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Comments on the Proposed International Financial and Reporting Standards Exposure Draft 5, "Insurance Contracts"

Dear Sirs:

We, The Japanese Institute of Certified Public Accountants, appreciate the opportunity to respond to the exposure draft, "ED5 Insurance Contracts ("ED5")." We disagree with certain aspects of the scope, definition and disclosure requirements specified by ED5. We would like to address our concerns and propose revisions as follows.

Scope

ED5 proposes to account for assets that back insurance contracts in accordance with existing IFRSs, for example, IAS 39, *Financial Instruments: Recognition and Measurement*, and IAS40, *Investment Property*.

In respect to life and long-duration property and casualty insurance products, because it is critical for insurers to manage the duration of the assets that back insurance contracts in line with that of their insurance liabilities, it is usually the case that the expected future cash inflows from the assets are matched with the expected future cash outflows arising from the insurance liabilities. Should the insurers apply different valuation methods for the insurance liabilities and the assets, the financial statements will not fairly present the financial position of the insurer. Therefore, we believe that the same method that is used for the valuation of the insurance liabilities should also be permitted to be used for the valuation of the assets to avoid such a mismatch.

We believe insurers should be allowed to use a consistent valuation approach for their insurance liabilities and assets that back insurance contracts in Phase I. We propose that, consistent with the valuation of the insurance liabilities, a cost or amortized cost approach in valuing assets be permitted during Phase I. However, assets that qualify for the cost or amortized cost approach should be restricted to highly-rated debt securities or loans that can effectively offset the expected future cash outflows arising from the insurance liabilities. In addition, the effectiveness of such debt securities and loans should periodically be reviewed, and if it is later concluded that those designated debt securities or loans have deteriorated in terms of their credit quality, they should be de-designated from the assets that back insurance contracts and should be accounted for under the existing IFRSs.

Definition

ED5 defines an insurance contract as a "contract under which one party (the insurer) accepts *significant insurance risk* (emphasis added) from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary."

According to ED5, if the contract does not transfer *significant insurance risk* to the insurer, the entire contract including the term that provides a trivial insurance benefit is considered as an investment contract, and shall be accounted for under IAS 39. However, IAS 39 does not describe how the component of insignificant insurance risk should be measured and recognized. If IAS 39 should be applied to the insignificant insurance risk, ED5 should clarify how such insignificant insurance risk that is subject to IAS 39 should be accounted for.

Furthermore, we believe that the restriction "significant" contains the following potential issues:

1. A lack of quantitative guidance in defining what is considered to be significant could create a room for misinterpretation and may result in inconsistent application of the standard. The concept of materiality described by the IFRS framework, which states, "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements." has been placed in practice and is a fully established technical concept. However, there is no practice for the assessment of significance of the change in future cash flows on a contract-by-contract basis. Unless quantitative guidance is provided, the assessment of significance will be a subjective process, and the result of the assessment could vary by insurer.

2. Even if quantitative guidance is provided, the following concerns would still remain:

(1) We suppose that quantitative guidance, if some were issued, would be based on actuarial concepts. If this is the case, the quantitative assessment of insurance risk will be a probability-based methodology and will be largely susceptible to an actuary's judgment on the degree of risk involved in a particular product. As a result, different conclusions could be drawn by different actuaries, resulting in a variation in the accounting treatment for the same contract.

(2) The insurance accounting proposed by ED5 will be applicable to products issued by non-insurance companies, which satisfy the definition of insurance contracts. However, except for the United States and certain other nations in Europe, the number of actuaries in the market is limited, and it is difficult to expect all companies that issue insurance products will have the requisite technical capability equivalent to that of the actuaries. Therefore, we doubt that all the adopters will be able to implement such actuarial quantitative guidance in the current environment.

3. As noted in Paragraph BC21 of ED5, certain traditional annuity contracts and single-payment endowment contracts may no longer be treated as insurance contracts. However, these products are considered to be insurance contracts in Japan, and this contradicts ED5's intention to retain the measurement and recognition of insurance liabilities based on local GAAP during Phase I.

4. Under the current situation where the accounting for insurance contracts in Phase II has not been concluded, the accounting implementation varying depending on how the definition of insurance contracts should be interpreted will likely result in confusion in practice. This is against the objective of ED5 set forth in Paragraph 1(a), which states that the Board intends not to make major changes that may need to be reversed for Phase II.

