts project in respect of this issue.

Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006.

We are sympathetic to the Board's move to introduce a fair value accounting model for insurance and agree with the Board's conclusions in BC138 – BC140. We do have concerns, however, that prior to the full development of a fair value model for insurance contracts and in the absence of accounting guidance underlying fair value measurement, the proposed requirement to disclosure a fair value may not be so meaningful to financial statement users.

We would recommend that the proposal in paragraph 30 become operative only after the Board completes the development of the fair value model for insurance contracts.

Question 11 – Other disclosures

(a) The Exposure Draft proposes requirements for disclosures about the amounts in the insurer's financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts.

We have no comment on the disclosures proposed in the ED. We do believe, however, that the disclosures are more appropriately situated in the Management Discussion and Analysis of an Annual Report, rather than as part of the financial statements.

(b) Is it appropriate for the proposed disclosures to be framed as high-level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements?

We believe this approach is appropriate.

(c) As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS.

The proposal in paragraph 34 of the ED relates to providing relief in respect of the requirement in paragraph 29 (c) (iii). We believe that paragraph 34 should contain a cross-reference to paragraph 29 (c) (iii) so that it is clear that, in the first financial year in which an entity applies the proposed IFRS, one can instead comply with the requirements of paragraph 29 as if it contained a reference to "five" and not "ten".

Question 12 – Financial guarantees by the transferor of a non-financial asset or liability

Is it appropriate that the transferor of a non-financial asset or liability should apply IAS 39 *Financial Instruments: Recognition and Measurement* to a financial guarantee that it gives to the transferee in connection with the transfer?

We concur with this proposal.