

IFRS Foundation

Special Interest Session

IFRSs for Insurance Contracts

28 July 2010— Mandarin Oriental Hotel (Tokyo)

To provide a comprehensive service for those with a special interest in the reporting of insurance contracts in accordance with IFRSs the IFRS Foundation will hold an intensive half-day session immediately before their IFRS conference, on the morning of 28 July 2010.

The session will focus on the IASB's insurance contracts project.

Programme

09:00 ***Registration***

09:30 ***Introduction***

Tatsumi Yamada

Member

IASB

09:35 ***Technical update***

Tatsumi Yamada

Member

IASB

10:15 ***Preparer's perspective***

Yutaka Amino

Managing Director

Sumitomo Life Insurance Company

10:45 ***Actuarial perspective***

Hideyuki Yoshida

Director

PricewaterhouseCoopers Arata

11:15 ***Round-table Q&A***

- Tatsumi Yamada—*Member, IASB*
- Yutaka Amino—*Managing Director, Sumitomo Life Insurance Company*
- Hideyuki Yoshida—*Director, PricewaterhouseCoopers Arata*

11:55 ***Concluding comments***

Tatsumi Yamada

Member

IASB

July 2010

International Financial Reporting Standards



IASB/FASB project on Insurance Contracts

Tatsumi Yamada
IASB Member

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation

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Agenda

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IASB project on Insurance Contracts

- Project basics
- (Tentative) Decisions reached
 - Measurement model
 - Recognition
 - Presentation and disclosures

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Project basics

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Project history

- IFRS 4 *Insurance Contracts*
 - started in 1997
 - standard issued in 2004 ('Phase I')
 - aimed at making only limited improvements
- Discussion Paper *Preliminary Views on Insurance Contracts* ('Phase II')
 - issued in 2007
 - further discussed since early 2008
 - 162 comment letters received

Project basics continued

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- FASB
 - joint project since 2008
 - intensified efforts
- Due process documents
 - Exposure Draft: expected for Q3 2010
 - Standard: expected for Q2 2011

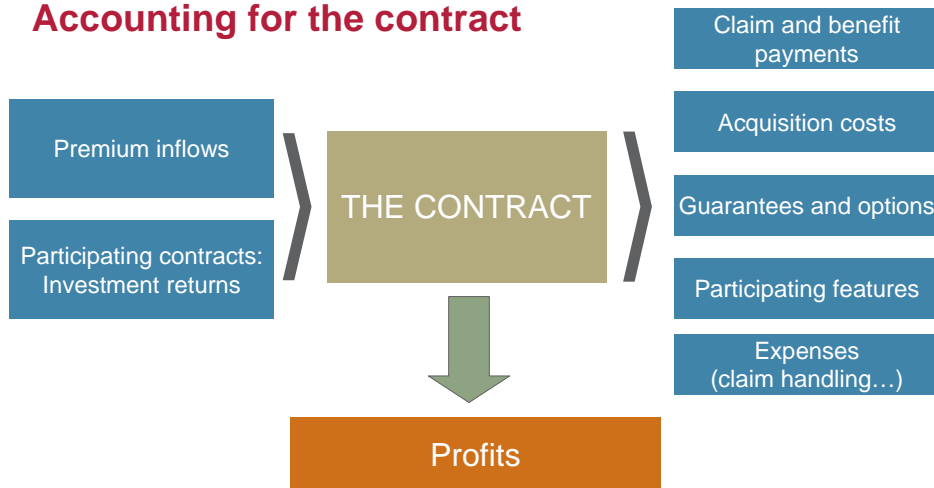
Related projects

- Financial Instruments
 - Classification and measurement
- Revenue Recognition
 - Contracts with customers
- Liabilities (Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*)
 - Measurement of uncertain liabilities

Scope of the project

- Accounting for insurance contracts
 - The contract
 - Combination of rights and obligations
 - Presented on a net basis
 - One model for all insurance types
 - Not about the insurer's other assets or liabilities
 - For the time being: not policyholder accounting
 - Definition
 - Investment contracts with discretionary participating feature

Accounting for the contract



(Tentative) Decisions reached

overview

- Measurement model
 - inputs and estimates
 - building blocks
- Recognition
 - acquisition costs
 - contract boundaries
 - participating contracts
 - unbundling
- Presentation and disclosures

Measurement model

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- Current measurement of an insurance contract
 - remeasured each reporting period
 - not locked-in
 - not updated for own credit risk
- Reflect insurer's perspective of the contract
- Building block approach
 - Four (or three) building blocks
- No deposit floor

Measurement model continued

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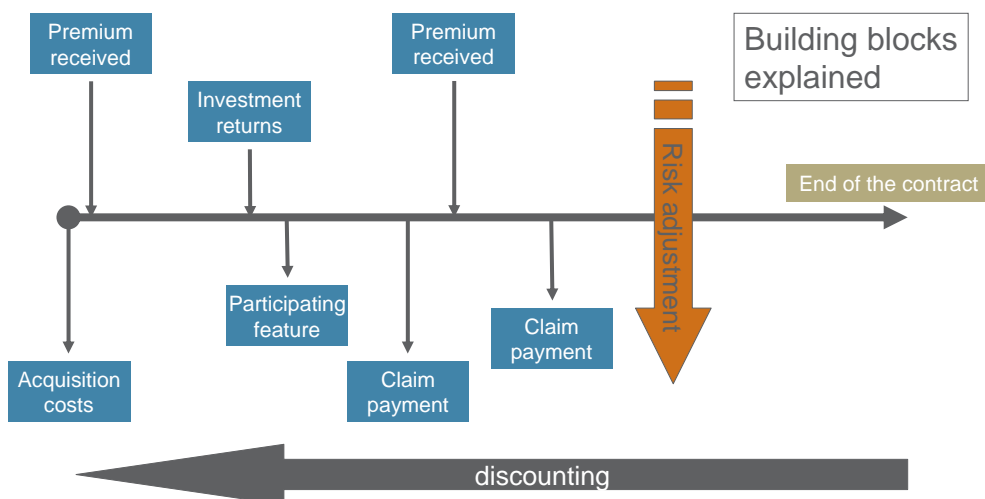
Inputs and changes in estimates

- Inputs
 - Financial market variables: consistent with observable market prices
 - Other variables: use all available information
 - unbiased
- Changes in insurance liabilities
 - profit or loss

Building blocks

- Expected (probability-weighted) future incremental cash flows
- Time value of money
- Margin
- Amount to eliminate 'day-one gains'

- 'Day-one losses' are recognised in profit or loss



Expected (probability-weighted) future incremental cash flows

- current estimates
- expected to arise from the contract
- scenario based
- on a portfolio level
- policyholder behaviour/ future premiums
 - ‘Looking through’ options

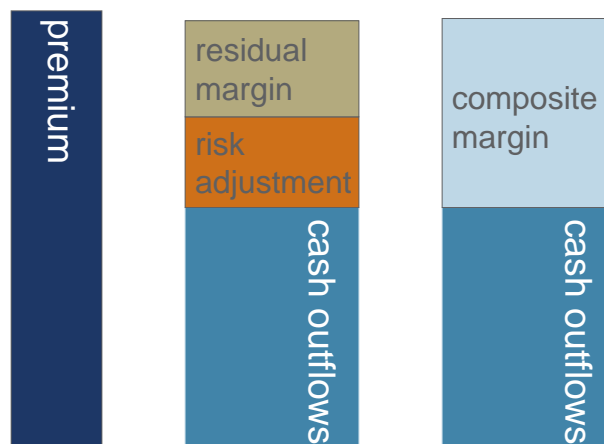
Time value of money

- Discount rate:
 - Reflecting characteristics of the insurance contract
 - Non-participating: risk-free plus adjustment for illiquidity
 - Participating: consider performance of assets
- Excluded: non-performance risk

Margin

- Two approaches:
 - Risk adjustment and residual margin
 - (explicit) risk adjustment plus an amount that eliminates 'day-one gains'
 - Composite margin
 - amount that eliminates 'day-one gains'

Margin continued



Two approaches considered

Risk adjustment [IASB]

“The maximum amount an insurer would rationally pay to be relieved of the risk”

- Measures the effects of uncertainty associated with future cash flows
 - insurer’s view of uncertainty
- Remeasured each reporting period
- Measured at portfolio level
- Permitted measurement techniques

