



**ASSOCIATION ACTUARIELLE INTERNATIONALE  
INTERNATIONAL ACTUARIAL ASSOCIATION**

20 November 2007

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

Dear Sir

**Re: IAA response to the IASB Discussion Paper on *Preliminary Views on Insurance Contracts***

In response to the invitation to comment on the above Discussion Paper, I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations. We believe that the IASB has provided an extremely useful paper from which an exposure draft can be developed.

These comments have been prepared by a task force of the Committee on Insurance Accounting of the IAA. If, upon reading these comments, you identify items that you wish to pursue, please do not hesitate to contact the chairperson of that Committee, Sam Gutterman, or any of the other members of the Committee. We would be pleased to elaborate on any of these comments or continue to work with the IASB in the future on this topic or other areas of common interest.

Yours sincerely

Yves Guérard  
Secretary General

Attachment: IAA comments

**A Commentary on the  
DISCUSSION PAPER: PRELIMINARY VIEWS ON INSURANCE CONTRACTS  
Released by the International Accounting Standards Board: May 2007**

**INTERNATIONAL ACTUARIAL ASSOCIATION**

The International Actuarial Association (the IAA) represents the international actuarial profession. Our fifty-seven Full Member actuarial associations represent more than 95% of all actuaries practicing around the world and are listed in an Appendix to these comments. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact on the areas of expertise of actuaries. The IAA appreciates the opportunity to respond to this important IASB discussion paper.

Our comments are written from the perspective of actuaries involved in financial reporting for insurers around the world, with an emphasis on measurement of insurance contract liabilities and reinsurance assets. The members of the committee are listed in an Appendix to this statement. Our response has been subjected to the due process required for it to constitute a formal view of the IAA, and it will be posted to the IAA's web site.

**GENERAL COMMENTS**

Overall, the IAA supports the major thrust of the Discussion Paper (DP) in requiring relevant and reliable measurement of the rights and obligations of insurance contracts. Such measurement should be based, to the extent that they are relevant and reliable, on market-based inputs. Where relevant and reliable market-based inputs are not available, the three building block approach based on a prospective measurement model for future cash flows as described in the DP is a sound base from which explicit measurement can be developed. Given the wide range and continuously evolving nature of insurance contracts, we firmly believe that a principles-based approach should be followed. Note that we believe that at the current stage of this important project it is too early to assign labels to describe these objectives.

Nevertheless, we have several specific comments and suggestions regarding the application of this overall approach that we believe the Board should consider in its deliberations on the development of an exposure draft of a standard for insurance contracts. These include the following:

1. All relevant contract and contract-related cash flows associated with the rights and obligations of the contract should be included in measurement, due in part to their bundled and inter-related nature. We believe that the imposition of arbitrary constraints that neither a buyer nor seller would consider introduces bias and is not consistent with the information needs of financial report users. These constraints include limitations placed on recognition of expected premiums, a deposit floor (a cash value floor for insurance contracts), reflection of policyholder behavior, or on expected policyholder dividend/bonus and non-guaranteed element payments.

2. Regarding the first building block, for many insurance contracts there will be a lack of supportable information regarding how market participants would assess some of the cash flows in an insurance contract, especially operating expenses. In these cases, the majority of our members support paragraph 62 of the Discussion Paper that indicates "that an entity would use estimates of its own (servicing) costs, unless there is clear evidence that the insurer is significantly more or less efficient than other market participants." However, we believe that it would be unrealistic to assert that a market participant would assume that a transfer would result in operational expenses less efficient than at an entity-specific level.
3. Although the recently offered *Frequently Asked Questions: Service Margins* has provided needed clarity surrounding this element of the Discussion Paper, we do not believe that service risks should be measured separately from insurance risk margins and that a combined market value margin covering the insurance and service elements of insurance contracts would be appropriate. Note however that in most cases, there is a dearth of relevant and reliable market information about the profit portion of service margins.
4. We do not believe that the Discussion Paper's proposed unbundling approach provides useful information to financial statement users, particularly in view of the likely cost involved in producing such unbundled information. Overall, we do not believe that there is a need for an unbundling of insurance contracts.
5. We believe that the treatment of non-guaranteed elements, e.g., participating bonuses/dividends and universal life charges, is a very important aspect of this project. We believe further clarity and objectives are needed in this area.
6. Whether to reflect the effect of inter-portfolio diversification is an important risk margin issue. We believe that diversification effects should be reflected to the extent that market participants would do so. Further, to ignore these effects would not represent either an exit value or settlement approach.
7. In developing a standard for insurance contracts, we believe that it is not only necessary to consider the balance sheet, but also performance measurement (income) statement and disclosure requirements. We encourage a principle-based approach and review of these other two elements of financial statements during the course of this project.

We extend our standing offer to assist the IASB in the remainder of this project. For example, we would be glad to assist the IASB in conducting further research regarding the accounting treatment for universal life insurance. We intend to continue our activity on the development of related actuarial measurement projects, including the current one on risk margin issues.

## SPECIFIC COMMENTS REGARDING THE QUESTIONS RAISED

**Question 1:** Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

### IAA Response:

- (a) **Recognition:** There are three possible choices for the time at which an insurance contract should be recognized: (1) the date the contract is agreed to by the affected parties, (2) the date the premium is paid, and (3) the date of insurance risk contract inception, usually the effective date of the contract.

Those who view an insurance contract as primarily a financial instrument tend to favor option (1), while those who view it as primarily a service contract tend to favor option (3). In fact, many insurance contracts have features of both, which makes the answer to this question difficult, yet important. To complicate things, the first two date choices can be either before or after the effective date of the contract.

A contract should be recognized at the earlier of (1) and (2). Note that, if (2) occurs prior to (1), the liability for this contract would be simply the equivalent of a prepaid asset (equal to the net amount received) and not based on the nature of the insurance contract, as the insurance contract has not yet been formed.

We assume that application of IAS 39 criteria imply that the rights and obligations arising from an insurance contract should be recognized from the date that the contract is agreed to by the affected parties. We suggest that this should be made clearer if that is the intention.

In discussing this, the first question that arises is when an insurance contract actually commences. We believe that in answering this question, the following points should be considered when determining the most appropriate point in time a liability as an insurance contract should be recognized. Recognition of the contract as an insurance contract before the risk inception date may have following significant implications:

1. Current insurance industry practice for most of the world is to delay recognition as insurance contract until the period that contractual insurance risk protection has begun. Consistent with this, the recognition of the premium, related expenses and the liability is also delayed till that date. Changing that practice will have significant system implications to many.
2. Agents of an insurer can bind the insurer to a contract, with the insurer not having the relevant information to base the measurement on at the agreement date.
3. While recognition may be clear, measurement may be problematic. Measurement of insurance contract liabilities is generally complicated and may not easily be calculated before the effective date. As an example, if it is required to recognize all bound contracts and where an agent can bind an insurer, the insurer would have to

estimate the number and type of contracts before it has even incomplete information about them. It is not clear how reliable or useful estimates of "bound but not reported" contracts at a particular point in time would be to users of financial statements.

4. If a significant amount of day-one gain or loss is expected, the complicated calculation of an insurance contract's liability may not be able to be determined, at least until the effective date of the contract.

Overall, we believe that the usefulness of the information of recognition and measurement at the agreement date should be balanced with the costs to achieve that information, as well as the potential for miss-estimation of the contracts written. This may require a reconsideration of the definition of an insurance contract in IFRS 4.

