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Insurance Bureau of Canada Bureau d'assurance du Canada

Office of the Superintendent of Financial Institutions
Bureau du Surintendant des institutions financières

Insurance Accounting Task Force of the Canadian Accounting Standards Board

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Peter Clark
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr. Clark:

ED 5 Insurance Contracts

This commentary on ED 5 is submitted jointly by the Canadian Institute of Actuaries (CIA), the Canadian Life and Health Insurance Association (CLHIA), the Insurance Bureau of Canada (IBC), the Canadian Life and Health Insurance Compensation Corporation (CompCorp), the Office of the Superintendent of Financial Institutions (OSFI) and the Insurance Accounting Task Force of the Canadian Accounting Standards Board.

The CIA is the national professional body and standards setter for our actuarial profession. The CLHIA is the national trade association for life and health insurers and represents insurers accounting for over 99% of the life and health insurance business in Canada. IBC is the national trade association for the property and casualty insurance industry whose members write approximately 92% of P&C premiums in Canada. CompCorp is the life insurance policyholder compensation corporation operated by the life insurance industry in Canada. OSFI is the Canadian regulator of all federally registered financial institutions and as such is one of the few integrated regulators of financial institutions. The Insurance Accounting Task Force of the Canadian Accounting Standards Board assists that Board in dealing with insurance accounting issues and is authorized to comment to the IASB on its own authority, but the views expressed are those of its members, not those of the Board.

General Comments

Before responding to the specific questions that were posed in ED 5, we would like to comment briefly on the tentative conclusions that the IASB has reached for phase II, as documented in ED 5.

We can support the tentative conclusion of the IASB that assets and liabilities arising from insurance contracts should ultimately be measured at fair value. Our support is based on two attributes of fair value measurement. First is the fact that fair value represents a prospective measurement approach rather than an historic cost method. More importantly, though, when properly defined, the fair value approach assures that assets and liabilities are valued on bases consistent with each other.

We are very concerned, however, that fair value will be seriously compromised by the introduction of artificial constraints such as the imposition of a floor on insurance liabilities equal to the amount payable upon demand. A demand deposit floor – on a contract-by-contract basis – would be totally inconsistent with fair value concepts for insurance contracts, which can only be based on expected patterns of behavior, such as surrenders, of a portfolio of similar contracts. Such a rule would significantly exaggerate the effect of surrender values (which are only one feature of insurance contracts – and not the most valuable at that) on the measurement of contract liabilities.

We see no reason to alter the definition in the exposure drafts of amendments to IAS 32 and IAS 39: "Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."

We are aware of the continuing debate regarding the inclusion of own credit risk in the measurement of fair value of liabilities. Some regard it as a non-issue to the extent that it is expected not to have a material effect on insurance contract liabilities because of the protections provided to policyholders by guarantee funds. Others are willing to accommodate its inclusion because it would be expected to offset the overly conservative adoption of risk free rates for discounting future cash flows. Despite inclinations to accept these practical accommodations of the concept, we are concerned that, to the extent that there are real transactions that involve the sale or transfer of insurance contract liabilities, there is little evidence that the transfer price takes account of own credit risk of the seller or the existence of guarantee funds.

The application of fair value measurement in many cases requires the use of modeling for those assets and liabilities without observable prices in liquid markets. The use of modeling and estimation techniques for fair value brings with it additional risks related to the reliability of the fair values generated from these techniques, including the entire range of issues relating to robustness of the models developed for this purpose, the degree of competence and objectivity applied in their operation, and adequacy of surrounding controls. In the extreme, there is the possibility of significant error or misrepresentation where the amounts generated by the models cannot be demonstrated to represent reasonably the fair values of the items being measured.

We would suggest, therefore, that the IASB give urgent priority to the development of additional guidance on the use of models for fair value measurement and that the IASB encourage the development of related assurance standards to coincide with the implementation of IAS 39 and the IFRS for Insurance Contracts in phase I.

Responses to Specific Questions in ED 5

Question 1 – Scope

ED 5 allows for the continuation of local GAAP for insurance liability measurement. The scope of ED 5 as currently set out, wherein assets supporting insurance contracts are dealt with in a separate standard, creates the strong possibility of inconsistent measurement of these assets relative to the insurance contract liabilities. This potential mismatch in asset and liability measurement will in turn mean that the insurer's reported equity will not reflect its underlying economic reality and prospects. Similarly, the measurement mismatch can give rise to spurious and volatile reported income amounts year by year, which will constitute misinformation for both investors and policyholders.