Confidence interval/CTE/Cost of Capital

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Residual margin [IASB]

- Allocation of ‘day-one gain’
- ‘Day-one loss’ exists when:
cash inflows < cash outflows + risk adjustment

Premium received 12



Expected claim payments 10

Risk adjustment 3

- Releasing it to profit or loss over the coverage period in a systemic way
 - passage of time, or
 - pattern that better reflects the occurrence of benefits and claims
- Accretion of interest (locked-in)

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Composite margin [FASB]

- Allocation of 'day-one gain'
- 'Day-one loss' exists when:
cash inflows < cash outflows

Premium received 12 < Expected claim payments 13

- Subsequent release to profit or loss
 - over coverage period plus claims handling period
 - amortisation according to the exposure from
 - providing insurance coverage
 - uncertainties related to future cash flows

Simplified approach

- Premium allocation model ('unearned premium')
- Required application
 - pre-claims liability for short-duration contracts

Recognition

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Recognition

- At the earlier of
 - the insurer being on risk to provide insurance coverage
 - the signing of the contract

Recognition continued

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Acquisition costs

- Incremental costs of selling, underwriting and initiating an insurance contract
- For contracts actually issued
 - included in the measurement as cash flows

Contract boundaries

- Where does an 'existing contract' end?
- Existing contract ends if insurer
 - is no longer required to provide coverage, or
 - can reassess the risk for a particular policyholder and change the pricing accordingly

Participating contracts

- Cash flows from participating features
 - (incremental) Participating benefits an insurer expects to pay arising from participating insurance contracts
 - Contract cash flows like any other

- Mutual insurers?

Unbundling

- Account for components of a contract as if they were separate contracts
- Starting point of the analysis:
 - whether a component can introduce variability in the overall contract cash flows
 - for risks that are not considered to be part of insurance protection
- Alternative: significant interdependence between components
- Not permitted otherwise

Reinsurance

- One model for all insurance and reinsurance contracts
 - No anti-abuse rules necessary
- Cedant: same measurement as used for underlying direct insurance contracts
 - Initial measurement: residual margin
 - Ceding commission reduces premium
- No offsetting
 - unless requirements for offsetting are met
- No derecognition of ceded contracts
 - unless obligation is discharged, cancelled or expired

Derecognition

- When the insurance liability no longer qualifies as a liability
 - When it is extinguished, ie when the obligation is discharged or cancelled or expires
 - Clarification in guidance:
at that point where the insurer is
 - no longer at risk and
 - no longer required to transfer any economic resources for the insurance obligation

Presentation of Income Statement

- Rejected model that recognises revenue on the basis of written premiums
- Measurement approach should drive presentation
- Margin approach, broadly showing:
 - Change in the risk adjustment [IASB] and the release of the residual or composite margin
 - Difference between expected and actual cash flows
 - Changes in estimates (remeasurements)
 - Interest on insurance liabilities

Presentation example

	<i>Inception</i>	<i>six months</i>	<i>six months</i>
	<i>1 Jan</i>	<i>to 30 Jun</i>	<i>to 31 Dec</i>
Risk margin		21	26
Residual margin		2	2
Insurance margin	0	23	28
Experience adjustment		(10)	(10)
Changes in estimates		(20)	0
Net gain at inception	0	0	0
Investment income		40	38
Interest on insurance liability		(25)	(23)
Net interest and investment	0	15	15
Profit	0	8	33

Disclosures

- Disclosure principle aims at
 - explaining **the amounts** recognised in the financial statements arising from insurance contracts; **and**
 - **the nature and extent of risks** arising from those contracts.
- Auditable information about effectiveness in risk management practices (vs. non-audited MD&A info)
- Risk disclosures similar to IFRS 7
 - Sensitivity analyses

Transition - measurement

- At that date determine:
 - the expected present value of cash flows arising from the portfolio of the contracts and
 - a risk adjustment
- Compare with the amount recognised according to previous accounting
- Record the difference in retained earnings
- The risk adjustment on transition is treated as risk or composite margin going forward

Transition – other issues

- Redesignation of financial assets
 - permitted
 - measured at fair value through profit or loss
 - to reduce inconsistency in measurement or recognition
 - adjustment to retained earnings
- Disclosure exemption
 - previously undisclosed claim development information
 - > 5 years

How do I get in contact?

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- Staying up to date
 - www.ifrs.org
 - go.ifrs.org/insurance_contracts
 - IASB Update
 - Board meeting webcasts
 - Comment on the proposal
- Contacts
 - Jane Jordan
Technical Manager
email:
jjordan@ifrs.org
 - Hans van der Veen
Practice Fellow
email:
hvanderveen@ifrs.org

Questions or comments?

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Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.



IFRSs for Insurance Contracts Preparer's Perspective



***Yutaka Amino
Managing Director
Sumitomo Life***



Key Points of Presentation

- IFRS4 Phase II has some advantage over the current Japanese insurance accounting but there is room for improvement
- From management's perspective, general purpose accounting should reflect:
 - (i) the economic substance of insurance business accurately
 - (ii) results of management's strategy to maximize a company's value appropriately
- In this presentation, I will outline our recommendations to improve the tentative decisions in IFRS4 Phase II and our strategy towards this



Table of Contents

- ① **Current Insurance Accounting Standards in Japan**
- ② **Desirable Accounting for Insurance Business from Management's Perspective**
- ③ **Our Analysis and Recommendations on IFRS4 Phase II**
- ④ **Sumitomo Life's Strategy towards IFRS4 Phase II**



① Current Insurance Accounting Standards in Japan



Current Insurance Accounting Standards in Japan

- Under Japanese GAAP(= Statutory Accounting Purpose), insurance liabilities are currently measured conservatively using the 'Statutory reserving method'
- Assets are mostly measured at fair value, Insurance liabilities are valued at cost

Statutory Reserve Method

- **Lock-in approach + Liability adequacy test**
 - Initial assumptions applied on 'lock-in' basis throughout contract life
 - The Appointed Actuary conducts liability adequacy test
- **Conservative assumptions specified by Regulators**
 - Valuation assumptions with allowance for adverse deviations (i.e. Statutory Standard Interest Rates and Standard Mortality Tables)
- **Conservative reserves by the 'net-level premium method'**
 - All acquisition costs recognized as incurred, No Day 1 profits or DAC recognized

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Arguable Issues in the Current Accounting Standards

- **Accounting mismatches from asymmetry between asset and liability measurement**
 - Economic substance of insurance business not reflected in financial statements, therefore even if ALM risk is increasing it's not represented in financial statements
- **The results of management's strategy are presented in financial statements with a time delay**
 - Despite acquisitions of profitable new business and efforts to improve persistency etc. contributing to profits over future periods, the results of these activities are not immediately reflected in financial statements

Due to these issues, it is important to use the information based on internal management accounting for management's analysis and decision-making to supplement the GAAP information

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Counter-Measures Against These Issues

- The sophistication of internal management accounting model and disclosures

E.g. analysis and control of 3 major profit sources using Zillmerized reserves

- Operating profits adjusted to be more economically realistic by recognizing day 1 profits equivalent to recoverable acquisition costs
- Analyzing and controlling 3 major sources (expense, mortality and interest margins) for profit management

Profit and risk management on economic value basis and voluntary disclosure of Embedded Value

- Supporting management's decision-making by attaining the actual economic substance of the company on a timely basis using the economic valuation for insurance liabilities
- Increasing no. of companies to voluntarily disclose EV (mainly stock companies)

E.g. • FY2005 Sumitomo Life disclosed the PVIF, a main component of EV

• FY2010 Sumitomo Life plans to disclose market-consistent EV

② Desirable Accounting for Insurance Business from Management's Perspective

Desirable Accounting for Insurance Business 1

- Consistent valuation standards for assets & liabilities should be used in financial statements to reflect actual economic substance of a company & results of management's strategy
 - financial statements should reflect changes in a company's risk (e.g. ALM risk) in a timely and proper manner
 - Financial statements should reflect the results of management's strategy which would contribute to profits over future periods, e.g. acquisitions of new business and improving persistency