Another issue that should be addressed is recognition (and derecognition) of contractual modifications, i.e., whether a revision to an existing contract should be treated as a new one. Circumstances and issues related to these situations include the exercise of certain policyholder options to modify an existing contract might be deemed to represent a cessation of the current contract and recognition of a new one. An example of where exposures can change is in group health and workers compensation, when employees are hired in the middle of the term of an insurance contract have been added to the contract as a result of a contractual option to add newly hired employees at the original price. Another example, in commercial automobile insurance, is the addition to a company's auto fleet covered under an existing contract, but that would also require additional premium which may or may not be at a guaranteed rate. In many cases, these situations would be similar to the many questions that arose in the process of implementing AICPA SOP 05-1 in U.S. GAAP. Nevertheless, we suggest that the exercise of these types of options result from existing features of current contracts and, therefore, should not result in the recognition of new contracts but rather continuation of the old ones.

Several reinsurance issues can arise that relate to when a reinsurance contract period is not identical to the contract period of the reinsured contract. The following is an example of such a case. Paragraph 218 of the Discussion Paper discusses a reinsurance contract whose contract period does not line up exactly with the contract period of a reinsured contract, including a direct insurance contract yet to be written. The DP attempts to avoid the problem of valuing a ceded amount, despite a prohibition on recognizing the corresponding direct amount, by stating that an option exists (under the IAS 39 recognition criteria), but likely with an immaterial value. This argument appears to be more a rationalization of a desired outcome than the application of a principle. We suggest that any profit on the reinsured contract should not be recognized until the insurance becomes effective. If it is an onerous contract, it should be recognized when the underlying option is granted through the reinsurance treaty.

The concept of asset delivery under the discussion of trade versus settlement date in IAS 39 is unclear when applied to many property/casualty and other short-duration insurance contracts where either party can cancel the remaining portion of the contract (with a specified notice period or upon non-payment of premium), although in certain cases these

may be subject to regulatory approval). The issue is whether the unexpired portion of such a unilaterally cancellable policy should be considered not-yet-delivered, as per the settlement date notion under IAS 39. The answer should be based on a principle whereby it can be determined whether an installment premium or something close to the unearned premium can be returned at any time at the request of the policyholder. We are somewhat uncomfortable with the practical situation where contract recognition/derecognition could occur every month on a contract under which a regularly scheduled monthly premium is payable.

- (b) **Derecognition.** It is not uncommon for insurers to offer existing policyholders the opportunity to replace or modify existing contracts for various reasons, such as increasing or decreasing benefit needs or premium paying abilities, or upon reinstatement (e.g., certain circumstances in which SOP 05-1 would apply under U.S. GAAP) as a bilateral contract change. Under the criteria in IAS 39.40, the cancellation or substantial modification of an existing contract results in derecognition. Although this should apply equally to insurance contracts, it may imply significant calculation issues under Implementation A, requiring the price for the margin to be determined afresh at the time of modification. In addition, a contract classification process may be needed, to determine whether a significant degree of insurance risk remains, and that may be inconsistent with a prior classification. We believe that an unconstrained contractual option that can be exercised unilaterally should be treated as the execution of the current contract and not as either a modification of the existing one or a new contract.

Also with respect to derecognition, we are somewhat uncomfortable with the use of the current rule-based 10% floor required for derecognition given in IAS 39.AG62. We prefer a principle-based approach for use in this type of situation, rather than one based on such a rule, though in practice such a rule might provide guidance.

**Question 2:** Should an insurer measure all its insurance liabilities using the following three building blocks:

- (a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,
- (b) current market discount rates that adjust the estimated future cash flows for the time value of money, and
- (c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?

If not, what approach do you propose, and why?

**IAA Response:** First, it has to be kept in mind that the proposed building block approach is not independent of the measurement attribute “current exit value”. Our comments on current exit value as a measurement attribute are included in our response to question 5. Hence our response to this question 2 is based on the premise that current exit value is the measurement attribute. It should be noted that we consider the basic building blocks are the means to measure the accounting attribute rather than being the attribute itself.

Overall, we support a prospective measurement model for cash flows in cases where relevant prices cannot be observed in a reliable exit market. Therefore, we believe that the three building blocks are appropriate for the measurement of these cash flows. The following are important observations.

1. The measurement principle underlying current exit value (note our comments regarding this principle in our response to question 5) is that it is an estimate of an exit (or transfer) price for the remaining rights and obligations of a portfolio, referencing relevant observations in the most appropriate exit market. This recognizes that normally there is no market from which to observe such prices reliably. Following the hierarchical logic described in SFAS 157 would imply that measurement should look first to observable prices for identical or relevant portfolios of insurance contracts transacted in an active and relevant market. However, since it has been demonstrated that neither the reinsurance, business combination, nor the transfer markets currently represent markets from which relevant observable prices can be obtained, they are not now reliable sources of inputs.
2. When these prices are not reliably observable for relevant portfolios or contracts as a whole or for identifiable parts, priority should be given to the use of relevant inputs that are observable on a reliable basis. For example, some cash flows, risks, or other identifiable parts, may be able to be replicated by assets in the capital markets. The input in those cases would preferably be used rather than the three building block estimate for that contract part. Since these observed inputs usually include associated margins, only the remaining parts would be estimated applying the relevant portion of the three building blocks. This guidance should be clearly included in a financial reporting standard as part of the description of the measurement attribute, before the remaining contract parts are estimated by applying the three building blocks.
3. For many insurance contracts, there will be a dearth of supportable information regarding how market participants would value operating expenses. In these cases, we support paragraph 62 that indicates "that an entity would use estimates of its own (servicing) costs, unless there is clear evidence that the insurer is significantly more or less efficient than other market participants". However, it is unrealistic to assert that a market participant would assume that a transfer would result in operational expenses less efficient than at an entity-specific level.

The key to the appropriateness of the three building blocks is their application and any constraints placed on them. We believe that the imposition of arbitrary constraints that neither a buyer nor seller would consider introduces bias and is not consistent with the information needs of financial report users. These constraints include limitations placed on recognition of expected premiums, a deposit floor (a cash value floor for insurance contracts), reflection of policyholder behavior, or on expected policyholder dividend/bonus and non-guaranteed element payments.

Regarding element b) we agree that discounting with a rate reflecting the time value of money of the characteristics of the liability is appropriate. However, we believe there is a need to distinguish several cases:

1. For cash flows that do not involve options or guarantees linked to capital and financial market items, a deterministic approach can be applied using the current market consistent rates.
2. It is important that there is a proper integration of building blocks (a) and (b) in cases where future cash flows are linked to the economic environment (e.g., interest rates and related items). In such cases, there is a need to model the cash flows stochastically using different economic scenarios or, equivalently, to use a representative range of deterministically selected economic scenarios. Examples of such cases include but are not limited to certain interest rate guarantees, voluntary policyholder termination behavior sensitive to interest rates and contracts in which inflation is inherently included. Each separate scenario may be associated with a unique interest rate path representing the financial circumstances of that scenario if that scenario is sensitive to prices in the capital markets.

In such cases, it is important that the underlying assumptions relating to the building blocks be, to the extent possible, internally consistent. It is, therefore, important that the cash flows of a scenario be discounted using discount rates from the yield curve associated with that scenario. Then, the discounted cash flows from each of the scenarios should be weighted by the probability of occurrence of the scenario and then totaled to derive appropriate present values. It should be noted that in this case the modeling would capture element c) for the financial risks involved, with a result that the risk margin can not be separately disclosed.

