



AMERICAN ACADEMY *of* ACTUARIES

November 30, 2010

International Accounting Standards Board (IASB)
30 Canon Street
London, EC4M 6XH
United Kingdom

Re: Comments on Insurance Contracts (Exposure Draft)

The American Academy of Actuaries'¹ International Financial Reporting Standards (IFRS) Task Force offers the following comments on the IASB Insurance Contracts Exposure Draft (ED).

We applaud the International Accounting Standards Board (IASB) for its continued work on the insurance contract accounting model and the consideration you have given the feedback to the 2007 Discussion Paper.

While much progress has been made by the Board we are concerned that as proposed, the ED's measurement model may not provide useful information for users of insurers' financial statements. In this letter we comment on the issues we feel are the most important in the exposure draft. While we have not attempted to answer all of the questions contained in the ED, we have referenced those questions that relate to our comments. We may have additional comments to submit in going forward. If you have any questions, please contact Tina Getachew, Senior Policy Analyst, Risk Management and Financial Reporting Council, by phone (+1 202/223-8196) or email (getachew@actuary.org). Thank you again for this opportunity to provide input.

Sincerely,

William C. Hines
Chairperson, International Financial Reporting Standards Task Force
American Academy of Actuaries
Risk Management and Financial Reporting Council

¹ The American Academy of Actuaries ("Academy") is a 17,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Interaction with Financial instruments standards

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?

In order to produce financial statements that faithfully reflect the economics of how insurance contracts are priced and managed the contract liabilities and the assets backing those liabilities need to be measured on a consistent basis. If they are not, the financial statements could reflect income and changes in equity that are not fully reflective of the economics and may potentially mislead users of the financial statements.

For example, consider a guaranteed annuity contract that pays a single sum in three years and may not be surrendered before that time. An insurer could invest the proceeds received to exactly match the certain liability cash flow and remove any risk associated with changes in interest rates between the valuation date and date the benefit is to be paid. Thus, on an economic basis there is no risk to the insurer should interest rates change over the three-year period. Income should emerge as the difference between the investment income earned on the assets and the interest required to support the liabilities. However, if the assets were valued at market value and the liabilities were valued at amortized cost, the value of the assets would change as the level of interest rates changed causing swings in profit and loss that are not reflective of the economics but instead result from the differences in the accounting values. The same would be true if the liability were measured at fair value and the assets at amortized cost.²

Building block 1 – estimates of future cash flows (Questions 2 and 7)

Question 2 – Fulfillment 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?*

The measurement of an insurance contract should include the expected present value of all relevant cash outflows less cash inflows that will arise as the insurer fulfills the insurance contract. The ED defines incremental cash flows in relation to the individual contract. This definition ignores the pooling concept that is fundamental to the business of insurance, including the pooling of acquisition costs. Not recognizing certain cash flows in the measurement (e.g., non-incremental acquisition costs) reduces the relevance of the financial statements to users. We also believe that the ED definition will result in different liability amounts being held depending on the form of the compensation used to distribute the same product. We do not believe this is appropriate, nor do we think this was the intention of the Board.

It is common for insurers to distribute the same product through different distribution systems. If incremental acquisition costs are defined at the contract level, insurers that issue the same

² The topic of accounting mismatch complete with numerical examples is treated more completely in the ACLI/IAA Second Joint Report dated June 3, 2003 and available at:
http://actuaries.org/LIBRARY/papers/ACLI_IAA_Second_Joint_Report.pdf

product through different distribution systems may hold different insurance liabilities. For example, in cases where some insurers have agents who are employees of the company and are compensated in part through salary and in part commissions. Commissions are paid only if the contract is issued and thus are incremental, but the salary component of compensation would not be considered incremental under the ED model. Insurers also distribute products through third parties where the compensation is entirely through a commission structure. The commission would be paid only if a contract was issued and thus would qualify as an incremental expense under the ED. In a competitive market the amount built into the pricing of a product for distribution costs would be similar across distribution systems. Thus, for a given insurance product the cash flows used to value the product under the ED will be dependent on the distribution system used, producing different liability income amounts both at issue and over the life of the product. The form of compensation to the distributor does not affect how the insurer fulfills the obligation taken on and should not, therefore, affect the liability held or the income recognized.

Question 2 - Fulfillment cash flows (paragraphs 17(a) 22–25 B37–B66 and BC51)

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?