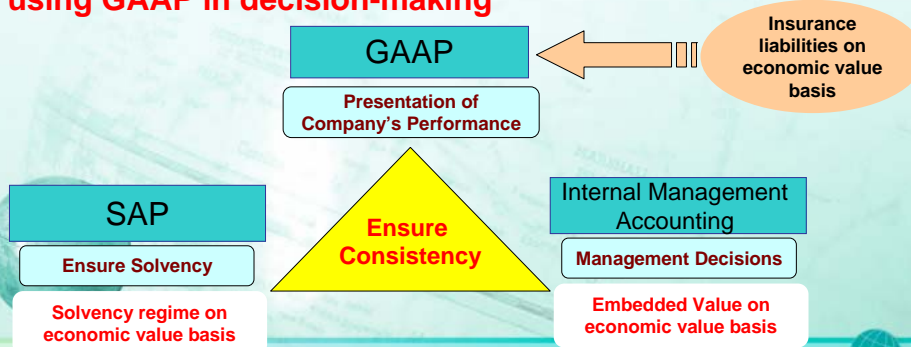
To achieve the above objectives:

Insurance liabilities should be measured on an economic value basis

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Desirable Accounting for Insurance Business 2

- GAAP would be more consistent with internal management accounting and SAP by introducing economic valuation for insurance liability measurements into GAAP
 - ⇒ **Management avoiding complicated adjustments when using GAAP in decision-making**



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③ IFRS4 Phase II

Our Analysis & Recommendations



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- 1. Best Estimates***
- 2. Measurement at Inception***
- 3. Subsequent Treatment of Margins***
- 4. Presentation of Performance Statement***
- 5. Transition***

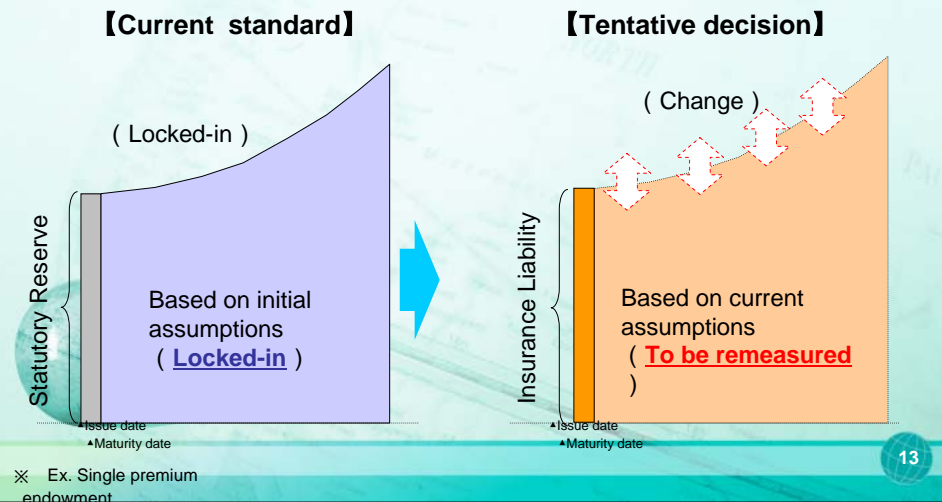
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✘ This presentation is based on the IASB's tentative decisions.

IFRS4 Phase II Tentative decision 1

Best Estimates

Insurance liabilities should be measured using current assumptions



Our Analysis on the Tentative Decision

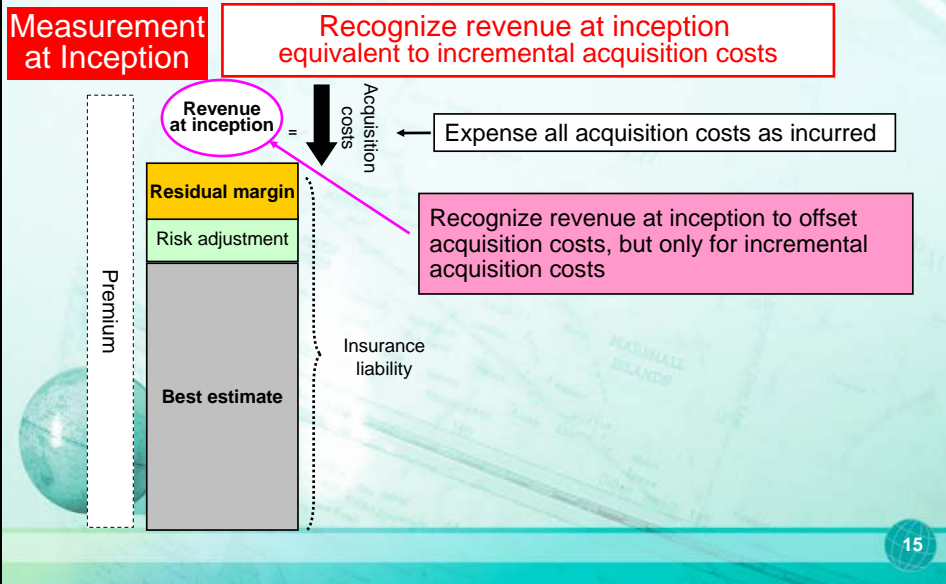
Insurance liabilities should be measured using current assumptions
(To be remeasured each reporting period)

We support this tentative decision

- Consistent valuation of assets and insurance liabilities will enable a faithful representation of economic substance and results of management's strategy, and enhance transparency for users

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IFRS4 Phase II Tentative Decision 2



Our Analysis on the Tentative Decisions

An insurer should expense all acquisition costs and recognize revenue equivalent to incremental acquisition costs

We mostly support this tentative decision

- **Improvement on the current accounting standard;**
 - At present, the acquisition of new business makes negative impacts on the performance statement
- **However, incremental costs are still not sufficient;**
 - Inconsistent with the economic valuation of insurance liabilities
 - Inappropriate representation of the profitability of insurance companies

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Our Recommendation

The amount equivalent to all recoverable acquisition costs should be recognized as revenue at inception

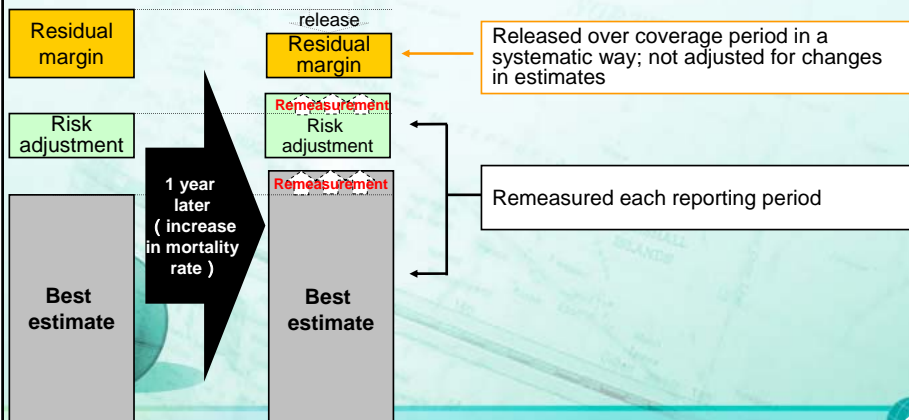
Acquisition of profitable new policies will no longer lead to accounting losses at inception

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IFRS4 Phase II Tentative decision 3

Subsequent treatment of margins

- Best estimate & risk adjustment should be remeasured each reporting period
- Residual margin should be released over coverage period in a systematic way



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Our Analysis on the Tentative Decisions

- Best estimate and risk adjustment to be remeasured each reporting period
- Residual margin to be released over coverage period in a systematic way



We do not support this tentative decision

- **Measurement objectives underlying residual margins are inconsistent**
 - At inception, residual margins are calibrated to the premium
 - In subsequent periods, residual margins would only be released without calibration
- **The profitability of contracts wouldn't be properly presented**
 - After the increases in best estimates and losses are recognized, revenue from the release of residual margins, which is 'deferred profits' in nature, will be recognized in the subsequent periods

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Our Recommendation

Residual margins should be remeasured to adjust for changes in the best estimate



- This will ensure consistency between initial measurement and subsequent measurement
- Furthermore, the profitability of insurance contracts would be properly presented

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IFRS4 Phase II Tentative Decision 4

Presentation of performance statement

Summarised margin model +Supplementary information
('Premium Revenue' and 'Claims and benefits as supplementary information .)