3. A similar comment can be made for certain forms of participating business, for which the determination of the cash flows does not reflect the investment portfolio that underlies this business. In such cases, stochastic modeling or the application of the replicating portfolio concept or similar techniques may be useful. However, in practice not all excess returns will be allocated to the policyholders, but rather only a portion with the remainder allocated to the insurer. Including all of the excess investment returns in the measurement of the liability will result in anticipation of excess investment income above the risk free rate being allocated to the insurer. Hence, the projected cash flows should only include the investment returns consistent with the dividends/bonuses (plus risk margin) arising from the capital market scenario, thereby avoiding anticipation of future investment earnings.

On element c), risk margins, we refer to our comments in response to question 3.

Considerable confusion has arisen regarding the purpose and practicality of the service (contract related expense) margin approach described in the DP. However, taking into account the additional clarification as provided in October 2007, the IAA has developed the following comments:

The measurement elements of the service component of an insurance contract include the following:

1. Expected expense (servicing costs). Building block a) should provide for this.
2. Risks associated with the expected expense, including persistency and time risk, and the measurement risk of the expected expenses (corresponding to the uncertainty associated with estimating the expected value for the contract until derecognition occurs). These risk elements are not different in concept from those associated with insurance cash flows. This is particularly important for an insurance contract in which the contract or claim period is lengthy. Building block c) should provide for this.
3. The equivalent of the profit portion of a third party purchaser or provider of the service.

We believe that element 3) is the component of savings-oriented insurance contracts that led the Board to incorporate into the building block approach an explicit reference to a margin for services. It appears that this attempts to incorporate a service-oriented characteristic into the measurement of an insurance contract whose insurance, financial instrument and service components are provided on a bundled basis. We do not believe that, in a hybrid insurance contract, a separate and explicit determination of a service profit is an appropriate approach. The primary problem is that, in most cases, element 3) is indistinguishable from servicing risks 2) above and can only be split in an arbitrary manner from the insurance risk incorporated in the risk margin. In any case, a profit margin for the service aspect of an insurance contract is not related to an artificial plug margin that may be the practical implication resulting from the Discussion Paper approach.

<p><b>Question 3:</b> Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?</p>
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**IAA Response:** We believe that the description of expected cash flows and risk margins included in a future IFRS should be principle-based and should not incorporate specific measurement guidance. We note that, although much of the discussion in Appendices E and F is useful in a discussion paper, it does not have a place in a financial reporting standard.

If reference is to be made to specific measurement techniques, it should be stated clearly that they serve only to provide examples and do not constitute requirements. This will tend to encourage both the development of new and improved methodologies in the future and also the adaptation of existing ones to deal with new types of contracts.

- (a) **Cash flow guidance.** With respect to expected cash flows, a discussion of the objectives and overall accounting attributes, together with more detailed actuarial guidance provided by the IAA and on a regional or local basis relative to local products and features, would be a useful model for use in the overall approach taken. This would be consistent with the underlying principles provided. We believe that the combination of experience in using the system, once adopted, along with transparent disclosure will serve to narrow the breadth of results to an acceptable range.

We have several additional comments:

1. Clear statement of objectives. To improve the clarity of the description of liabilities, paragraph E5 should state its objectives more clearly. Although it is to “develop a single ‘best’ estimate of future cash flows,” this seemingly simple statement has been interpreted in various ways and thus should not be used in an accounting standard. Many have interpreted this to mean a statistical median or mode, which we do not believe is appropriate. We believe that its intent is to be a current estimate of the expected (i.e., the probability weighted mean of all possible outcomes) value of the discounted future cash flows. An improved statement of the objective is "to obtain the expected value as defined, based on probabilities". This would better describe measurement as an estimate of the expected value by determining the expected value of probability distributions.
2. “Probability-weighted” terminology. There has been some confusion regarding the use of the term “probability-weighted”. In some real-world cases, probability distributions do not exist and cannot be developed in a cost-justified manner. However, we believe that the confusion has been generated by an overly narrow view of this phrase. What is meant is that the measurement objective is an unbiased expected value, not a median or mode. Clarification of this point would be helpful.
3. Requirement to consider each possible scenario explicitly. It is frequently impractical, if not impossible, to consider every scenario. Nevertheless, the variation in possible results and any bias that a non-symmetric probability distribution creates should be considered in estimating the expected value of the actual distribution function. There should be no requirement to estimate the distribution function itself.
4. Constraints on inclusion of cash flows that are inextricably linked with contractual cash flows are inappropriate. For example, while paragraph E2 states “incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations,” paragraph 154c) states that “future premiums (and resulting additional benefit payments to policyholders) should be included... if, and only if, any of the following criteria is met: ... (c) including the premiums and the resulting policyholder benefits will increase the measurement of the liability,” No such premium limitation will ever be reflected in the measurement of the value of an

insurance contract by a potential purchaser or insurer. Such a constraint introduces measurement bias and is not consistent with the information needs of financial report users, and in fact may produce misleading results. The provision in paragraph 154c thus introduces a bias that is undesirable and inconsistent with the measurement objective. The Discussion Paper does not include such a constraint in its treatment of a possible deposit floor (a cash value floor for insurance contracts), but it does so in areas such as reflection of policyholder behavior and regarding expected policyholder dividends/bonuses and non-guaranteed element payments.

5. Unit of measurement. For measurement purposes, it is common and sound practice to group contracts according to sub-portfolio characteristics, e.g., age for life insurance or geographic area for property insurance. Such groupings should continue to be considered as appropriate, no matter how the unit of account is determined.

The IAA suggests that an appropriate principle to be included is that all expected cash flows associated with the contract should be reflected. In establishing the cash flows to be taken into account, expected policyholder behavior should be incorporated. We provide in our response to Questions 6 and 7 further support for such a principle.

The Discussion Paper indicates that the characteristics of the applicable contracts held by the reporting entity should be reflected in determining assumptions and that the portfolio is the applicable unit of account. This is important in several aspects of measurement; for example, when assessing the extent to which the entity's expected legal costs should be included in the expected cash flows. Further, it is consistent with the underlying nature of the insurance provided.

Paragraph 186 indicates that the unit of account does not affect the measurement of building block 1. In the case of operating expenses, this is not necessarily the case since the unit of account is an important factor in this type of expense. This concern also extends to claim liabilities (including both claim payments and claim-related expenses). This is because a claim settlement/negotiation strategy is generally determined for a block of claims, not a single claim. The reason is that precedents set for one claim settlement/negotiation may be enforceable or apply to all similar claims.

- (b) Risk margin guidance.** We believe that in an accounting standard the guidance for risk margins should, to ensure reliability of results, identify the goals to be achieved, the principles to be applied, and any limitations to be considered. In addition, the IAA believes that, in particular, the description of the combined risk and service margin should be clarified by emphasizing the underlying objectives and principles involved, and not by specifying rules or methods (also see our response to Q2).

We do not believe that the wide range of methods discussed in F9 needs be included in the standard because, based on the experience of certain of our member associations, such an enumeration will not likely serve to narrow the range of results to meet the IASB

objective of reliability and, in fact, might impede efforts to develop new approaches and techniques. Inclusion of a specific method without appropriate caveats may effectively imply IASB approval of the technique. We believe the criteria for selecting the margin approach applied are more important to be included in a financial reporting standard. In addition, we observe that estimation of margins for insurance products is complex and is a developing area of practice. We believe that appropriate disclosure requirements regarding application of margins will result in more convergence on methodologies for establishing margins.