The objective should be to estimate the expected value (in a statistical sense, i.e., mean) of the present value of the cash flows arising from the contract. We are concerned that the wording in the current ED, particularly paragraph B38, overemphasizes the term “probability-weighted” and may imply that identification of and assigning probabilities to every scenario of commercial substance may be required. There are many ways of producing appropriate estimates of mean value measures including methods that do not involve explicit identification of and assigning probabilities to every scenario and we do not see why preparers should be restricted in their approaches. Any approach used should be appropriately disclosed. Based on paragraph B39 we perceive that it is not the intent of the Board to limit the methods used to meet the objective of estimating a mean value and suggest that the wording of paragraphs B38-B41 be rewritten as:

B38 In principle, the objective is to calculate the statistical mean of the present value of possible cash flows, not to develop a single ‘best’ estimate of future cash flows. This objective may also be called ‘expected value’ or ‘probability-weighted average’.

B39 For insurance risks, either the form of the probability distribution or the parameters of the probability distribution are often unknown, so judgment is needed to select a technique for estimating the amounts and timing of the cash flows. To achieve the objective, it is necessary to consider all relevant information and not simply ignore data or information that may be difficult to obtain for a reasonable cost or within a reasonable timeframe.

B40 The estimated amounts and timing of cash flows should reflect conditions at the end of the reporting period. Such estimates shall not reflect the effects of events that occur after the end of the reporting period (though appropriate disclosure of such non-adjusting events shall be provided in accordance with IAS 10 Events after the Reporting Period).

B41 The estimates shall include unbiased estimates of the probability of catastrophic losses under existing contracts. However, the estimates shall exclude possible claims under possible future contracts (where “future contracts” could include renewal of existing contracts beyond the contract boundary as defined in paragraphs 26-29 and ##). [Drafting note: ## refers to our recommended addition for ceded reinsurance between ED paragraphs 43 and 44.

In order to produce a measurement of insurance contracts that faithfully represents the economics of the business when scenarios are used, consistency within a given scenario between the economic assumptions used to produce the future cash flows underlying a scenario and the discount rate used to calculate the present value of those cash flows is necessary. We recommend that this requirement be included in the standard or application guidance. If this consistency is not achieved, measurement may be misstated.

We recommend adding a paragraph to the application guidance, immediately after draft paragraph B41:

B## Where fulfillment cash flows depend on the performance of specific assets, the discount rate also depends on the expected performance of those assets. If that asset performance depends on uncertain future variables (such as market interest rates), then it may be necessary to determine the expected value using the present value of possible cash flows at discount rates that reflect the interest rates underlying the asset performance for different scenarios, rather than first estimating expected cash flows under all scenarios and then discounting the expected cash flows using a single set of discount rates that do not reflect the different underlying scenarios of asset performance.

Similarly, where scenarios reflect different future economic conditions such as future inflation impacts on the amount or timing of fulfillment cash flows, then the discount rates applicable to such scenarios should be reflective of the future economic conditions underlying a specific scenario.

Discounting

Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)

- 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?*
- 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?*
- 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 fulfillment cash flows should not reflect the risk of non-performance by the insurer?*

In all cases the discount rate used by the insurer should reflect the characteristics of the insurance contract. The characteristics of the insurance contract include many items. Liquidity, currency and timing are three characteristics, but there are others as well. For example, some non-participating insurance contracts include non-guaranteed elements that introduce a degree of investment risk into the contract. Some people also believe that tax status is a characteristic of the contract. We urge the IASB to make it clear in the final standard that all characteristics of insurance contracts need to be considered and that the three mentioned may not be the only ones affecting the choice of a discount rate.

- We believe there are many ways to arrive at an appropriately risk-adjusted expected present value of a set of cash flows. Adjustment to the risk-free rate to reflect the characteristics of the contract is only one such method. There are others methods which are equally appropriate (please refer to our letter to you dated September 15, 2009 on this subject). Three methods mentioned there are described below. We encourage creation of guidance making it clear that alternate techniques such as these are allowed:
 - Use of the expected earned rate as the discount rate, with downward adjustment to reflect any investment risk retained by the insurer. For example, the insurer may retain default risk or interest rate risk due to a cash flow mismatch between the investments and the liability. One could base the adjustment for these risks on the cost of the capital needed to provide for them, although other methods could be used. Whatever method is used, the adjustment would generally be less than the full spread between the expected earned rate and the risk-free rate, since the risk-free rate would not reflect the illiquidity in an insurance contract. This approach can be described as starting with the expected earned rate and adjusting downward to reflect characteristics of the contract, rather than starting from the risk-free rate and adjusting upward to reflect characteristics of the contract. In either case, the discount rate reflects the characteristics of the contract and does not reflect investment risk retained by the insurer, if any.
 - Making an adjustment for risk through the use of alternative probability weighting of scenarios rather than through adjustments to the discount rate. The Black-Scholes method is one example.
 - Use of a different discount rate in each economic scenario. Scenario-specific discounting is commonly used when contract cash flows depend upon economic conditions, and is required to properly reflect that dependence.