【 Summarised margin model 】

	Inception	H1	H2
Risk adjustment		21	26
Residual margin		13	13
Insurance margin	0	33	39
Experience adjustments		-10	-10
Changes in estimates		-20	0
Acquisition costs	0		
Net gain at inception	0	0	0
Investment income		40	38
Interest on insurance liability		-25	-23
Net interest and investment	0	15	15
Profit	0	19	44

(Ref.) Traditional life model

	Inception	H1	H2
Premium revenue	0	500	500
Investment income		40	38
Claims and benefits		60	875
Change in insurance liability		421	-421
Expenses		40	40
Acquisition costs	0	0	0
Total expenses	0	521	494
Profit	0	19	44

※ Source : Agenda paper of the I A S B Board meeting in February

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Our Analysis on the Tentative Decision

Under the summarised margin model, 'Premium Revenue' and 'Claims and benefits' would be presented in the notes to financial statements as supplementary information.

We do not support this tentative decision

- An entity's revenue and expense should be presented on the face of financial statements
- Presenting 'premium revenue' and 'claims and benefits' is essential and would facilitate:
 - understanding of life insurers' business model
 - comparability of life insurers' performance

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Our Recommendation

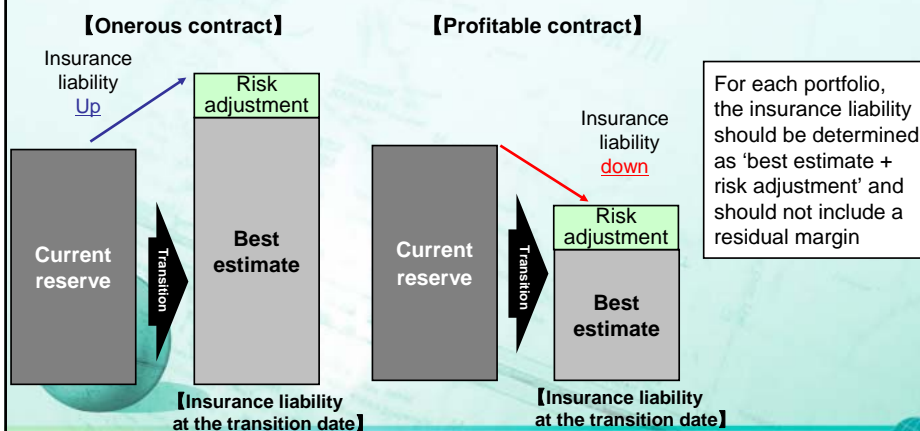
The traditional life model will best depict the life insurance business
Margin analysis should be disclosed as supplementary information

'Premium revenue' and 'Claims and benefits' should be presented in the performance statement

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IFRS4 Phase II Tentative Decision 5

Transition For in-force contracts, insurance liabilities should be determined as 'best estimate + risk adjustment'



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Our Analysis on the Tentative Decision

For in-force contracts, insurance liabilities should be determined as 'best estimate + risk adjustment' and should not include a residual margin



We support this tentative decision

- From management's perspective, we welcome the decision to have consistency between GAAP and internal management accounting measurements of insurance liabilities (such as EV)
- In practice, it would be extremely burdensome and costly to retrospectively determine residual margins for in-force contracts.

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④ Sumitomo Life's Strategy towards IFRS4 Phase II

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Potential Impact of IFRS4 Phase II

- Insurance liabilities to be remeasured every reporting period
- Using FVO on financial assets in bid to avoid accounting mismatches

ALM to be a more important part of risk management for insurers

- Lack of super long-term (over 30 years) & liquid government bonds in the market
- Strong demand for whole life protection
 - ⇒ May cause larger duration mismatches between assets & liabilities

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Sumitomo Life's Strategy

A look forward at possible impacts of the future introduction of IFRS4 phase II and new Solvency regime proposed by IAIS

Management's focus on economic valuation

**Profit and risk management
on an economic value basis**

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Management's Focus on Economic Valuation 1

Life insurers' conventional management methods:

- **Risk management** based on the current accounting system
- **Profit management** through 3 profit sources

2005 Present Value of Policies in Force (PVIF)

- Started measurement and disclosure of PVIF (one of main components of EV) as a supplementary management benchmark

2009 New risk management system

- Introduced a full-scale risk management system on an economic value basis

2010 Market-Consistent EV

- Adopted Market-Consistent EV as a management benchmark
- Plans to disclose Market-Consistent EV for FY2010

IASB

IFRS4
Phase II

IAIS · FSA

New Solvency
Regime

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Management's Focus on Economic Valuation 2

Implementation of integrated risk management on an economic value basis

Concept of integrated risk management

Risk Buffer

Total Capital

Core
Capital

>

Total Risk
Amount

Market risk

Credit risk

Property investment risk

Underwriting risk

Minimum guarantee risk
(Variable annuity)

Operational risk

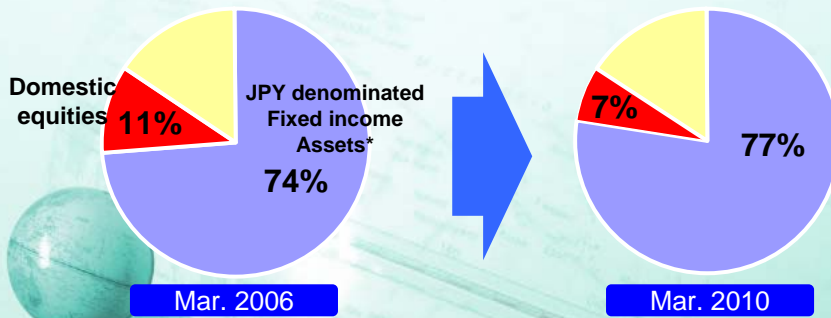
Including surplus on an
economic value basis

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Risk Management on Economic Basis 1

- Right-sizing of high risk assets

Portfolio of assets (General account)



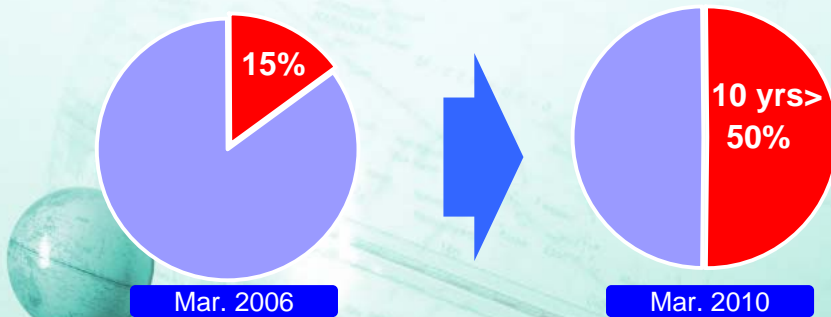
*Government bonds, Municipality bonds, Corporate bonds, Loans, Monetary claims bought, Foreign currency-dominated bonds (with fixed yen value)

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Risk Management on Economic Basis 2

- Reducing ALM risk by lengthening asset durations

% of over 10 years duration bonds*



*domestic bonds, municipality bonds, corporate bonds, foreign currency-dominated foreign bonds

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Risk Management on Economic Basis 3

- **Further actions for risk reduction**

Developing new non-interest sensitive products to reduce the sensitivity of insurance liabilities

Introducing a new pricing method



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Profit Management on Economic Basis

- **Maximizing economic value based profits through the following actions:**

Enhancing our multi-channel sales strategy

Continued focus on improving persistency

Pursuing better investment returns by optimizing asset allocation

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To summarize

- **New insurance accounting standard is expected to improve users' understanding and communication**
- **From management's perspective, general purpose financial statements should reflect:**
 - * **Economic substance of insurance business**
 - * **Results of Management's strategy to maximize company's value**
- **Intentions to comment on acquisition costs and residual margins for the forthcoming ED**
- **Further preparation for the future introduction of IFRS4 phase II and new Solvency regime**



IFRS Foundation Special Interest Sessions:
IFRS for Insurance Contracts
Actuarial perspective

Hideyuki Yoshida
Tokyo July 28, 2010



Disclaimer

The content and opinions expressed in this presentation do not necessarily reflect those of the Professional Associations (IAA, IAJ, etc) and Firms (PwC, etc) associated with the Author.