The IAA has prepared a draft paper on this subject that includes, among other matters, recommendations for selection criteria for margins. This paper, the IAA *Exposure Draft on Measurement of Liabilities for Insurance Contracts* will be developed further in the next few months.

The issue of reflection of the effects of inter-portfolio diversification is an important one. We believe that it is more important for users of this information to be able to compare values of individual portfolios (and product segments), rather than consider the net effect of the diversification of the entity. Therefore, we believe that diversification effects should be reflected to the extent that market participants would do so. Further, to ignore these effects would not represent an exit value approach,

While recognizing that the insurance industry currently uses several different techniques, the IASB should be principled in its standard. Acceptable criteria (or characteristics), together with emerging experience during and after implementation of an insurance contracts standard for risk margins should facilitate the development of unbiased estimates of these margins, and at the same time should narrow the range both of acceptable risk margin approaches and of assumptions used in such approaches.

Over time, we expect to prepare a model international actuarial standard of practice for this purpose in conjunction with the adopted IFRS on insurance contracts.

**Question 4:** What role should the actual premium charged by the insurer play in the calibration of margins, and why?

- (a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.
- (b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?
- (c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.
- (d) Other (please specify).

**IAA Response:** Most of the IAA committee believes that, in concept, the role described in paragraph (c) is the most appropriate choice provided. However, in many cases (b) might be the practical outcome of the process followed, particularly in cases where the result of the calculation using the three building blocks is close to the premium applied. In fact, (b) can be seen as a subset of (c). Nevertheless, although in many cases premium can be useful for this purpose, it is certainly not the only factor to be considered. It is more important that market inputs be used where they are reliable and relevant, and where market inputs are not available, the applicable building blocks should be estimated in a sound and rigorous manner.

Depending on the situation, premiums may play different roles. However, we note that (1) the use of the actual premiums charged assumes that the reporting entity's pricing model and pricing decisions are reasonably consistent with those of other market participants, (2) actual premiums are often subject to retail market competitive pressures that may differ from that experienced in an exit market and may not appropriately represent the expected cash flows, and (3) any constraints placed on the measurement of the liability for the entire contract to which the premiums relate should also be consistent with both the entity's pricing and current exit values.

In respect of cases (1) and (2), we believe this is similar to that discussed in paragraph 66b of the Discussion Paper. The premium charged may not be appropriate for the reasons given in (1) and (2) and, as a result, it may be inappropriate to use the premium charged as a basis to calibrate the margins in the liabilities and to support the choices made in estimating the cash flows. Paragraph (b) would not result in a calibration of the liability to the premiums where premiums are demonstrably inadequate or greater than the application of the building blocks would indicate.

In addition, none of the three assertions may be true. For example, pricing and contractual current exit values (for both the insurer and any market participant) have to be based on the recognition of all expected cash flows relating to a contract without restrictions, such as those proposed to apply to renewal premiums or policyholder dividends/bonuses. Note that margins on renewal business of longer duration contracts are usually more significant the longer they are in existence because they consist of more uncertain cash flows. The liability should be measured in accordance with market pricing principles that take into account all cash flows without application of these constraints.

Note that there is little, if any, role that premiums play in calibrating margins for liabilities associated with claims once relevant information on claim activity is available. In addition, since many insurance contracts involve more than a single premium, the underlying principle is better phrased in relation to the present value of premiums, rather than the initial premium.

Since an insurance contract often consists of a bundle of financial instrument, service and insurance risk characteristics, all of which are provided for by the premium, it can be difficult to assess the relationship between the premium (the cash considerations paid by

a policyholder) and the expected cash flows under a contract with the different elements of the premium.

Overall, we believe that the premium should not be ignored; however there is a difference of opinion as to how important it should be for this purpose. Some consider option (c) to be the most appropriate concept, since it recognizes the underlying principles better and it can be applied consistently throughout the term of the liability. Others believe that (b) should be applied in practice or at least that some limitations on deviating from the present value of premiums less acquisition cost should exist and at least be embodied in the application guidance. A minority believes that initial gains should not be permitted except in extraordinary cases. The proponents of each approach claim that their preferred approach would reduce arbitrariness of measurement, which is seen as an important objective by all.

**Question 5:** This paper proposes that the measurement attribute for insurance liabilities should be ‘the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute ‘current exit value’.

(a) Is that measurement attribute appropriate for insurance liabilities? Why or why not? If not, which measurement attribute do you favour, and why?

**IAA Response:** We believe that the appropriate measurement attribute for insurance liabilities should be based on the current economic value of the rights and obligations of the insurance contracts, represented by their expected (i.e. probability-weighted) future cash flows. Ideally, that value would be established by projecting the ultimate value at which the liability can be settled with the insured or the claimant.

It is unfortunate that the current Framework does not provide an adequate basis from which to develop appropriate measurement guidance. We hope that the revised Conceptual Framework will provide such a basis.

In discussing whether the current exit value meets this objective, we believe it is useful to identify three main features of the definition of a current exit value:

1. the “current” notion, i.e., the requirement to apply an up-to-date measurement,
2. the “transfer” notion, i.e., the requirement to assume in measurement that the contracts are transferred to another entity, and
3. the restriction of the measurement to the rights and obligations under the contract, i.e., ignoring all cash flows which are not a result of rights or obligations.

Each of these features is discussed below.

1. The current notion. The IAA agrees with using current up-to-date expectations for all future assumptions.

2. The transfer notion. Regarding this notion, there are, currently differing views within the IAA. While recognizing the problem of comparability between entities, since transfers are unusual for most insurance contracts, a current measure of the value to settle contracts with policyholders over time may provide the best description of what would constitute the value to a user in making decisions as described in paragraph 14 of the Framework. Thus, the measurement attribute for insurance contracts should not preclude the possibility of adopting the value needed to settle contracts over time. However, since the contracts' obligations must be settled, the transfer (exit value) price will have to reflect the ultimate settlement with the policyholder. That is, the value the potential transferor assigns to the liability should be the same as the value that the transferee would assign to the liability, as they both would estimate the same transfer price, although the expected cash flows, risks born or service needs may not be the same for the transferee as for the transferor.

The use of portfolio specific (that is, the reflection of the risk characteristics of the insureds or claims in the “portfolio” reflecting the substance of the rights of obligations covered by the contracts in the portfolio) and market assumptions would enhance the comparability of insurance liabilities through measurement that is independent of the entity holding the contracts. Not only is this consistent with economic reality (that is, consistent with financial markets and related to the characteristics of the insureds (claimants)), but also it will help to forestall others from creating products or entering into reinsurance deals that take advantage of deviations from reality. Nevertheless, since insurance contracts are not traded in an active marketplace, to the extent that relevant and reliable prices or input are not available, measurement should reflect the application of models of expected future conditions and their probabilities.

It is important to note that neither a portfolio specific nor market approach makes use of market averages, general industry experience, or industry benchmarks, but rather, it captures the specific characteristics of the portfolio.

There is a divergence of views on the IAA Committee regarding whether the attributes of the obligation would be best expressed as being entity-specific in nature. These assumptions, referred to below as being held by the “minority view”, depend on the entity which actually settles the obligation with the policyholder or the claimant as they are settled, i.e., the need to identify the entity-specific situation in the transferee.