The exposure draft for amending IAS 39, however, does provide for the ability to select alternative measurements of assets, allowing insurers in different countries to attempt to achieve consistency in asset and liability measurements. On the other hand, the "tainting" rules for held-to-maturity assets place real constraints on this attempt. We would recommend a direction from the IASB that consistency of measurement should be a paramount accounting policy objective. We also note that one-time redesignations of the type permitted by paragraph 35 will need to be allowed on the introduction of new liability measurements under phase II.

Regarding the exclusion from the ambit of ED 5 (in paragraph 4(f)) for direct insurance contracts that the entity holds, the reference to a chain of defined terms leaves it unclear whether or not reinsurance contracts held are to be part of the exclusion.

Question 2 – Definition of an Insurance Contract

We are in general agreement with the definition of an insurance contract as a "contract under which one party (the insurer) accepts a significant insurance risk from another party (the policyholder) …". We have some concerns, however, that the related guidance may still leave open the possibility for accounting arbitrage or abuse as issuers include in contracts just sufficient insurance risk to qualify as insurance contracts. For example, an issuer might include a significant exposure to a very remote risk to qualify a contract as an insurance contract and thereby avoid the requirements of IAS 39.

Question 3 – Embedded Derivatives

We agree with the statement in paragraph 6 that an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount. We would extend that rule, however, to a cash surrender option embedded in an insurance contract even where the surrender value varies in response to a change in an equity or commodity price or index.

Instead of forcing insurers to incur significant costs in changing measurement systems in phase I to separate out options for variable surrender values, the IASB should focus on developing the loss recognition test and disclosure standards that are proposed in ED 5.

Question 4 – Temporary Exclusion from the Criteria in IAS 8

We agree that insurance contracts issued and reinsurance contracts held should be exempted from IAS 8 paragraphs 5 and 6 until the implementation of phase II. However, we do have concerns about the use of the expiration date 1 January 2007.

We understand that the inclusion of this date signals the IASB's commitment to completing and implementing phase II within as short a time frame as possible after phase I and we commend this commitment. There is, however, a risk that this date may not be met even with the best intentions of the parties involved. If an unforeseen delay occurs, entities that issue insurance contracts and hold reinsurance contracts will be faced with a dilemma of how to account for these contracts in the interim period between phase I and phase II. Therefore, we suggest that that the exclusion from IAS 8 paragraphs apply until phase II is finalized rather than to the specific date.

We support the elimination of catastrophe and equalization provisions and the requirement for a loss recognition test.

Question 5 – Changes in Accounting Policies

Our organizations fully support the requirement in paragraph 14 that an insurer can change its accounting policies only if such changes make the financial statements more relevant to the decision-making needs of users.

However, we disagree with the statement in paragraph 16 that an accounting policy that reflects future investment margins in the measurement of insurance liabilities would be deemed not to meet this criterion. It is our view that the relatively recent accounting regimes in Canada, Australia, and South Africa, which incorporate this discount mechanism, are the most relevant and informative models currently in place in the world. It would be unfortunate if other countries were prevented from adopting global best practice accounting during phase I – which could last for some time if phase II is delayed for any reason.

In the discussion in paragraph 16(d) on contractual rights to future investment management fees it is unclear what is meant by "… as implied by a comparison with current fees charged by other market participants for similar services" – that is, whether it refers to the absolute dollar amount or to the percentage rate applied to assets under management as at the measurement date.

We believe it is unnecessary to qualify fair value or limit the basis of its determination in this manner. In particular, there is no reason to presume that the fair value of the contractual rights equals the origination costs paid. Furthermore, the reference in connection with fair value to fees charged potentially confuses two quite different items. Fair value would be affected not only by the expected stream of future fees but also the stream of future costs necessary to earn the fees and other factors.

Question 6 – Unbundling

We believe that unbundling deposit components of insurance contracts is appropriate where the insurer's existing accounting policies would not otherwise recognize all liabilities under those contracts.

Question 7 – Reinsurance Purchased

The IASB acknowledges (in BC92) that the various accounting rules being proposed when an insurer buys reinsurance are conceptually imperfect and will not be needed in phase II. Given that, we suggest that any reinsurance proposals be limited in application to the few specific reporting anomalies of most concern to the IASB.