The risk of insurer performance is, in most cases, not a characteristic of the insurance contract and, as such, should not be considered in the choice of a discount rate.

Risk Adjustment Objective

Question 5 –Risk adjustment (paragraphs 35, 37, B67, B103 and BC105–BC123)

- 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 have three concerns regarding the objective of the risk adjustment as stated in paragraph 35 of the ED.

1. It does not appear to fully reflect the uncertainty associated with the underlying fulfillment cash flows and seems to be inconsistent with the objective expressed in paragraphs 17a and 22c, and in appendix A.
2. It does not appear to appropriately capture timing risk
3. The term “maximum” may be misinterpreted.

The objective refers to the risk that the ultimate fulfillment cash flows exceed the expected cash flows. It does not refer to the risk that the ultimate fulfillment cash flows are less than the expected cash flows. The maximum amount an insurer would rationally pay to be relieved of all of the uncertainty (both less than and more than the expected cash flows) would be very different from the amount to be relieved of only the unfavorable uncertainty. If the measurement uses an expected value – which by definition is measured across all potential outcomes, both lower and higher than expected, plus a risk adjustment that only accounts for the risk of higher than expected outcomes, the risk of lower than expected deviations would not be reflected in the measurement at all.

We believe the desired measurement objective is better represented by “eliminating uncertainty” than by being “relieved of the risk that the cash flows exceed those expected” and would thereby be consistent with the overall measurement objective. Paragraph 17 (a) of the ED states that the initial measurement of an insurance contract should be “adjusted for the effects of uncertainty about the amount and timing of those future cash flows...” Paragraph 22 (c) has a similar reference; “an explicit estimate of the effects of uncertainty about the amount and timing of those future cash flows...” Both paragraphs refer to uncertainty without any qualification limiting it to higher than expected uncertainty.

We recommend replacing the word “exceed” in the objective with the words “differ from.” Alternatively, we recommend using the wording from the definition of risk adjustment in Appendix A of the ED, “to capture the effect of uncertainty about the amount and timing of the ultimate fulfillment cash flows” by reflecting the amount the insurer would rationally pay to “eliminate the uncertainty about the amount and timing of the ultimate fulfillment cash flows.”

We note that the objective for the risk adjustment does not directly refer to present values but instead refers to ultimate cash flows. The ED’s definition of insurance contract includes within its scope contracts whose payment amount is certain but the timing of such payment is uncertain. These contracts have uncertain cash flows, but it is not clear that the timing risk is captured in the risk adjustment objective. The reference to “ultimate” cash flows seems to indicate that the time value of money is not reflected in the risk adjustment. We believe this timing risk should be captured in the objective. We recommend that the word “ultimate” is removed or changed to “actual”.

We have concerns that the reference to the word “maximum” in the measurement objective can be easily misunderstood. The measurement objective needs to be clear that the amount that the insurer would rationally pay should not be set at some arbitrary low value because the insurer

would certainly pay a low amount to be relieved of the risk (or to eliminate the uncertainty). However, by specifying a “maximum amount” in the ED, the application of the techniques may be inappropriately interpreted to be some maximum confidence level, CTE, capital amount, capital rate, or some other determination of a maximum value. Since the purpose of the risk adjustment amount is “to capture the effect of uncertainty,” the risk adjustment amount should reflect an amount that might be paid to obtain cash flows that are certain versus keeping the cash flows that are uncertain. We recognize that the risk adjustment will reflect the insurer’s specific risk preferences for the various characteristics of uncertainty. For example, there will be some cases where there is little model risk or slight parameter risk, but the probability distribution is quite skewed, or other situations where there is substantial uncertainty in the estimation of the parameters (such as the mean estimate), but the probability distribution model is symmetrical.

We believe that, in other words, that the insurer’s risk adjustment should depict the amount that reflects the tradeoff between paying a certain amount versus an uncertain amount(s). In concept, this is similar to the tradeoff made in the purchase of insurance by a policyholder or in the purchase of reinsurance by an insurer at a guaranteed rate. Consequently, for an insurer who has a very large diversified portfolio of similar risks managed together in a pool, the risk adjustment might be de minimus.