Actuarial Observation

- As of this writing (July 14, 2010), the Exposure Draft has not been published and the contents in this presentation are based upon published documents by IASB/FASB up to this time.
- It is expected that actuarial associations around the world (including IAA and IAJ) will prepare their own comment letters in due course after the Exposure Draft is published.
- To gain local actuaries' opinions on this subject at this timing, **the author conducted a survey on various issues regarding the IFRS Insurance contracts project in early June this year.**
- **Nine senior actuaries from nine life insurance companies contributed to this survey.**
- The following slides refer to actuarial observation for each issue based upon the survey on top of the author's own views. In addition, IAA documents are frequently referred to.
- There are five topics in the main presentation which the author believes require mathematical skills and actuarial knowledge most.

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1. Risk adjustment

(1) Explicit risk adjustment approach:

This approach includes two margins:

- 1) An explicit risk adjustment for the effects of uncertainty about the amount and timing of future cash flows from the perspective of insurer rather than from the perspective of a market participant.
 - 2) An amount that eliminates any gain at inception of the contract (**residual margin**).
- **Explicit risk adjustment is the maximum amount insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed those expected. (Objective)**
 - Explicit risk adjustment would be updated (re-measured) each reporting period.
 - Under the explicit risk adjustment approach, the guidance would limit the range of permitted techniques by specifying the available techniques, (See slide 1.1).
 - Although the risk adjustment is included in the measurement as conceptually separate from other building blocks (cash flows and discount rate), this is not intended to preclude “**replicating portfolio approaches**”. To avoid double counting, the risk adjustment does not include any risk captured in the replicating portfolio.

1. Risk adjustment (continued)

(2) Composite margin approach:

- This approach includes a single margin that eliminates any gain at inception of the contract (**composite margin**).
- Under composite margin approach, no explicit risk adjustment, is made, as objective may not sufficiently robust to promote rigorous application.

(3) Should there be an explicit risk margin?

Advantages

- An explicit measurement of uncertainty is useful information
- Explicit risk margin could be remeasured to reflect changes in price and quantity of risk
- Reflects risk in skewed tail distributions
- Lessens amount of residual margin subject to the complexities of amortising/remeasuring the residual margin
- Consistent with some regulatory regimes
- Explicit risk adjustment currently required under transition rules for inforce business at transition

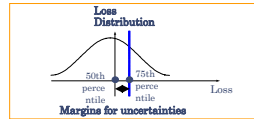
Disadvantages

- Little chance of comparability and consistency without rules
- Market may not trust explicit margin calculations
- Not sure objective of risk margin can be consistent with fulfilment objective
- Cost/benefit for all sized companies uncertain
- Can it be done quickly enough for quarterly reporting?
- Difficult to audit

1. 1 Draft guidance on risk adjustment techniques

IASB permits the following techniques for determining risk adjustments and no others:

- 1. confidence interval;** Also known as value-at-risk (VaR), in which the risk margin is the difference between a specified quantile (percentile) of the distribution and the expected value.



- 2. conditional tail expectation (CTE);**

$$CTE(p) = E\{x | x > z(p)\} = \frac{\int_{z(p)}^{\infty} xf(x)dx}{\int_{z(p)}^{\infty} f(x)dx}$$

where $f(x)$ is the probability density function, p , is the selected quantile and $z(p)$ is chosen so that

$$\int_{z(p)}^{\infty} f(x) dx = 1 - p$$

- 3. cost of capital**

$$Risk\ Adjustment = (r - i) \sum_{t=0}^{\infty} \frac{C_t}{(1 + i)^{t+1}}$$

i = Risk-free rate of return on investments
 r = Total rate of return demanded by investors for taking on insurance risk
 C_t = Amount of capital required (or allocated) to support an insurance portfolio at time t .

1. 2 Risk adjustment - Actuarial Perspective

Desirable risk margin characteristics (IAIS, IAA, and Draft application guidance except e.)

- The less that is known about the current estimate and its trend; the higher the risk margins should be.
- Risks with low frequency and high severity will have higher risk margins than risks with high frequency and low severity.
- For similar risks, contracts that persist over a longer timeframe will have higher risk margins than those of shorter duration.
- Risks with a wide probability distribution will have higher risk margins than those risks with a narrower distribution.
- To the extent that emerging experience reduces uncertainty, risk margins will decrease, and vice versa.

Reference Materials for Risk Adjustment

- Section 6 of the IAA's "Measurement of Liabilities for Insurance Contracts: Current Estimate and Risk Margins" (April 2009).
http://www.actuaries.org/LIBRARY/Papers/IAA_Measurement_of_Liabilities_2009-members.pdf
- Analysis of Methods for Determining Margins for Uncertainty under a Principle-Based Framework for Life Insurance and Annuity Products by SOA/PwC March 2009.
<http://www.soa.org/files/pdf/research-analysis-life-annuity.pdf>
- The CRO Forum Market Value of Liabilities paper
<http://www.croforum.org/assets/files/publications/croforummvpaperjuly2008.pdf>

1. 3 Risk adjustment techniques – Actuarial Perspective

The way to develop Cost of Capital rate (CoC) seems very subjective. The IASB staff paper, shows the following example:

- $\text{CoC} = 8\% = 18\%$ (investor's required rate) - 2% (asset risk) - 1% (ALM risk) - 3% (Operational risk etc.) - 4% (Risk free rate).
- Determination of those subtracting components, other than risk free rate seems challenging for actuaries.
- Common challenge for all techniques is how to develop the "right" risk distribution for each portfolio. (transparency and full disclosure should be required.)
- The capital will be economic capital not regulatory capital.

(CFO FORUM MCEV PRINCIPLE 9; COST OF RESIDUAL NON HEDGEABLE RISKS seems to have a similar issue.)

Principle 9: An allowance should be made for the cost of non hedgeable risks not already allowed for in the time value of options and guarantees or the PVFP. This allowance should include the impact of non hedgeable non financial risks and non hedgeable financial risks. An appropriate method of determining the allowance for the cost of residual non hedgeable risks should be applied and sufficient disclosures provided to enable a comparison to a cost of capital methodology.

1. 4 Risk adjustment techniques - Actuarial Perspective and Auditability

(Example)

Imagine there are two companies, A and B which have totally identical liability portfolios. The auditor is the same for both companies.

Both companies came up with current estimates of liability, say US\$100Billion.

Company A used CoC approach assuming 99.5% confidence level Economic Capital and 6% CoC rate and calculated risk adjustment as US\$ 8 billion. At the same time, Company A disclosed Quantile approach based risk adjustment using 75% confidence level which resulted in US\$2billion. Company A had difficulty reconciling those two numbers; they adjusted the various parameters and took the average of two approaches; **US\$5 billion** was the final statement number.

Company B (which has a more conservative management view) also used CoC approach assuming 99.95% confidence level of Economic Capital and 6% CoC rate and calculated risk adjustment as US\$ 11billion. At the same time, Company B disclosed Quantile approach based risk adjustment using 90% confidence level which resulted in US\$4billion. Company B had difficulty reconciling those two numbers and decided to use the larger of the two numbers which is **US\$11billion** as the final statement number.

The liabilities are identical for both companies, only judgments of management are different. Assume those companies are listed on a major Stock Exchange.

The difference of the total liability (excluding residual margin) is US\$6billion which could prove to be important to the users of the financial statements.

2. Level of measurement

- If the measurement approach includes an explicit risk adjustment, **that adjustment should be determined for a portfolio of insurance contracts rather than individually.**
- The current definition of a portfolio of insurance contracts in IFRS 4 will be retained (“contracts that are subject to broadly similar risks and managed together as a single portfolio”).
- The explicit risk adjustment **would not reflect the effects of diversification or negative correlation between portfolios.**
- Residual and composite margins would be determined initially and subsequently at a **cohort level** that groups insurance contracts (a) by portfolio, (b) within the same portfolio by date of inception of the contract, and (c) by length (life) of the contract.

Discussion Comments

- There will be practical implementation challenges when measuring the residual and composite margin at such a granular level (portfolio, inception year, life of contract).