The **majority** believes that the characterization of such a liability that corresponds to the transfer notion is a reasonable principle and hence forms an appropriate basis for the measurement of this liability. The “current exit value” approach here is defined without rule-based constraints, and thus, is a reasonable measurement attribute for insurance liabilities. This is because conceptually it captures what a market participant would charge for assuming the liability. The use of entity specific assumptions is questioned by the proponents of this notion, since it may result in non-comparable values for what is actually the same liability and, in fact, may not

represent an unbiased estimate of the future experience. In any case, the use of a transfer notion incorporates settlement with the policyholder or claimant, as any transferee must ultimately settle the net obligations involved.

Nevertheless, the proponents of the transfer notion recognize the practical difficulty of setting expenses to a non-entity-specific basis. Most of the proponents of the transfer notion, while still maintaining it as part of the measurement attribute, believe that application guidance similar to the paragraph 62 of the Discussion Paper is appropriate, i.e., in practice, an insurer would use an expense assumption equal to its own, unless there is clear evidence that the insurer is significantly less efficient than other market participants.

The **minority** view is that the “transfer” notion is conceptually inappropriate as a principle for those items which are generally not transferred and where, even if they were transferred, there is no observable and applicable market price for the administration and settlement services inherent in insurance contracts. In their view, the use of assumed expense levels of a hypothetical transferee would not be relevant or provide useful information for current or potential investors of the reporting entity, since under normal circumstances they would not affect the actual economics of the reporting entity. It is felt that information regarding the effect of such hypothetical circumstances would not be of use to current or potential investors.

Using the expense levels of the reporting entity as application guidance to a transfer notion measurement attribute would not provide reliable information, since that does not comply with the stated measurement attribute. Such hypothetical effects of a transfer are not considered, but the risks arising from the portfolio are measured as they are actually expected to affect the reporting entity.

However, as in case of the transfer notion, the measurement attribute for the margin as supported by the minority applies the market participants’ view as an appropriate benchmark, since the main users of the financial report, the investor or potential investor in the reporting entity is also a market participant and requires relevant information about the risk born and servicing needs. That is best achieved by using the view of general participants in the capital market as a benchmark for the margin.

In summary, those holding the minority view propose a modified measurement attribute wherein the transfer notion is replaced by a “settlement” notion. The underlying assumption in a settlement approach is that the contract is executed within its current organizational environment and measured on that basis, providing information for current or potential investors on a basis they consider to be a useful benchmark.

Some believe that any realistic advantageous alternative to own settlement that can achieve an improvement of expected cost in an active market, at least for administrative services, should be considered, e.g., by reflecting relevant expected outsourcing costs. Others note that it is unlikely that an active market for such

services will exist in most jurisdictions and thus favor a pure settlement notion not allowing a market alternative assumption to achieve a reduction in expected expenses.

3. The restriction of measurement to the rights and obligations under the contract, i.e., ignoring all cash flows that are not a result of rights or obligations. There is a general rejection of the restriction of the measurement attribute to “rights and obligations”, at least if they are interpreted as strictly as in IAS 36 and IAS 37, rather than applying the flexibility of the Framework definitions, especially as interpreted in the meantime within the IASB-considerations about a new Framework. We do not believe that recognition and measurement should be constrained by the legal terms, but rather should allow reflection of anything that is recognizable as an asset or liability under the Framework, especially if the contractual features form an economic whole. The recognition decision should be made for that unity, not for artificially separated parts. We believe that such an artificial separation does not provide decision useful information. A more in depth discussion is included in our response to questions 6 and 7.

At the present time, accounting rules for certain financial assets and service contracts allow, or require, valuation at other than current exit value (e.g., amortized cost). As long as this is the case, insurance contract liabilities and other financial liabilities held by an insurer and the financial assets that back those liabilities should be valued in a consistent manner. To the extent that this is not achieved, financial statements will not be measured on internally consistent bases and thus may not provide completely useful financial information to the users of the accounts and, in fact, could present spurious gains or losses that are not related to economic reality.

On balance, we (including most of those who favor the minority view regarding their preference for a different measurement attribute) favor Implementation B rather than Implementation A. In part this is due to its consistency with the definition of current exit value. While, operationally, implementation A seems more consistent with an entry value approach, it is inconsistent with the settlement of the obligations of an insurance contract or a prospective view of the rights and obligations under a contract. In addition, Implementation A is not applicable to claims liabilities.

<b>Question 5 (b)</b> Is ‘current exit value’ the best label for that measurement attribute? Why or why not?
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**IAA Response:** First and foremost, we believe a consistent set of soundly based and relevant measurement objectives is far more important than the label. The Board is currently considering as a definition of fair value, the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This definition, which is taken from SFAS 157 *Fair Value Measurements*, is not distinguishable from the definition of current exit value in the Discussion Paper.

However, it is important to note that, based on this accounting approach, in practice the DP does not include in the measure of a contract's liability, certain types of cash flows related to the contract, e.g., all expected renewal premiums, policyholder dividends (bonuses) and other non-guaranteed elements, all of which would be expected to be included in the price to transfer the insurance contract. This difference is due to a different basis for the unit of measurement which, for the purpose of the definition, is the contract (with certain clear exceptions, e.g., separable riders that on a standalone basis could constitute a different type of contract that would be measured on a different basis).

If, based on the comments received, the Board decides that current exit value is fair value, it should then consider how the insurance contracts standard fits within its fair value measurement concepts. This may require the Board to have substantially completed its fair value measurement project before it issues a final insurance standard.

If the Board favors the measurement concepts in the Discussion Paper but decides that they do not constitute a fair value, then for the purpose of application to business combinations, it should articulate the distinction between the two measurement bases. Considering IAS 39.11 (c), the label might have some further importance or it is necessary to clarify, that the measurement attribute chosen for insurance contracts is in compliance with the requirements of IAS 39.11(c).

We are concerned about a measurement that is not fair value but that purports to be a current exit value. It appears, conceptually, to be ambiguous and users may not understand why it is not fair value. We recommend that the Board decide earlier, rather than later, whether it is pursuing a fair value measurement and that it either develop the insurance contracts standard as an application of fair value measurement or that it articulate and adopt an altogether different measurement concept. The term to be used to describe the method selected should be based on the substantive objectives of measurement included in the final standard. These decisions can feed into the Conceptual Framework project with a better focus on measurement objectives.

We believe that the Board should decide early on the objectives of the measurement base for insurance contracts. Only after that should it decide the label to be used.

**Question 6:** In this paper, beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:

- (a) incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?
- (b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?
- (c) not recognise them? Why or why not?

**IAA Response:** We support option (b). Given our position in response to question 7, we believe this question is related to balance sheet presentation.

Our position is that the measurement of insurance contract liabilities should be based on the value of the bundle of its expected future contractual cash flows. All economic rights and obligations, including the benefits of beneficial and non-beneficial policyholder behavior, should be reflected in the measurement. Future premiums do not exist in isolation as they only exist in conjunction with the obligations under the rest of the contract. Moreover, the separate identification and measurement of beneficial policyholder behavior is often arbitrary. Therefore, we believe that contractual cash flows arising from both beneficial and unfavorable policyholder behavior should be included in the liability measurement. This approach, often referred to as a “unitary” measure, would incorporate the cash flows resulting from beneficial policyholder behavior in the current exit value.