We recommend that the measurement objective be better articulated by replacing the word “maximum” with wording that refers to an equivalent amount where the insurer is indifferent between paying a certain amount (to eliminate the uncertainty) and keeping the uncertain cash flows. Suggested wording: “The risk adjustment should depict an amount the insurer would rationally pay to eliminate the uncertainty about the timing and amount of the ultimate fulfillment cash flows, where the insurer is indifferent between paying such an amount that is certain versus paying the uncertain cash flows.”

Risk Adjustment Techniques (Question 5 (b))

Question 5 – Risk adjustment (paragraphs 35, 37, B67, B103 and BC105–BC123)

- 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?*

We do not agree with limiting the techniques that could be used in estimating risk adjustments. We believe that while there are situations where the three techniques noted in the ED could be used to properly estimate a risk adjustment, there are other methods that could also be used and there are other situations where none of three methods may be appropriate.

Actuaries have significant experience in estimating the value of insurance contract liabilities with uncertainty in a principle-based environment. Experience working in this environment has shown that standardized estimation techniques do not necessarily result in comparable estimates, and in some cases can make comparable estimates nearly impossible to achieve. This is because any method or model has inherent strengths and weaknesses, as well as inherent differences in data, assumptions and resource needs. No one method works well in every situation, and in a particular situation with particular facts and circumstances, no one method will work perfectly.

It is standard actuarial practice to consider multiple methods. For example Actuarial Standard of Practice Number 43 - Property/Casualty Unpaid Claim Estimates (applicable for U.S. practice) states an actuary should consider multiple methods unless there is a clear rationale to do otherwise.

The apparent intention of limiting the techniques that could be used is to achieve some level of comparability between entities or to prevent manipulation of the results by selecting techniques that achieve a certain result. We do not believe that comparability or prevention of manipulation would be achieved by such limitations, but we do think that the limitations could prevent some insurers from using risk adjustments that they believe reflect the risks to which they are exposed. Each of the techniques defined in the ED require the estimation of parameters and an assumption as to what level of uncertainty should be included in the measurement. Since the guidance provided in the ED does not limit the preparer with regard to developing estimates or selecting the level of uncertainty, each preparer will use his or her own judgment, likely resulting in different risk adjustments being calculated for similar or the same risks.

Comparability in principle-based estimates is best achieved by providing a clear measurement objective, and then allowing the preparer to select the estimation method that best achieves that objective based on the particular facts and circumstances for the valuation (i.e., estimation) with an important emphasis on appropriate and robust disclosure.

Risk Adjustment – Level of Aggregation

Question 5 - Risk adjustment (paragraphs 35, 37, B67, B103 and BC105–BC123)

- d) *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?*

Measurement of insurance contracts at a portfolio level rather than a contract level is appropriate and consistent with how insurance contracts are priced and managed. The ED states that the measurement of the risk adjustment is to be at the portfolio level, but paragraph 36 restricts the measurement to reflecting only the risk diversification within the portfolio and not the risk diversification between portfolios. We are concerned that this constraint will result in overstated risk adjustments and., if the portfolio is defined at too low a level, significantly understated equity values.

The impact of diversification between portfolios can be significant. Preliminary results from research³ conducted by the Casualty Actuarial Society (CAS) showed that for certain U.S. property and casualty commercial lines of business the risk adjustment reflecting diversification across those lines was less than half of the sum of the risk adjustments determined for each line of business separately. The difference in risk adjustment could be more than one-third of total expected income on the illustrated lines of business.

³ The research conducted by the CAS was not yet published at the time this comment letter was issued.

Significant diversification impacts such as those illustrated by the CAS research can be passed through to policyholders in the form of lower premiums or used to reduce the overall level of capital required to support the insurer's total insurance liabilities. If the risk adjustments calculated under the proposed model do not reflect the impact of such diversification across portfolios, the insurer's liabilities may be overstated in the aggregate, resulting in losses at issue for portfolios that are expected to be profitable, and potentially result in a lower value of equity for the reporting entity than would be relevant to users of the financial statements.

We recommend that insurers be allowed to reflect the impact of diversification across portfolios when the diversification has a discernable impact on the risk adjustment included in the measurement of the insurance liabilities and that company reflects that diversification in pricing.