2. 1 Level of measurement - Actuarial Perspective

(IAA Discussion regarding Level of measurement)

- ✓ Margins will be determined initially and subsequently at a cohort level. Does this mean that we know insurance liability only on a cohort basis not on a policy by policy basis? Or will the liability for a cohort be allocated to individual policies by some formula?
- ✓ For current Boards' decisions, the margins could be allocated to the individual policies but because they specify the risk and the risk of one policy is not the risk of the portfolio divided by the number of the policies, I don't see very much sense in allocating the margins to the individual policies. As I said above, I would keep the risk margin as a non-allocable item. (Opinion of an IAA insurance accounting committee member)
- ✓ Additive calculation of each portfolio's risk adjustment is not mentioned, but it seems clear from the previous page saying “**Not reflect the effects of diversification or negative correlation between portfolios.**”

3. Discount rates

- The discount rate for insurance liabilities should conceptually adjust estimated future cash flows for the **time value of money in a way that captures the characteristics of that liability**.
- Those characteristics are **not** best reflected using a discount rate based on expected returns **on actual assets backing those liabilities** (unless those asset returns affect cash flows to policyholders).
- **Liquidity** is one of the relevant characteristics that should theoretically be reflected in the discount rate.
- Exposure draft will **not** propose to include an adjustment for **nonperformance risk** (including credit spreads), but will solicit views on this from constituents.

Reference Materials for Discount rate

Calculation of the illiquidity premium applied will be particularly challenging. See the work of the European Insurance Industry for Solvency II where this is also an issue.

1. **QIS 5 Technical Specification Risk-free interest rates by CFO FORUM and CRO FORUM**
http://ec.europa.eu/internal_market/insurance/docs/solvency/qis5/cfo-forum-cro-forum-paper-risk-free-rates_en.pdf
2. **Application of the illiquidity premium to liabilities by CRO FORUM and CFO FORUM**
http://www.cea.eu/uploads/DocumentsLibrary/documents/1274972972_application-of-illiquidity-premium-to-liabilities.pdf

3. 1 Discount rates - Actuarial Perspective

(IAA's reference materials)

- ✓ Section 5 of the IAA's "Measurement of Liabilities for Insurance Contracts: Current Estimate and Risk Margins" (April 2009).
- ✓ "Summary of Liquidity Premium Estimation Methods" by Barrie & Hibbert (October 2009).
- ✓ IAA Educational Monograph on the Topic of Issues Associated with the Determination of Discount Rates for Financial Reporting Purposes to be prepared.

4. Participating features in insurance contracts

IASB	FASB
<ul style="list-style-type: none">• Include all cash flows that arise from a participating feature in the measurement of the insurance liability on an expected present value basis.	

Discussion Comments

- Potential conflict exists between the proposed insurance model (reflecting all *expected* cash flows, including those that are discretionary) and the definition of a liability.
- But limiting liability to amounts that meet legal or constructive obligation definition seen by some as not useful for users as it represents minimum rather than expected payments.
- Staff noted potential practical difficulty in determining which part of participation feature meets the definition of a legal or constructive obligation.
- FASB changed its position after reconsideration of measurement objective to include a **broader notion of cash flows**.

4. 1 Participating features in insurance contracts

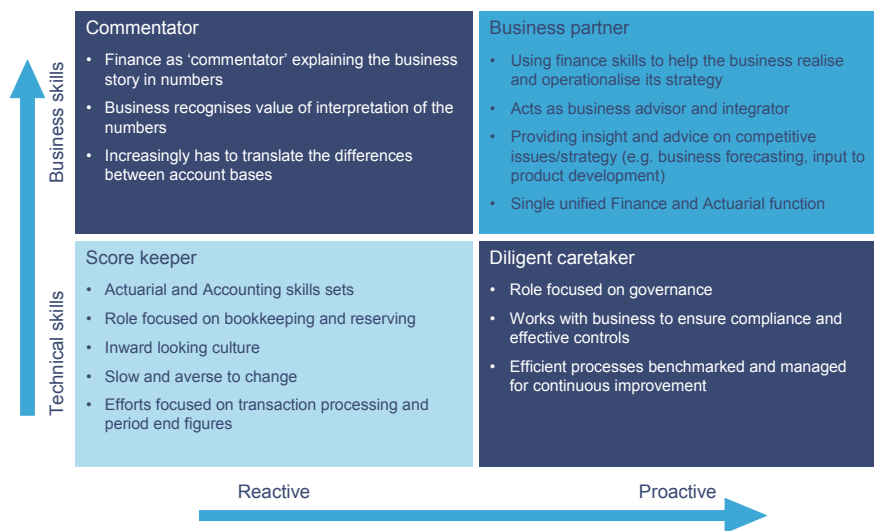
Japanese life insurance companies' par contracts have many features such as following:

- ✓ **Netting of three sources of gains** (Mortality, Interest, Expenses) in one contract. Normally interest component is negative and this is offset by other sources of positive gains. (mortality and expense gains.)
- ✓ **Netting effect between base policy and riders.** (Example; Whole life with term rider, normally whole life dividend is likely to be negative and this is offset by term rider's mortality gain.)
- ✓ **Computation has to be done on a contract by contract basis.** So, Model-pointing approach is not easily acceptable by auditor when projecting future dividend cash flows using stochastic model for future interest element projection (there are many interest rate projection models.) This is more a **calibration issue**.
- ✓ **Five year interest only dividend** (Special Par contracts started by non-mutual companies): Interest component is only one source of gain. There will be positive years and negative years, we accumulate those positives and negatives until end of 5th year. And only when the total is positive, is a dividend paid. How shall we measure dividend liability?

5. The challenge for the finance function

- **The roles** that are undertaken by a high performing finance and actuarial function are **changing**.
- Previously **finance function was seen purely as the accounting and reporting function**, producing financial and management accounts.
- Now world class finance and actuarial teams are re-shaping themselves to take on a **much more prominent and value adding role alongside the business**.
- Questions finance functions are asking themselves:
 - **What role** does Finance function **aspire to**?
 - **Where does the business currently see the role**?
 - **What will be required to enable a change** in emphasis in these roles?

5.1 The challenge for the finance function - Roles in the finance & actuarial function



6. Concluding remark

For more than a half century, we have had a system of accrual accounting that will be moved towards the new measurement approach consisting of building blocks concept.

1. From technical perspective

following will be of particular importance.

- The financial and administration system transformation---- process and data flow will increase , massive computations will be involved with stochastic modeling.
- There will be many technical challenges for actuaries to compute risk adjustment using three proposed approaches.
- Auditors will need to be prepared for model validation of more complicated techniques utilized by their clients.
- On a positive note, there are many similarities between IFRS Phase II, Solvency II, ERM, and MCEV, so synergy effect should be realized. For example, financial modelling computation engine can be shared among *those financials with minor modification*.

2. From Company (management's) perspective

- How may products change?
- How may capital raising change?
- How might key performance indicators change?
- How will economic mismatches be reduced?

Q & A



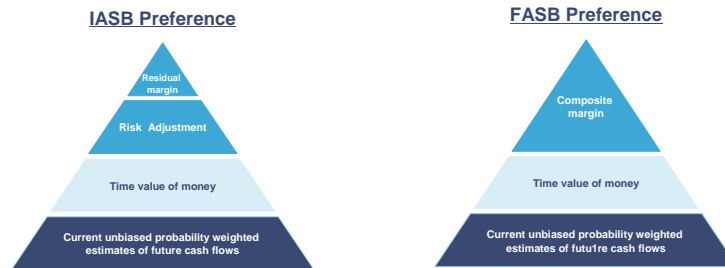
Appendix A - Other Issues Update

Other Issues Update

A-1 Measurement approach

- Measurement approach should portray a current assessment of the contract, using the following building blocks:
 - unbiased, probability-weighted average of future cash flows expected to arise as insurer fulfils the obligation
 - incorporation of time value of money
 - a margin* (see next page)
- These building blocks should be used to measure the combination of rights and obligations arising from an insurance contract rather than to measure the rights separately from the obligations.
- That combination of rights and obligations should be presented on a net basis.
- Objective for measuring an insurance contract should refer to a value rather than cost.
- Cash flows under the building block approach would include cash flows *that arise as the insurer fulfils* the contract rather than the narrower objective of including those cash flows needed to fulfil the contract.

A-1 Measurement approach (Continued)



*Two different margin approaches proposed are **explicit risk adjustment approach** and **composite margin approach**. Both approaches eliminate any gain at inception. The Boards are split between the two approaches with FASB favoring the composite margin approach, and with IASB favoring the explicit margin approach.