As such, we propose to remove the term "significant" from the definition of an insurance contract.

Temporary Exemption from IAS 8

Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item.

ED5 proposes that, for accounting periods beginning before January 1, 2007, an insurer will be exempt from applying those criteria to most of its accounting policies for insurance contracts that it issues and reinsurance contracts that it holds.

We are against the proposal of the exemption for accounting periods beginning before January 1, 2007.

The Board has expressed its commitment to thoroughly investigate all relevant conceptual and practical questions and complete an extensive due process in Phase II of its project. We understand that the proposals in ED5 are based on the assumption that the conclusions in Phase II will be readily implemented from periods beginning on or after January 1, 2007. We believe, however, it is inappropriate to set a specific due date at January 1, 2007 at this point, as there are a number of outstanding issues that need to be resolved. Therefore, the exemption period should be "periods before the period in which Phase II is required to be adopted."

Prohibition on Catastrophe and Equalization Provisions

While ED5 proposes to exempt an insurer temporarily from certain provisions of IAS 8, it also proposes to prohibit an insurer from recognizing catastrophe provisions and equalization provisions.

We disagree with the prohibition of the recognition of catastrophe provisions.

Paragraph BC61 of ED5 states that, as a basis for the prohibition of the recognition of catastrophe provisions, such provisions represent an obligation for losses that will occur after the end of the current contract period, and they do not meet the definition of liabilities. However, the catastrophe provisions required in Japan represent the obligation for future catastrophic losses. We agree with the Board's view that there is no objective way to measure catastrophe and equalization provisions, as noted in Paragraph BC61(h). We are also aware that the existing method used to calculate the catastrophe provisions in Japan should be reconsidered to exclude those contracts whose contract periods have expired, which are currently reflected in the computation. However, we disagree with the Board's conclusion to separately treat catastrophe provisions by requiring a more precise and sophisticated measurement in Phase I, while retaining local GAAP for other insurance liabilities. As it has not yet been concluded on how all the insurance liabilities should be measured and recognized in Phase I, the prohibition on catastrophe provisions, because of concern about the justification to measure the catastrophe provision, will create an anomaly in measurement and recognition based on local GAAP.

Loss Recognition

In principle, we agree with the Board's conclusion to require a loss recognition test. However, for the purpose of the practical application of the provision, we believe there should be more guidance on when and how to apply IAS 37.

In addition, ED5 requires the insurer to disclose the fair value of its insurance assets and insurance liabilities as at the year-end date on or after December 31, 2006. We believe that, when the fair value disclosure becomes mandatory, the guidance should clarify whether the future cash flows to be used for the loss recognition test could still be based on (i) the insurer's accounting policy as noted in Paragraph 11, (ii) IAS 37 as noted in Paragraph 12, whether both (i) and (ii) are acceptable, or it should be based on the fair value.

Particularly for a general insurance business, because there are issues around measurement, the probable maximum loss ("PML") is not required to be disclosed (Par. BC136). We believe the Board should clarify the relationship and relevance among the loss recognition test, PML and fair value.

Disclosure of Fair Value of Insurance Assets and Liabilities

ED5 requires an insurer to disclose the fair value of its insurance assets and liabilities on or after December 31, 2006.

As there are no stipulations on how the measurement and recognition should be carried out, and the method to be used to determine the fair value of the insurance liabilities has not been concluded, we believe it is too early to mandate the disclosure of fair value. The adoption of this disclosure requirement should be postponed to Phase II.

Furthermore, while a conceptual framework of a method to calculate the fair value of the insurance liability could be developed, it will take much more time to develop a practical methodology. In the absence of a practical methodology, the requirement of disclosure of fair value would impair the comparability of financial statements among insurers.

Paragraph BC6 of ED5 describes the Board's tentative conclusions for Phase II, which includes the employment of an asset-and-liability approach and the recognition of insurance assets and liabilities at their fair value. However, no practical methodology has been established to ensure the objectivity and transparency of the valuation with fair value for insurance assets and liabilities. In addition, we are concerned whether the determination of the fair value will be an auditable process for the auditors to form their opinion. As such, fair value accounting should be thoroughly studied, and we understand this is the reason why the Board separated its insurance accounting project into Phase I and Phase II. Therefore, we believe that the Board's tentative conclusion on fair value accounting is not relevant to Phase I and should not appear in ED5.