We also recommend that a portfolio of insurance contracts (of broadly similar risks) issued by different legal entities under common ownership with a reporting entity be considered to be "managed together as a pool" if there are contractual intercompany arrangements that provide fungibility between such legal entities with common ownership or if there is the practical ability to achieve such fungibility. An example of such an arrangement would be an intercompany reinsurance pooling agreement.

Risk Adjustment Application Guidance (Questions 5 (e))

Question 5 - Risk adjustment (paragraphs 35, 37, B67, B103 and BC105–BC123)

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?

These three techniques could be used to compute a value but that value would not necessarily satisfy the measurement objective as it is currently stated. Specifically, the criteria given to evaluate the techniques can be satisfied without satisfying the objective.

Paragraph B91 states "Paragraph B72 sets out the characteristics that a risk adjustment must have in order to satisfy the objective (i.e., to estimate the amount an insurer would rationally pay to be relieved of the risk that the actual fulfillment cash flows may exceed those expected)." The criteria set out in paragraph B72 are all desirable characteristics of a risk adjustment but none of them directly relate to how much an insurer would pay to be relieved of a risk. They describe how a risk adjustment's size should relate to the underlying risk exposure and the underlying experience.

For example, one could determine a risk adjustment using a confidence interval and set the confidence level at an artificially low level and still have:

- higher risk adjustments for risks with low frequency and high severity vs. adjustments for risks with high frequency and low severity,
- higher risk adjustments for contracts with longer durations vs. adjustments for contracts with shorter durations,
- higher risk adjustments for risks with wide probability distributions vs. risks with narrower probability distributions,
- higher risk adjustments for risks about which less is known vs. adjustments for risks where more is known, and

- lower risk adjustments to the extent indicated by emerging experience.

We recommend that the final standard require these criteria be considered when choosing a measurement technique but the wording of the final standard should be clarified that these criteria alone are not sufficient to meet the measurement objective for the risk adjustment. For each portfolio, the selection of one or more techniques, the calibration of the selected techniques, the selection of assumptions or comparables to parameterize the techniques, and the selection of an appropriate percentile, or capital amount and capital rate, should consider the insurer's specific circumstances within each portfolio.

Residual Margin (Question 6)

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 agree that a residual or composite margin should be established so that no gain is recognized at issue. However, we have concerns about how these margins are calibrated.

- 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?*

Calibration

We agree that the residual or composite margin should be measured at a level that aggregates insurance contracts into portfolios. We believe this is consistent with how contracts are priced and managed.

The residual margin should be calibrated to the premium net of incremental acquisition expenses, provided that incremental acquisition costs are measured at the portfolio level, rather than at the contract level. This is consistent with how insurance products are priced and managed. This also reflects the fact that all acquisition expenses (for both contracts that are issued and those that are not) are included in the price charged to the entire portfolio of contracts actually issued, or at least to an aggregation of insurance contracts within a portfolio with similar dates of inception. Please see our responses to questions 2a and 7 that discuss this issue further.

- 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)?*

Amortization

We believe that the residual margin should be recognized over the coverage period of the contract.

We suggest that paragraph 50 be written as:

50 An insurer shall recognize the residual margin determined at initial recognition as income in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

- (a) on the basis of the passage of time, but
- (b) adjusted for known seasonal patterns of incurred claims and benefits, or
- (c) another basis that best reflects the exposure from providing insurance coverage.

Remeasurement

Paragraph 53 of the ED specifies that an adjustment should be made to the residual margin only if fewer contracts are in force than was expected at the beginning of the period. We believe that if an adjustment should be made, the adjustment should be for both when fewer or more contracts are in force than was expected. Furthermore, we note that this would imply that the pattern of residual margin release should take into account the expected persistency of the policies.

Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140)

- (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?*

The measurement of an insurance contract should include the expected present value of all relevant cash outflows less cash inflows that will arise as the insurer fulfills the insurance contract. The ED defines incremental cash flows in relation to the individual contract. This definition ignores the pooling concept that is fundamental to the business of insurance, including the pooling of acquisition costs as well as overhead costs. Not recognizing certain cash flows in the measurement (e.g., non-incremental acquisition and overhead costs) reduces the relevance of the financial statements to users. We believe that the ED definition will result in different liability amounts being held depending on the form of the compensation used to distribute the same product. We do not believe this is appropriate, nor do we think this was the intention of the Board.