A-2 Measurement of margins at inception - explicit risk adjustment approach

- In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit.
- A loss arises at inception if the expected present value of cash outflows, plus explicit risk adjustment exceeds the expected present value of cash inflows.
- An entity should recognize that loss in profit or loss at inception.

A-3 Measurement of margins at inception - composite margin approach

- In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit.
- Composite margin is the difference between the expected value of cash inflows and the expected cash outflows.
- In composite margin approach, a loss arises at inception if the expected present value of cash outflows exceeds the expected present value of cash inflows, i.e., **any Day 1 loss would not include a risk adjustment.**
- An entity should recognize that loss in profit or loss at inception.

A-4 Unearned premium

IASB	FASB
<ul style="list-style-type: none"> • An unearned premium measurement approach (simplified measurement approach) for pre-claim liabilities for certain short-duration contracts would be required rather than permitted. • Building block approach for claim liabilities, including an explicit risk adjustment, but excluding a residual margin. 	<ul style="list-style-type: none"> • An unearned premium approach for preclaim liabilities for certain short-duration contracts meeting specified criteria would be required rather than permitted. • Scope potentially limited to those short - duration contracts with a short-term coverage period and perhaps a relatively short "tail" (claim payout period). • Claim liabilities would be discounted unless the effect is not material. • No margin allocated to claim liability under the unearned premium approach.

A-5 Subsequent treatment of residual margins under explicit risk adjustment approach

- Insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates.
- Insurer should release residual margin **over coverage period in a systematic way that best reflects exposure from providing insurance coverage on the basis of passage of time**; but if the insurer expects to incur benefits and claims in a pattern that differs significantly from passage of time, the residual margin should be released on the basis of the initial expected value of benefits and claims to be incurred over the coverage period.
- Residual margin would be included as part of insurance liability.

A-6 Subsequent treatment of composite margin under composite margin approach

- Composite margin is “released” or “allocated” **over both the coverage and claims handling periods** (relates to building block measurement).
- Amortise composite margin based on a combination of **two drivers, the provision of insurance coverage and the uncertainty in future cash flows**.
- Approach specifies using a formula that calculates a ratio of current period allocated premiums plus claims and benefits cash flows to the expected value of total premiums plus claims and benefits and then applies this ratio to the composite margin. (see slide **A-6.1**)
- Composite margin would **not be “remeasured”** (no change to initial inception amount).
- Composite margin would not be adjusted for changes in cash flow estimates, i.e., not a “shock absorber”.
- Allocation pattern/term could change based on cash flow changes.
- Composite margin would be included as part of the insurance liability.

A-6.1 Subsequent treatment of composite margin under composite margin approach

Amortised using formula:

$$\frac{\text{Premium allocated to current period} + \text{Current period claims and benefits}}{\text{Total contract premium} + \text{Total claims and benefits}}$$

It would be better if time and shape of the distribution of the risk be considered in the formula.

“*time*”: the rate at which risk is released over time; and

“*shape*”: the risk distribution of possible outcomes around the mean value, at the reporting date, over a specified time horizon.

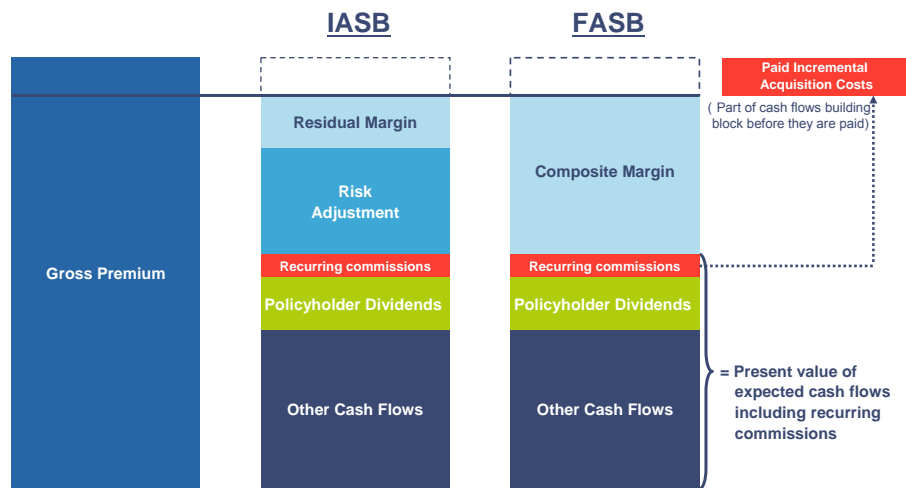
A-7 Acquisition costs

IASB	FASB
<ul style="list-style-type: none"> Acquisition costs that are “incremental at the contract level,” such as initial and recurring commissions, would be included as cash flows in the building block approach. “Incremental at the contract level” means those acquisition costs that would not have been incurred absent the contract sale. 	

Discussion Comments

- Immediate expense with no income offset or no capitalization viewed by industry as inconsistent with economics of contract pricing and major change from current practice.
- FASB changed its position after reconsideration of measurement objective to include a broader notion of cash flows.
- “Incremental” is **more restrictive than current GAAP in many territories.**

A-7.1 No Day 1 Gain, but Day 1 loss may occur



A-8 Participating features in insurance contracts - Investment Contracts with DPF

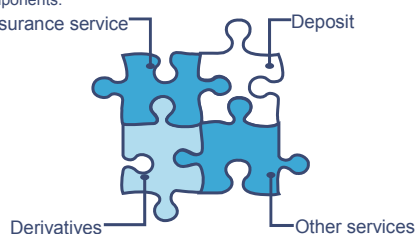
IASB	FASB
<ul style="list-style-type: none"> Included in scope of insurance contracts standard if they participate in the same pool of assets as insurance contracts. Other participating investment contracts included in scope of financial instruments standard. 	<ul style="list-style-type: none"> Included in scope of financial instruments standard.

Discussion Comments

- IASB chair made decision to include participating investment contracts in insurance contracts exposure draft after a split vote by IASB.
- Several IASB members as well as FASB members concerned with lack of conceptual basis for including financial instruments in an insurance standard and potential arbitrage, arguing that all financial instruments should be measured consistently.
- Unclear how unbundling of account balance decision will impact participating investment contracts.

A-9 Unbundling

- Issue is whether and how to unbundle the components of an insurance contract (e.g., insurance, deposit, service, embedded derivative components) for recognition and measurement purposes.
- Staff proposal built around notion of **lack of significant interdependence** potentially being replaced.
- Possible alternative proposal is that if the policyholder could redeem or withdraw his/her investment without the occurrence of an insurable event, or if the amount varies primarily based on a financial variable, insurer must unbundle.
- Factors to consider in unbundling include whether the component exposes the insurer only to financial risk, whether there is a separate observable market for the component, whether the component alters cash flows in a manner not linked to or directionally of insurance protection, or whether the component represents an account balance.
- **"Account balance" definition** would be based on the characteristics described in existing US GAAP guidance for universal life insurance contracts.
- Embedded derivatives in insurance contracts should be unbundled using the unbundling principle being developed for insurance contracts.
- Where unbundling is not required it should be prohibited.
- The key challenge is the allocation of such factors as par dividends, and experience elements between the unbundled components.



Possible measurement models:

- Fair value
- Amortised cost
- Fulfilment model
- Through other comprehensive income

A-10 Presentation of performance statement

- The staff paper (June 23) provided examples of the four potential presentation approaches for insurance contracts that had been discussed at previous meetings:
 - (1) written premium approach
 - (2) allocated premium approach
 - (3) summarised margin approach
 - (4) expanded margin approach
- **Summarized margin approach now preferred over an expanded margin approach** as it is most consistent with the liability measurement model. Both approaches show the following information on the face of statement:
 - **Release of expected margin during the period**
 - **Difference between expected and actual cash flows**
 - **Changes in estimate (re-measurement)**
 - **Results from investments (with interest income separate from interest on insurance liability)**
- Summarized margin approach would be **supplemented by additional information including a reconciliation of changes in the liability and volume of business written.**
- Unclear how presentation for short-duration contracts subject to practical expedient/unearned premium measurement approach is impacted by the Boards' latest decision to adopt summarized margin presentation.