In some cases, the distinction between beneficial and non-beneficial policyholder behavior is difficult to assess. For instance, for a certain life insurance contract, a policyholder termination can be beneficial, while the same termination a year later can be non-beneficial (when the contract is “lapse-supported”). For that same contract, depending on the circumstances and expectations, whether termination is beneficial or non-beneficial may depend on the circumstances or assumptions at the time. We do not believe that this distinction is particularly useful or meaningful, while at the same time distinguishing between these conditions is often problematic.

In fact, except when the components are independent of each other, we do not favor unbundling the contractual components. To that end, we encourage the IASB to remove, or at least reduce, whatever difference exists in measurement approaches for these components.

**Question 7:** A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?

- (a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder’s risk profile and at a price that is contractually constrained.
- (b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?
- (c) All cash flows that arise from those terms of existing contracts that have commercial substance (i.e. have a discernible effect on the economics of the contract by modifying significantly the risk, amount or timing of the cash flows).
- (d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.
- (e) No cash flows that result from beneficial policyholder behaviour.
- (f) Other (please specify).

**IAA Response:** Our view is that the closest description that the Board should adopt is criterion (c). Insurance contracts are bundles of inter-related cash flows for which separation for

recognition and measurement purposes would result in divergence of accounting from common pricing practices. Thus, placing a constraint on the inclusion of certain cash flows will neither relate to economic reality nor be representationally faithful.

Take, for example, a single premium contract that includes an option to cancel the contract before its maturity. The liability of the contract on surrender (voluntary termination) may be less than the discounted value of the contract held to maturity, in which case a decision by the contract holder to cancel the contract is favorable to the insurer.

In a transaction involving a portfolio of such contracts, the exit price should be calculated using the probability that a certain number of the contracts will be cancelled by the policyholders. In this case, a calculation that assumes that no contracts will be cancelled can result in a value greater than the amount that would be paid on a transfer of the rights and obligations of the contracts.

The difference between these two amounts, the second with the assumption of no cancellations and the first assuming expected cancellations, should not be characterized as an embedded asset. Rather, it is a reflection in the measurement of the liability associated with the likelihood that the policyholders do not execute their rights in a manner consistent with what would be expected in an “efficient” market. In an “efficient” market, a policyholder who wishes to monetize the contract would sell the rights to the maturity value for an amount greater than the cancellation value, and the contract would not be cancelled.

The concern that the cancellation rights represent an intangible asset of the insurer, the writer of the option, stems from the focus on the cancellation option in isolation. An equivalent contract could be written that would create a deposit with the right to an insurance benefit if the deposit is left with the insurer. In this case the accounting would be focused on the proper measurement of the insurance obligation rather than being concerned about the recognition of an asset. The most appropriate, probability weighted, and explicit approach to measurement in either case is an unbiased projection of expected cash flows reflecting policyholder behavior.

Additional insight can be gained by examining a 100% quota share reinsurance arrangement. In this case it would be inconsistent to recognize the expected value of future premiums in the calculation of the ceded reinsurance asset, while not being able to recognize that in the measurement of the directly written premiums. A consistent approach to the treatment of the rights and obligations of an insurance contract is necessary to create a standard that stands up to economic and business reality.

The Board’s concerns with future premiums, premiums that typically are intended to include amounts to recover acquisition costs, are apparently based on the insurer’s lack of control of the receipt of premiums, even though they are an inter-linked part of the contract and the insurer stands ready to accept them. The DP states that IAS 38 prohibits the recognition of internally generated customer relationships. However, IAS 38 refers to

customer lists, which are qualitatively different from the relationship an insurer has with a policyholder. As we interpret it, the customer relationship inherent in a contract with substantive and inter-linked rights and obligations and with predictable cash flows, is simply not comparable to a customer list. The cash flows are identifiable and it is probable that both the economic benefits and costs can be measured reliably and hence that their realization is likely. The costs generally include commissions, fees, direct acquisition costs and other related expenses, all of which can be measured reliably. Hence, we conclude that the intangible asset for the customer relationship should be recognized.

The tentative decisions in the DP, consistent with criterion (a), seem overly prescriptive and rules-based, rather than principles-based. The Board does not appear to want the insurer to recognize an asset for the portion of future premiums that relate to a customer intangible unless future premium payments are needed to retain a right to insurability or to some other contractual guarantee. This indicates that, to ensure that an insurability option is recognized, it may be necessary to allow insurers to recognize the intangible asset that would not otherwise be recognized. It is important to note that both the rights (the receipt of the premiums) and corresponding obligations should be recognized; to do otherwise would not only produce a biased estimate of a current exit value, but it also would have little to do with economic reality. It is not clear how the existence or absence of guaranteed insurability changes the attributes of the asset (or negative liability) to make it recognizable.

The effect of a guaranteed insurability option can be measured separately without reference to future premiums. Its recognition does not depend upon also recognizing the intangible asset. Nevertheless, we do not favor separate consideration of inter-related subsets of cash flows for purposes of recognition and measurement. Rather, we believe that market participants calculate current exit value by considering the bundle of cash flows based on realistic expectations for policyholder behavior, and that the measurement of liabilities should be consistent with these pricing practices.

We believe that a principle-based boundary can be constructed that, based on the concept of commercial substance, differentiates those premiums that relate to an existing contractual relationship from those that do not. For short duration contracts (e.g., those of a twelve month period), premiums that relate insurance benefits beyond the current contract terms should not be considered when measuring liabilities whenever there does not exist pricing or underwriting constraints subsequent to that period. For longer duration contracts (generally those whose expected duration is greater than a twelve month period), premiums that create new obligations, but do not substantively relate to existing rights and obligations, should not be considered. Although stated somewhat differently, they follow the same underlying principle. Based on this approach, expected future premiums on universal life contracts would form part of the contracts' measurement, whereas additional future deposits on many flexible premium deferred annuity contracts would not be included in projected cash flows when measuring liabilities. In addition, although it would be possible to calculate liabilities for universal life insurance without reflection of such obligations to accept such premiums, we believe

the results would not reflect the commercial substance and economic reality of the contract. In addition, the calculations required under a) for universal life insurance contracts would be quite complex, possibly requiring several iterations of calculations.

We suggest that the Board consider providing more clarity on the principles or examples identifying commercial substance, since this is not a universally understood term.

**Question 8:** Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

**IAA Response:** We agree that acquisition costs should be recognized as an expense when incurred. This approach is consistent with a prospective approach to valuation (which would apply under either a “current exit” or “current entry” model) in which the recovery of acquisition expenses requires no further separate consideration if the measurement attribute is based upon building block (a) with no additional constraints.

Nevertheless, the approach to recording such costs is less important than the consistency with the recording of the pre-claims liability or stand-ready obligation. If the pre-claims liability or stand-ready obligation is established gross of such expenses, then such acquisition expenses should be an allowed pre-paid asset, even though it may not appear to meet the definition of an asset. If such pre-paid expenses are not allowed to be reflected as an asset as would likely be the case, then the related pre-claims liability or stand-ready obligation should be established net of such expenses.

The proposal to expense acquisition costs differs from the current treatment of origination costs incurred to secure investment contracts as described in IAS 18, A14(b)(iii). See our response to question 15 for further discussion of this correspondence.

Note that the liability value of many insurance contracts can be negative (equivalent to an asset) at its start and can turn positive later on. We have no problem with this outcome because it is consistent with a current exit or settlement approach. In part because of the definition of an asset, we believe that it would be inappropriate to report such values on other than the liability side of the balance sheet.