As to the specific requirements in paragraph 18, it is not clear why recognition of gains on inception is prohibited when an economic gain has truly been earned. While the recognition of spurious gains arising from different bases of measurement should be prohibited, there are cases in which substantial real gains can arise, depending on the state of the reinsurance market from time to time and on other circumstances. The effect of not allowing recognition of real gains may be to force an enterprise to recognize an asset at an amount other than its fair value, which is contrary to the logic underlying the business combinations standard (among others) and the current direction of phase II.

ED 5 proposes in paragraph 19 that a cedant shall apply IAS 36 *Impairment of Assets* to its rights under a reinsurance contract. Given the contractual link of the direct liability to the reinsured liability, the application of such a different measurement or test under IAS 36 is not appropriate, especially during phase I when it can be inconsistent with local GAAP. We believe that the measurement and impairment test of reinsurance assets should be consistent with the measurement and impairment test of the direct insurance liabilities.

<u>Question 8 – Insurance Contracts Acquired in a Business Combination or Portfolio Transfer</u>

We have no objection to allowing, but not requiring, an expanded presentation that splits the fair value of acquired insurance contracts into two components as described.

<u>Question 9 – Discretionary Participation Features</u>

We have no objection to the limited proposals for discretionary participation features in ED 5. When the IASB deals with these features more comprehensively in phase II, it will be necessary to define more precisely which features are being targeted.

<u>Question 10 – Disclosure of the Fair Value of Insurance Assets and Liabilities</u>

In general, we favour the disclosure of the fair value of insurance assets and insurance liabilities – provided that, as is intended, it gives useful information to users of an insurer’s financial statements. As we indicated in our earlier general comments in connection with the work of the IASB on phase II, our concern is that in the absence of guidance or a framework for determining fair values, a range of measurement bases will be adopted, making comparisons difficult. The effective date of such disclosure, then, should depend on progress made on development of a fair value measurement model.

Question 11 – Other Disclosures

The general approach to proposed disclosures in ED 5 – framed in terms of high level requirements, supplemented by implementation guidance – seems to be the most appropriate one available, given the broad range of insurance contracts marketed around the world. We understand and respect the need for principles to provide a context for the preparation of more specific qualitative or quantitative information. However, we are concerned that the relatively limited specificity of phase I implementation guidance may result in wide-ranging diversity in the depth and quality of disclosures during this period.

For example, the disclosure requirements regarding assumptions (paragraphs 27 (c) and (d)) might not be effective because for larger insurers with multiple product lines, there may be no single assumption that has a significant effect on the insurer's financial statements. On the other hand, ED 5 might be interpreted to require massive amounts of disclosure that would ultimately by their volume become virtually meaningless to the reader. It will take time for best practices to emerge.

In this regard, we note that Canada has been developing a model for disclosing sources of earnings that provides one possible template for identifying and analyzing components of insurance risk. Some period of experimentation and field testing will be required before preparers' results can be considered sufficiently robust for possible incorporation into (the notes to) the audited financial statements. In the meantime, it will be a key element of the appointed actuary's report. We would be pleased to provide the IASB with further information about this model and to assist the IASB if the model could be usefully adapted for ED 5 purposes.

Question 13 – Other Comments

As noted in our opening remarks, we have serious concerns about the possible imposition of a demand deposit floor on the fair value of liabilities. We are also concerned about the implications of incorporating own credit risk in the measurement of fair value. At the same time, we are uncomfortable with the overly conservative and unrealistic results that would be generated by discounting future cash flows at risk free rates. We would encourage the IASB to run field tests of the various fair value methodologies before deciding on a specific measurement standard.

Although this letter is intended to comment on phase I proposals we have taken the opportunity to comment on certain phase II issues and tentative conclusions. We have not comprehensively reviewed and considered all of the phase II issues discussed in ED 5 and look forward to commenting further on phase II issues in due course.

The Canadian life and P&C insurance industries, our actuarial profession, the insurance task force of our accounting profession, and our federal regulators hope that these comments, derived from over a decade of experience with modern prospective measurement methodologies, will be of value to the IASB in its deliberations.

Respectfully submitted,

Canadian Institute of Actuaries

Canadian Life and Health Insurance Association

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