It is common for insurers to distribute the same product through different distribution systems. If incremental acquisition costs are defined at the contract level, insurers that issue the same product through different distribution systems may hold different insurance liabilities. For example, some insurers have agents who are employees of the company and compensated in part through salary and in part commissions. Commissions are paid only if the contract is issued and thus are incremental, but the salary component of compensation would not be considered incremental under the ED model. Insurers also distribute products through third parties where the compensation is entirely through a commission structure. The commission would be paid only if a contract was issued and thus would qualify as an incremental expense under the ED. In

a competitive market the amount built into the pricing of a product for distribution costs will be similar across distribution systems. Thus, for a given insurance product the cash flows used to value the product will be dependent on the distribution system used, producing different liability income amounts both at issue and over the life of the product. The form of compensation to the distributor does not affect how the insurer fulfills the obligation taken on and should not, therefore, affect the liability held or the income recognized.

We recommend that “incremental” be defined in relation to the portfolio of contracts, which by definition are managed together as a pool.

To achieve this we recommend that incremental acquisition costs should be defined in relation to the portfolio of contracts that are bound within a similar time period. The fact that pooling is fundamental to the nature of insurance is referenced in several places in the ED’s basis for conclusions as reasons for using the portfolio in other aspects of the measurement model. We believe the reasoning is equally applicable to the definition of incremental. We believe that this is consistent with how insurers price and manage their business.

Paragraph BC136 notes that, “In essence, the insurer typically charges the policyholder a price that the insurer regards as sufficient to compensate it for two things: (a) undertaking the obligation to pay for insured losses and (b) the cost of originating the contracts. Thus, a faithful representation of the remaining obligation should not include the part of the premium that paid for the incremental acquisition costs.”

Paragraph BC61 refers to pooling as “a fundamental feature of insurance contracts.”

Paragraph BC119(a) notes that, “Determining risk adjustments at the level of individual contracts ... would contradict the rationale of insurance, which is to pool risks by grouping similar contracts into a portfolio.”

Consistent with these observations, the exposure draft looks to the portfolio level in projecting policy administration and maintenance costs (B61(g) and B63) and in determining risk adjustments (36 and BC120).

The requirement that incremental acquisition costs be measured at the level of the individual contract is inconsistent with these observations and with the requirements for administration and maintenance costs and for risk adjustments.

Inherent in the pooling of insurance risk and the creation of portfolios of insurance contracts is a need to underwrite a large number of applications so that they can be appropriately evaluated based on characteristics of the risk and that sufficient volume is achieved for pooling to work. In that process, it is expected that a portion of the applications will not result in the placement of an insurance contract, either because the application will be rejected by the insuring entity or the applicant will refuse the final offer made by the insuring entity. That portion can be estimated with sufficient reliability to include, in the price of a product, the expense of processing all applications, whether placed or not.

As a result, “the cost of originating the contracts,” as noted in BC136, includes incremental acquisition costs that can be measured reliably at the portfolio level, not just those incurred at the individual contract level. The conclusion made at the end of BC136 should logically be applied to costs that are incremental at the portfolio level. In this respect, we also call attention to B63, which recognizes that, “Some costs relate directly to insurance contracts or contract activities but are the result of activities that cover more than one portfolio ...” B63 describes the treatment of such costs as incremental at the portfolio level. Although B63 specifically excludes acquisition costs from consideration, that exclusion would be logically and practically inconsistent with rationale provided in BC136.

We recommend the same treatment proposed in the ED for incremental acquisition costs also be applied to all other incremental costs, where such costs are either deducted from the premium cash flows, or otherwise directly incurred as a result of contract activities related to one or more portfolios of contracts, at the approximate time period that the contracts are bound.

Modified Measurement Approach

Question 8 – Premium allocation approach

- 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 recommend that the final IFRS should permit but not require a modified measurement approach for the pre-claims liabilities of some short-duration contracts. A test for onerous contracts should be applied at inception if the modified method is used.

- 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?*

The modified approach, as specified in the ED, is overly complex. The requirement to discount additional future premiums, update interest each quarter, reflect seasonality, and perform a test for onerous contract make this method as much or more work than measuring the contract using the building block approach with little or no benefit. We believe the traditional, internationally accepted, basis for calculating an Unearned Premium Reserve would be a better approach for this purpose.

Contract Boundary

Question 9 – Contract boundary principle

- 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?*

The proposed boundary principle works well for many individual life insurance and annuity contracts. However, there are a number of health insurance and some property & casualty products offered in the United States whose premium rates are subject to approval by regulation for which this boundary may cause significant application difficulties, which may have a significant effect on how these contracts are measured. These contracts would meet the

definition of a short term contract in the ED, except for regulations or laws that impose limitations on non-renewal and restrictions on premium rates, where there may be a limited ability for an insurer to re-price the renewal of a short term individual contract, to fully reflect the risk of the particular policyholder.