A-10.1 Income statement presentation

Summarised Margin

	Inception 1 January	Six month to 30 June	Six months to 31 December
Risk adjustment		21	26
Residual margin		2	2
Insurance margin	0	23	29
Experience adjustments		(10)	(10)
Changes in estimates		(20)	0
Acquisition costs	0		
Net gain at inception	0	0	0
Investment income		39	37
Interest on insurance liability		(25)	(23)
Net interest and investment	0	15	14
Profit	0	8	33

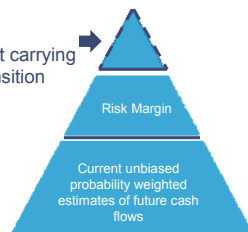
Expanded Margin

	Inception 1 January	Six month to 30 June	Six months to 31 December
Revenue	20	113	114
Policyholder benefit		(50)	(65)
Expenses		(40)	(40)
Acquisition Costs	(20)		
Release of benefits and expenses accrued in previous periods		0	20
Insurance margin		23	29
Experience adjustments		(10)	(10)
Changes in estimates		(20)	0
Net gain at inception	0	0	0
Investment income		39	37
Interest on insurance liability		(25)	(23)
Net interest and investment	0	15	14
Profit	0	8	33

A-11 Transition and effective date

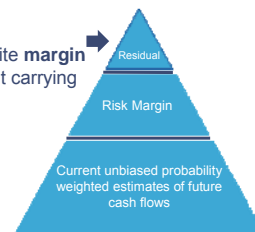
IASB/FASB decision

Difference from current carrying value in **equity** on transition



Staff proposal

Residual or composite **margin calibrated** to current carrying value on transition



“Portfolio of contracts subject to broadly similar risks and managed together”

A-11.1 Transition and effective date

- Theoretically, some actuaries would prefer the **'full retrospective application'** as compared to the **'pure prospective application'** because **it would be more accurate and fair and equitable to existing policyholders.**
- However, it may be impracticable to apply because, for example, **undue costs and efforts due to calculation of residual/composite margin.**
- Regarding participating business, we need to consider, that IFRS is not the legal basis of determining policyholders' actual rights under that feature.
- However, legal implication of policyholder equity change at transition needs careful consideration beyond IFRS accounting framework. (eg, demutualization)

Appendix B - Result of Industry Actuaries Survey

B-1 Measurement approach

Some of the comments from local actuaries are as follows:

- ✓ Majority of local actuaries who participated in the survey preferred explicit risk adjustment approach.
- ✓ A few indicated from practical viewpoints that it is desirable that measurement approach of regulatory accounting and general purpose accounting would be better if consistent.
- ✓ Some indicated that by having explicit risk margin, a sensitivity test will become more feasible.
- ✓ Some commented that they have no preference. Since both IASB/FASB use a hybrid method, measurement for renewal years do not have rational meanings.

B-2 Measurement of margins at inception - explicit risk adjustment approach

Some of the comments from local actuaries are as follows:

- ✓ Within the Boards' discussions, there seems to be **no logical reasoning about No gain at Issue**. This leads to the current situation of not being able to describe the measurement approach for the following years. Some have no preference as to choice of "Cost of Capital" or "Quantile" methods. Please let them know if there are any differences from the auditability perspective.
- ✓ Some prefer "Cost of Capital" approach. The Quantile approach has modelling difficulties. Although "Cost of Capital" approach has similar modelling problems, it is used in regulatory requirements like Solvency II and connected to the recognition of "Economic Capital" which considers market needs.
- ✓ If Risk Adjustment is used, reliability of measurement needs to be considered. It is difficult to decide one single method of calculation of RA when **considering a variety of products** in the international market and future development of technology.
- ✓ Some agree not to recognize "Initial Gains". **If Japanese pricing practices are considered, there should be normally no initial "Loss"**.
- ✓ Some believe that "Cost of Capital" approach is desirable when Some consider future Solvency II.
- ✓ Theoretically, Some believe that "Cost of Capital" approach is desirable, but others do not understand the calculation.
- ✓ At inception, insurer should recognize initial loss is supported by some.

B-3 Measurement of margins at inception - composite margin approach

Some of the comments from local actuaries are as follows:

- ✓ If Composite margin approach is used, considering allowance for future risks, there is a possibility that the total liability is not sufficient. Therefore, Liability adequacy test is a **must**.
- ✓ No gain at issue is supported. However, after year 1, by updating assumptions, immediate recognition of gains/losses is not desirable and margin should be defined as such. Whether initial loss should go to P/L or not will require consideration of consistency with subsequent years' treatment (P/L or OCI).

B-4 Unearned premium

Some of the comments from local actuaries are as follows:

- ✓ It would be important to define "what short duration exactly means". Life insurance companies should not be affected.
- ✓ Unearned premium method may not be suitable for Long term home owners' fire insurance (Japanese specific product).

B-5 Subsequent treatment of residual margins under explicit risk adjustment approach

Some of the comments from local actuaries are as follows:

- ✓ Some basically agree with the Boards' approach. However, regarding method of releasing residual margin, for comparability purpose, **certain guidance or disclosure will be necessary.**
- ✓ Some do not believe that the proposed approach is rational. Unless the meaning of measurement is well defined, Some have a great concern that the standards will not be practical on a principle basis. Detailed rules may be necessary if auditability is to be secured. Consistency between 1st year and subsequent years must be maintained. For example, for the subsequent years, the total amount of liability is locked in and residual margin is calculated as difference. Then it will function as a shock absorber and becomes rational and consistent.
- ✓ Some object to the idea of having residual margin. Deferral of profit recognition is against asset/liability method and will not support the **objectives of ALM risk management.**
- ✓ If the changes in estimates will not be reflected in the residual margin, all changes will go to net gains or OCI and Some have a **concern about instability of the results.**
- ✓ Some think that **further discussion** is necessary on this topic.
- ✓ Some support the Boards' approach.
- ✓ Some support the release on the basis of passage of time. If there are no changes in assumptions, no **distorted emergence of profit** in a particular year is desirable.

B-6 Subsequent treatment of composite margin under composite margin approach

Some of the comments from local actuaries are as follows:

- ✓ If Composite margin is not adjusted by changes in estimates (considering allowance for future risks), there is a possibility that the total liability is not sufficient. Therefore, a Liability Adequacy Test is a must.
- ✓ Some believe that consistency with release of risk is necessary, but under the composite margin approach, to do it properly is not realistically achievable.
- ✓ Composite margin will make a sensitivity test difficult.
- ✓ Release should be for the entire contract period rather than over contract and claim period.

B-7 Discount rates

Some of the comments from local actuaries are as follows:

- ✓ Some basically support the Boards' approach. However, as to liquidity premium, for the purpose of comparability, guidance or disclosure will be necessary.
- ✓ Some believe that consistency with other standards (IAS 19, IAS37, etc.) is needed.
- ✓ Own credit risk should not be included.
- ✓ If expected return is considered to be an approximation of replicating portfolio of liability, use of expected return on assets may have certain supporting grounds. Further discussion is appreciated.
- ✓ Some agree to include liquidity premium and not to include own credit risk.
- ✓ Some support including liquidity premium as characteristics of liability. However, what kind of premium is to be included needs further consideration.

B-8 Acquisition costs

Some of the comments from local actuaries are as follows:

- ✓ In Japan, by enforcing net level premium statutory reserving methods, abuse of new business acquisition costs were controlled by regulation. Therefore, from the perspective of policyholder protection, certain measures to control abuse of new business acquisition costs will be necessary.
- ✓ There should be no reason to differentiate acquisition costs from other expenses. A consistent approach is desired.
- ✓ Clarification of incremental acquisition costs is needed.
- ✓ To achieve consistency with pricing, immediate expensing of acquisition costs does not seem rational.

B-9 Unbundling

Some of the comments from local actuaries are as follows:

- ✓ Regarding unbundling, Some think that only complex financial instruments which manipulate insurance contract standards should be unbundled.
- ✓ Interdependency based judgment is appropriate. However, in practice, strict application of the rule will be difficult and it should be a matter to be decided by each local jurisdiction.

B-10 Presentation of performance statement

Some of the comments from local actuaries are as follows:

- ✓ Due to consistency with measurement approach (building block approach), summarized margin is easy and useful.
- ✓ Premiums and claim payments are core parts of the business activities of insurance companies and useful information for the user of statements and those items should be included in the performance statement.
- ✓ As consideration of accepting risks, premium collected as an index of performance should be recognized as income.

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