**Question 9:** Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

**IAA Response:** Currently IFRS 4 does not permit an exemption from the requirement of IAS 3 *Business Combinations* that assets and liabilities be measured at fair value as of the closing date of the acquisition. Currently, absent specific guidance on the measurement of fair value for level three inputs (using the language of SFAS 157), insurers primarily use methods consistent with their valuation of the contracts as applied in the transaction process. These calculations may have attributes that differ from the tentative decisions in the Discussion Paper; for example, they often reflect future premiums that would not be considered to be included under the proposed Discussion Paper guidance.

We suggest that the insurance contracts standard should indicate clearly whether the measurement objectives also apply to business combinations and portfolio transfers. If the measurement objective in the insurance contracts standard is fair value or its equivalent, then its use in a business combination would be understood. If it is not a fair value or equivalent standard, then the differences from a fair value measurement should be delineated so that measurement in a business combination can be made to comply with IAS 3. Otherwise, there should be an exemption from IAS 3 that permits use of the insurance standard in business combinations.

The main differences are that under IFRS 3 the total acquired asset or liability, including all intangible assets including goodwill, is measured and that the measurement equals the amount paid (i.e., no initial gain is permitted but, of course, such is due to the recognition of other intangibles). Under the Discussion Paper approach, only the rights and obligations of the contract are measured.

As noted in the Discussion Paper, internally generated customer intangibles are recognized in a business combination. Any exclusion from the measurement of liabilities, of premiums that do not provide guaranteed insurability and of anticipated favorable policyholder behavior in the estimation of future cash flows in directly written business would not apply to portfolios acquired in a business combination or in a portfolio transfer. Hence, the fair value of acquired portfolios would be measured differently from the current exit value of directly written contracts. After purchase, such an artificial distinction is not consistent with the definition of a liability and is unrelated to economic reality. In contrast, generally, the fair value of financial instruments should be the same regardless of whether they are entered directly or traded.

If the measurement principle for insurance contracts is current exit value, we do not believe that there is a reason for the introduction of a difference between the measurement of directly acquired insurance contracts and contracts acquired in a business combination. An adverse consequence of a different measurement model would be that the difference creates an opportunity for accounting arbitrage. Where permitted, insurers may perceive an accounting advantage in buying and selling portfolios or may enter into other financial arrangements in order simply to obtain a more faithful *representation* of their economic rights and obligations, rather than doing so for real economic reasons. If there is a difference, it would have to be reflected in goodwill, whose value would remain the same unless the results of an impairment test are adverse.

<b>Question 10:</b> Do you have any comments on the measurement of assets held to back insurance liabilities?
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**IAA Response:** Conceptually, as reiterated in prior IAA comments and research, we believe that assets and liabilities should be measured in a consistent manner. We have emphasized that the business of insurance relates to the transfer of insurance risk, resulting in obligations that result in liabilities. As a result, the key focus should be on the measurement of insurance liabilities. The valuation of assets backing these liabilities

should be consistent with the valuation approach for the liabilities. Any different approach would not recognize the economic reality of the insurance contracts.

Consequently, any difference in measurement bases may result in artificial accounting mismatches that do not reflect economic reality. We believe an important measurement principle is that accounting mismatches should not arise in circumstances where there is a direct relationship between the value of the liabilities and the corresponding assets. To the extent that guidance deviates from this principle, any differences should be disclosed.

We note that if, in the final standard, the measurement principle for insurance contracts liabilities is current exit value, the corresponding value of assets that support these liabilities should be capable of being measured at fair value, and hence at that time a one time re-designation provision should be allowed, similar to the transitional provision included in paragraph 45 of IFRS 4.

In addition, if the measurement objective for insurance contracts is defined in a manner consistent with fair value and fair value becomes the general measurement attribute for financial and hybrid instruments, this will best ensure that the financial reports of insurers are as consistent as possible with financial reports of other types of financial services entities. We encourage migration toward a consistent balance sheet within a reasonable timeframe to accomplish this objective.

**Question 11:** Should risk margins:

(a) be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?

**IAA Response:** Some believe that the risk margin for a portfolio of insurance contracts under the exit value approach as described in the Discussion Paper, is equal to the sum of the risk margins for any segmentation of that portfolio into smaller parts. This applies on all levels, from the whole entity down to individual contracts. As a consequence, in principle it should not matter whether risk margins are determined on a portfolio basis, nor how that portfolio basis is defined. In contrast, some others believe that in determining the risk margin the size of portfolio should be reflected.

As a practical matter though, we believe that it is appropriate to determine risk margins on the basis of portfolios of broadly similar risks being managed together. There are two major reasons for this belief, both practical in nature:

1. It would be unduly onerous in some cases to collate the statistical data necessary to assess risk margins at a more detailed level than is required for the management of a portfolio.
2. Unless parts of the portfolio are to be managed separately, in which case in terms of the proposed criterion these parts are separate portfolios, there is no practical use to which a finer subdivision of risk margins can be put.

Although some believe it is not appropriate to reflect the effect of statistical volatility in the risk margin, it may be appropriate to disclose or incorporate this expected volatility into regulatory capital assessment. However, for the purpose of measuring liabilities, it is the price for uncertainty associated with the lack of a sufficiently large (credible) experience base to determine the expected value of future cash flows that should be incorporated in the risk margin. It is not uncommon to confuse these two concepts.

**Question 11 (b)** reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?

**IAA Response:** We believe the Board's analysis of diversification risks should not have started from the perspective of the entity, but rather from the perspective of the buyer. We also believe that the pragmatism allowed for in the analysis of portfolios should be dealt with explicitly at the inter-portfolio level, acknowledging that some diversification opportunities presented by portfolios will affect prices in imperfect markets. We also recommend that the nature of insurance assets as identified in the Discussion Paper, should receive more attention and that this would lead the Board not to force the valuation of portfolios of contracts into the straight-jacket much more easily worn by traded securities.

We acknowledge that the objective is to value the assets and liabilities of an insurer, and not the entity as a whole. Accordingly, we do not expect that the sum of the values recognized in the balance sheet will equal the value of the entity. Nevertheless, we do not believe that all diversification effects can be excised from the valuation of portfolios.

We believe that part (b) should be considered in two parts: in relation to the entity being valued and in relation to the hypothetical purchaser of the liabilities in the hypothetical transfer that underlies a current exit value. Whether under an exit value or settlement approach, the risk margin should be measured from the point of view of a market participant/investor.

As discussed in paragraphs 56 to 62 of the Discussion Paper, it would not be appropriate to allow for entity-specific influences on those cash flows in a current exit value measurement attribute. Since diversification and negative correlations *within the entity* are inherently entity-specific, they would not influence exit value and, hence, the risk margins. From this perspective, therefore, we believe that the view in paragraph 202(b), that risk margins should not reflect the benefits of diversification between portfolios, is correct because it relates to diversification within the entity being valued.

Exit values, however, are intended to reflect the way in which the market prices insurance risks. It is clear that market participants set their prices reflecting their ability to diversify, including diversification through the use of reinsurance. Conceptually, a portfolio could be defined as a collection of contracts which are homogeneous in terms of risk. Since in practice this will seldom, if ever, be perfectly achieved in constructing a

portfolio, a buyer, hypothetical or otherwise, will be confronted with valuing a group of contracts that has an expected value influenced by varying levels of diversification (resulting from the inexact process of collating contracts into a portfolio).