We recommend that paragraph 27 (b) be adjusted as follows:

- (b) has the right or the practical ability to set a price that either:
 - (1) fully reflects the risk of the particular policyholder; or
 - (2) may not fully reflect the risk of each particular policyholder but does, in conjunction with prices set for other contracts in the same portfolio with similar date of inception, fully reflect the risk of that portfolio or,
- (c) has limited or restricted rights, due to regulatory restrictions, to non-renew and to set a price at renewal that fully reflects the risk of the particular policyholder, but has the practical ability to set a price where such limitations or restrictions still allow the insurer to reflect the risk of the particular policyholder according to the allowable price applicable to the risk.

Unbundling

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 have no concerns regarding unbundling for the purposes of presentation of results. We do, however, have some concerns regarding unbundling for measurement purposes. In general we believe that unbundling should be required only in those cases where two otherwise independent contracts were put together for non-economic reasons. We also believe that unbundling should be allowed in order to achieve a better accounting match between the measurement of the contract and the assets backing the contract.

The criteria for account value driven products is not clear. The use of universal life as an example implies that these products should be unbundled, however, most universal life contracts sold in the United States would fail the criteria of having to pass on all investment experience.

Insurers sell some services (e.g., premium collection and benefit payment services) on a stand-alone basis and also packaged with an insurance contract. It is not clear from the unbundling guidance in the ED whether these services should be bundled together when sold separately as if they were one contract. We are also unclear whether if they were sold in a single contract the services and insurance coverage should be unbundled and valued separately. We recommend the final standard provide an objective for unbundling which provides more clarity on this topic.

Ceded Reinsurance

Question 16 – Reinsurance

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

We support the expected loss model as it closely aligns with the current fulfillment value method.

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

We agree with the intent of the proposals for valuing ceded reinsurance, but we are concerned that the draft does not adequately express that intent.

- The draft is deficient with respect to recognition and contract boundaries for reinsurance contracts. As worded, the draft seems to require that these be determined independently from the underlying insurance contracts. In some instances, we believe that would be inappropriate.
- The draft does not clearly specify how ceded reinsurance of short-duration contracts should be presented.
- The draft could be interpreted in a way that is too restrictive on the approach to valuing ceded reinsurance.

Recommendations

We recommend adding provisions in the final standard to adequately address recognition and contract boundaries for reinsurance. In between draft paragraphs 43 and 44, insert new a paragraph:

The cedant shall recognize a reinsurance contract and its boundary consistent with the reinsurance coverage of the underlying insurance contract(s) as follows:

- (a) The cedant shall recognize the financial impact of reinsurance coverage based on the later of the date it recognizes the reinsurance contract, as described in paragraphs 13-15, and the first date to which the reinsurance coverage would apply to each underlying insurance contract.
- (b) The boundary of ceded reinsurance coverage with respect to each underlying contract:
 - a. shall begin with the later of the reinsurance contract boundary, as described in paragraphs 26-29, and the first date to which the reinsurance coverage applies within the contract boundary of each underlying insurance contract, and
 - b. shall end with the earlier of the reinsurance contract boundary, as described in paragraphs 26-29, and the last date to which the reinsurance coverage applies within the contract boundary of each underlying insurance contract.

We recommend expanding paragraph 75 for the presentation of reinsurance covering short-duration contracts:

75 (c) the cost of associated reinsurance, disaggregated either in the statement of comprehensive income or in the notes, consistent with paragraph 75(a), into:

- (i) premium payments.

- (ii) ceding commissions.
- (iii) claims incurred.

We recommend that guidance be added to Appendix B with respect to reinsurance contracts, and removal of the words “Initial measurement of” from this section. Immediately after Example 2 in B36, add:

B## Although reinsurance is to be presented separately from the underlying contracts that are subject to the reinsurance, the value of the ceded reinsurance asset, including amounts in the disclosures (paragraphs ##-##), should be calculated to appropriately reflect the fulfillment cash flows after application of the reinsurance, including the risk adjustment. In general, where the fulfillment cash flows net of reinsurance result in reduced (increased) uncertainty of the cash flows compared to the cash flows gross of reinsurance, the risk adjustment will increase (reduce) the value of the reinsurance asset.

Basis for Recommendations

Recognition and Contract Boundary

Although the ED applies the same measurement principles to ceded reinsurance contracts as to the underlying insurance contracts, it can result in different methods of valuing ceded reinsurance.