Disclosure

The disclosure of (i) the explanation of the reported amounts in the balance sheet and income statements of an insurer as specified by Paragraphs 26 and 27 of ED5, and (ii) the amount, timing and uncertainty of cash flows as specified by Paragraphs 28 and 29 relate to an insurer's insurance risk management policies and practical operations that will need to be in place. Therefore, an insurer should be able to disclose such information once the risk management system or the management information system necessary for the required disclosure is tailored accordingly and effectively operated. However, we believe some of the required disclosure items are not appropriate in light of the circumstances. In summary, they are:

(1) Those concluded in advance of Phase II;
(2) Those considered to be commercially sensitive information (as noted in BC128); and
(3) Those whose benefit does not exceed the associated cost.

In addition, Paragraph BC126 of ED5 states that the disclosure requirements specified by ED5 will remain largely unchanged for Phase II. With this in mind, there are certain disclosures that we consider too early to be mandated at Phase I because of the time required for insurers to modify their accounting system in order for them to be able to disclose the required information.

We believe it is appropriate to make the implementation of these disclosure items optional at Phase I and to require adoption after the considerations for Phase II in order to establish a guideline that provides information to develop "systems to meet the disclosure principles in Phase I (Par. BC126)."

Based on the reasons discussed above, we propose that, among the items discussed in the Draft Implementation Guidance of ED5, the requirement of the following items should be deleted or made optional at Phase I.

1. Accounting policies

   Paragraph IG 8: Based on the tentative conclusion for Phase II (BC6), etc., the disclosure of fair values is required. As we discussed above, we believe it is too early to require such disclosure in the absence of a definite conclusion related to fair value accounting.

2. Significant assumptions and other sources of measurement uncertainty

   Paragraphs IG19 through IG23: As discussed in Paragraphs BC128 and BC129, there are issues with respect to the disclosure of assumptions. From this perspective, we agree with the approach which focuses on the disclosure of the process used to determine the assumptions rather than the assumptions themselves. However, we believe that the disclosure of the objective of the assumptions, the source of data used as inputs for the assumptions, the extent to which the assumptions are consistent with observable market prices or other published information, a description of how past experience and others are taken into account, a description of how the insurer developed assumptions about future trends, such as mortality and others, and an explanation of how the insurer identifies correlations between different assumptions are not pertinent to the objective of assisting users of the financial statements to test the "reported data for sensitivity to changes in those assumptions (Par. BC127)." Also, we believe these disclosure items would provide indirect information about the insurer's business strategy and pricing of its products. Therefore, requiring such information may simply overwhelm users of accounts, and we believe they should not be mandated.

   In order to be suitable for the objective of disclosure, we believe, instead of disclosing the process used to determine the assumptions, it is more beneficial to disclose the weighted average rate or range of rates related to mortality and loss ratios, as well as the interest rates used in determining the contract pricing for each significant group of insurance products in force at the end of the period. With this information, we believe the users of the financial statements, while there are certain inevitable limitations, should be able to assess the sensitivity to changes in assumptions.

   In addition, the explanation that "future cash flows from insurance contracts are inherently uncertain and that estimates of those cash flows are also subject to uncertainty (IG20 (h))" is related to the substance of insurance accounting, and accordingly it should be described at the beginning of the section of "disclosure of significant accounting policies."

3. Changes in assumptions

   Paragraphs IG 24 through 25: The disclosure of assumptions and changes in assumptions entails substantial cost to prepare while there are inherent limitations to its usefulness as discussed in Paragraphs BC128 and BC129. Furthermore, the disclosure of changes in each individual assumption in order for the users to analyze the sensitivity to the changes in the assumptions free of the discretion of the analysts obliges an insurer to incur even more cost, while there are known inherent limitations as discussed in Paragraph IG25. Therefore, we believe the disclosure pertaining to changes in assumptions should be optional, and if they are disclosed, they should be accompanied with a notation that clearly explains the inherent limitation surrounding the information.

4. Risk disclosures

   Except for the following, we agree with the foundations of the disclosures as specified by Paragraph IG31, and the grouping and segmentation of insurance contracts as specified by Paragraphs IG32 through IG36.