We look specifically at paragraphs 54-60 on Pre-claims liability for short-duration contracts. Nowhere does the ED establish a relationship between a reinsurance contract and the classification of the underlying insurance contracts. As written, the ED can easily result in situations where a reinsurance contract does not come under the definition of a short-duration contract even if all of the underlying insurance contracts are short-duration.

For example, a property/casualty reinsurance contract may cover the full term of all underlying contracts issued during a specified time period. If that time period is one year and the underlying contracts are all one year contracts, then the reinsurance contract would cover events that occur over a period of two years. This would not seem to meet the criteria stated in the ED for a short-duration contract, yet all of the underlying contracts would be short-duration contracts.

Our recommendation considers the reinsurance coverage in relation to the underlying contracts. The terms of a reinsurance contract can constrain the duration of the reinsurance coverage, but because the obligations of the reinsurance contract are dependent on the underlying contracts, the term cannot be lengthened beyond that of the underlying contracts. Similarly, options included in the reinsurance contract could effectively, if not explicitly, alter the boundary of the reinsurance contract. Consideration should be given to the term and options of the reinsurance contract and the term of the underlying contracts, to reflect the substance of the reinsurance contract when valuing the ceded reinsurance asset.

With our recommendation, it will be possible for reinsurance coverage to be judged short-duration even in circumstances where the underlying insurance contract is not short-duration. In some situations, it may be appropriate for the reinsurance coverage to be valued using the short-duration approach; in others, that may be inappropriate. The standard should not try to anticipate which approach will be appropriate for every such situation. This is one more reason why, as we recommend in response to question 8, the final standard should permit but not require a modified measurement approach for pre-claims liabilities of short-duration contracts.

Presentation

Example 2 in the Application guidance could be construed as mandating that the effect of reinsurance on profit or loss be presented as a single line in the statement of comprehensive income or in the notes.

We believe that important information would be lost in such a presentation. By clarifying, in paragraph 75, that presentation is to separate the cost of reinsurance into its different components, we will prevent that loss of information that would be relevant to users.

Paragraph 46 instructs the cedant to treat ceding commissions as a reduction of the premium ceded to the reinsurer. We have no objection to that treatment in valuing the ceded reinsurance asset. However, in presentation of short duration contracts this would distort analyses of underwriting earnings on a net of reinsurance basis, as it would distort net (of reinsurance) ratios of underwriting expenses and claims incurred as percentages of premium. These net of reinsurance presentations are currently used extensively by managements and many analysts. We recommend requiring disclosure of the ceding commission separately to facilitate traditional reinsurance analysis.

Calculation

Although reinsurance is to be presented separately from the underlying insurance contracts, reinsurance is to be valued consistently with the underlying contracts. Often, the most effective way of achieving this result will be to value the reinsurance as the difference in value of the underlying contracts on two different bases—one without considering the effect of reinsurance on cash flow and risk, and one considering the full effect of reinsurance on cash flow and risk. Under other conditions, it may be most appropriate or practical to value ceded reinsurance separately.

This addition to the application guidance would avoid an overly restrictive interpretation of how ceded reinsurance is to be valued.

Transition Requirements

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 do not agree with the transition requirements, in particular the requirement that there be no residual margin on existing business. This will unfairly portray existing business as having no expected profit other than the release of the risk margin and will, coupled with the forced loss at issue on new business due to the treatment of non-incremental acquisition costs, lead to significantly different liabilities being held for contracts that were recently issued prior to transition and contracts issued after transition. Expected future profits will be significantly higher on new business than on existing business which might incent insurers to sell their existing business to each other in order to increase the level of expected profit.

There are at least three options for calibrating the residual margin on existing business at transition;

1. Estimating and rolling forward the residual margin that would have existed at issue of each portfolio of contracts
2. Estimate the residual margin as if you purchased the existing business from another party at the transition date
3. Setting the residual margin such that the initial liability at transition equals the net reserve liability (net of DAC, other contract related intangibles) held just prior to transition.

The first method involves the most significant amount of work and might not be feasible for many companies as it requires obtaining information on the original pricing of long term policies that were issued as much as fifty or more years ago.

The second method is more feasible but still involves a significant amount of work to determine the liability in a business combination. One advantage to this method is that accounting guidance for business combinations already exists.

The third method would be the easiest to implement, but may be the least relevant amount as the current liabilities may have no relationship to the liabilities otherwise required under the proposed ED.