   With respect to the insurance risk borne by an insurer, Paragraph IG31(a) requires the disclosure of the nature of the exposures. The paragraph, however, does not specifically provide what should be disclosed as insurance risk exposure. In other words, the term "insurance risk" is merely defined as risk other than financial risk that is transferred from the holder of a contract to the issuer by Appendix A of ED5, and because "[T]he usefulness of particular disclosures about insurance risk depends on the circumstances of a particular insurer (Paragraph BC132)," there is no further discussion on insurance risk in the exposure draft. At a minimum, occurrence risk, severity risk and development risk that were discussed in the Issue Paper should again be discussed in the exposure draft to clarify how the disclosure should be made.

5. Risk management objectives and policies for mitigating insurance risk

   The disclosure items described by Paragraph IG37 are largely consistent with the disclosures required by IAS 32 Paragraphs 43A through 46, and they should normally be part of an insurer's existing control methodology. However, the disclosure of an insurer's risk acceptance policies as described by Paragraph IG37(a) and the methods employed by an insurer to limit insurance risk exposures as described by Paragraph IG37(c) should be optional, as they could be commercially sensitive information for an insurer. Also, the disclosure of the method an insurer uses to assess and monitor insurance risk exposures for the entire portfolio as described by Paragraph IG37(b) and the assets and liabilities controlled by asset and liability management techniques as described by Paragraph IG 37(e) should be optional in Phase I considering the level of existing systems.

6. Terms and conditions of insurance contracts

   The disclosure items discussed in Paragraphs IG38 and IG39 are exactly the same as those required by IAS 32 Paragraphs 47(a) through 51 (except for accounting policies described by (b)).

   Since there is no reason not to require an insurer to disclose the items specified by Paragraph IG38, we agree with the provision. However, an analysis of the recognized insurance liabilities, and reinsurance assets, by the period in which the net cash inflows and outflows are estimated to occur as required by Paragraph IG39(a) has simply been imported from IAS 32 Paragraph 49(e). Since there is no clear guidance as to how to estimate the future cash flows arising from the insurance liabilities, and considering the cost associated with system development, we believe it is not appropriate to require an insurer to disclose such information.

7. Insurance risk

   This disclosure requirement shares the same principle of the disclosure of interest rate risk and credit risk required under IAS 32. However, we do not agree with the following aspects of this disclosure requirement:

   (1) We disagree with requiring disclosure of the amount of risk exposures as noted in Paragraph IG40(b) for the same reason we noted for Paragraph IG39 above. (It is unclear whether quantitative information is required, as Paragraph IG40(c) states, "If an insurer reports quantitative information about insurance risk…")
   (2) The disclosure that there is inherent uncertainty about both the reliability of the estimates and assumptions and inherent variability of the item being measured, as described by Paragraph IG40(f), is the same in substance with the disclosure required by Paragraph IG20(h), and therefore they should be consolidated.
   (3) Because of the same reason for the discussion of Paragraph IG41 as noted below, we disagree with the Board's decision to require the disclosure about the sensitivity to changes in variables.

8. Sensitivity analysis

Consistent with the disclosure of the exposure to the effects of future changes in interest rates and the amount of the maximum credit risk exposure that is required by IAS 32, Paragraphs IG41 through IG43 of ED5 require a disclosure of the sensitivity analysis.

The sensitivity analysis described in Paragraphs IG41 through IG43 does not refer directly to cash flows but instead focuses on the sensitivity to the reported amount of profit or loss and equity. Such sensitivity analysis represents the cumulative impact of the changes in a large number of assumptions, each one of which interacts with all the others. Not only will it force an insurer to incur a tremendous amount of cost and effort to produce such analysis, but also the analysis itself could provide misleading information to the users of the financial statements.

To begin with, we believe it is unreasonable to argue the sophistication involved in disclosing the exposure to the effect of future changes in the interest rates is substantially equivalent to that of analyzing the sensitivity of an insurer's profit or loss to the changes in an overwhelming number of assumptions surrounding an insurer's business. If the sensitivity analysis is a required disclosure, then guidance with an appropriate level of detail should be provided.

9. Key performance indicators

   Paragraph IG59 does not require, but permits the disclosure of such key performance indicators of an insurer as lapse and renewal rates and total sum insured. We believe, however, these performance indicators provide critical information for the users of financial statements to assess a particular insurer's ability to secure future cash inflows. We believe the disclosure should be mandatory, and the Board should discuss the reason for not requiring such disclosures in the exposure draft.

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We would be pleased to discuss any aspect of this letter with the Board or its staff at your convenience.

Very truly yours,

Michiyoshi Sakamoto
Chairman
Technical Committee for IASB