However, despite market evidence to the contrary, the Discussion Paper argues that the risk margins used in measurement should not reflect the effects of diversification between portfolios. That is, it takes the position that there should be no attempt to capture the value resulting from having portfolios which, between them, reduce the risks faced by the insurer. This position is taken, also, despite the fact that different buyers may arrive at different groupings of contracts when constructing portfolios. For example, one entity, because of its size and state of development, may divide its contracts into A and B portfolios, whereas the market might always see the aggregation of A and B as the portfolio.

If efficient markets are to be assumed for purchases of insurance contracts, the hypothetical buyers would be expected to be fully diversified and would be unwilling to pay any premium for diversification. However, the market for portfolios of insurance contracts is never likely to be deep and liquid, especially given the existence of a relatively small number of large global insurers who compete for insurance business, rather than trade in it at a portfolio level.

More fundamentally, the Discussion Paper does not focus on the characteristics to be assumed of the hypothetical buyer (e.g., whether the buyer is assumed to be fully diversified or only with the potential to be diversified) and does not explain how that assumption would, if at all, affect observed prices to arrive at current exit price.

We are concerned that insurance contracts would be treated as if they are similar to investments traded in efficient markets. This would be inconsistent with the fair value hierarchies discussed in various parts of IASB and FASB literature.

We believe that the Board's analysis of insurance contracts as customer relationship assets indicates that insurance contracts cannot be measured in the context of the nature of traded securities. Should we determine the fair value for an asset of this nature by assuming a well diversified buyer or should we estimate fair value by reference to what evidence exists in an imperfect market place? We believe that we should look to whatever evidence can be found and that it would be impractical to ask reporting entities to remove from observed prices an allowance for imperfection in the market.

<b>Question 12:</b> (a) Should a cedant measure reinsurance assets at current exit value? Why or why not?
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**IAA Response:** As a matter of principle, a cession (a contract transferring a set of expected economic consequences from one entity to another) should be recognized and measured in a manner consistent with direct written business and on the basis of identical principles. As far as a reinsurance asset is concerned, this measurement should reflect the way an entity measures the ceded risk. In this context it is essential to recognize that the

measurement of reinsurance assets should be based on an assessment of the extent of the risk relief provided to the reinsured by the reinsurance contract. The reasoning of paragraphs 208-210 of the Discussion Paper is sound.

In fact, that set of arguments serves as a prototype to solve other insurance related problems or cessions, in general, where cash flows and risks that refer to seemingly distinct issues can only be assessed by treating them together and offsetting the net effect. This may apply, for example, in measuring policyholder participation rights, as well as in measuring insurance contracts from a policyholder's viewpoint.

The approach presented in the Discussion Paper is different from the effect of mirror accounting, where accounting of a reinsurance asset in the cedant's balance sheet would follow the accounting of the related insurance liability in the reinsurer's balance sheet. Such an approach would not reflect the economics of the relationship, in particular, the asymmetry of risk between the two parties, and therefore should not be considered as appropriate to be incorporated in an IFRS standard.

This argument does not imply that the measurement of reinsurance assets should be based on the current exit value under any interpretation of that value. The measurement of a ceded reinsurance asset, as in the case of any other form of cession, should be consistent with the measurement approach for the corresponding direct item.

**Question 12 (b)** Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?

- (i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.

**IAA Response:** Consistent with our response to question a), we agree with b(i). Buying reinsurance enables the direct insurer to reduce the risk of (adverse) variances from the expected value. Consequently, the risk charge for the cedant should be reduced by an offsetting asset reflecting the additional value provided by the reinsurance. Since the reinsurance contract refers explicitly to, and is directly related to, the ceded cash flows, such contracts cannot be considered in isolation from the underlying business.

Comparing the risks of the underlying portfolio with and without reinsurance provides the natural valuation for the margin in the reinsurance asset. The difference of the risk margin on the liability, gross and net of reinsurance, gives the appropriate value to be reflected in the measurement of the reinsurance assets. This concept is particularly relevant for reinsurance programs with a significant asymmetry in assessing the risk between the direct business and the parts ceded to a reinsurer. Hence, the approach outlined in paragraph 210 of the Discussion Paper is not only applicable for non-proportional reinsurance contracts (e.g., stop-loss or excess-of-loss reinsurance), but may be considered as general guiding principles for measuring reinsurance contracts. This would reflect the fact that most reinsurance contracts have special features which give rise to a certain risk asymmetry between cedant and reinsurer. Among such features are retention limits and reinsurance commissions.

**Question 12 b(ii)** An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.

**IAA Response:** In general, the reinsured bears the risk of bad debts and disputed coverage (non-performance risk) that might be reflected in the measurement of the reinsurance asset. Hence, we recognize that it is appropriate to diverge from the existing impairment rules for reinsurance assets according to IFRS 4.20 and IAS 39 as far as the assessment of the risks of default and disputes are concerned. This is also consistent with the overall measurement principle that the expected value of cash flows is an appropriate basis for measuring the value of any set of insurance cash flows.

We note that the expected loss measurement should be calculated taking risk into account and hence should include a risk margin. In other words, the expected loss should be calculated using the three building block approach. We would suggest clarifying this intent.

However, we argue that, for practical reasons and for reinsurance assets that relate to a very high quality international reinsurer, utilization of an incurred loss model should be permitted. In this case, only when there are clear indications of a need to change the default risk estimate, which may reflect a different market assessment of the credit standing of the reinsurer or characteristics particular to the type of liabilities being ceded (e.g., liabilities with an observed history of significant reinsurance disputes), would a default and dispute risk be reflected in the measurement of the reinsurance asset.

**Question 12 (b) (iii)** If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

**IAA Response:** A general feature of many reinsurance contracts is that they contain two elements of risk transfer: one is the risk transfer for contracts the direct insurer already has on its books and the other is the anticipated risk transfer for direct insurance contracts that may be issued in the future. The Discussion Paper argues that, in principle, under a current exit value approach, one might need to measure both elements.

In this context, one can imagine the following cases:

- The underlying business is expected to be profitable and parts of the expected profit will be shared with the reinsurer, i.e., future new business will reduce the reinsurance asset if the direct insurer has higher initial gains from future business. There is no need to anticipate the potential reduction of the reinsurance asset if conditioned on future (higher) gains. Such reductions should not be recognized in advance.
- The underlying business is expected to be unprofitable and parts of the expected loss will be shared with the reinsurer, i.e., the future new business will increase the reinsurance asset, but that is contingent on the direct insurer having initial

losses from future business. It should not be presumed that the insurer will write loss-making business.

- The underlying business is expected to be unprofitable and in combination with the reinsurance contract a total expected loss will be even higher. That would result in a reduction of the reinsurance asset. However, it should not be presumed that the insurer will write loss-making business in the future.
- The underlying business is expected to be profitable and in combination the reinsurance contract a total expected profit will be even higher. However, it should not be expected that the insurer is able to write future contracts with an initial gain under a current exit value measurement.

In addition, it is important to note that the direct contract and the ceded reinsurance contract are not always recognized at the same time. Any such timing asymmetry should be reflected in a manner consistent with general recognition principles.

For all the cases noted in bullet form above, a similar argument to that presented under question 5(a) applies. Since a reinsurance contract can never exist “out of its own” but only in relation to the underlying direct insurance contracts, it should be measured in a corresponding manner. Hence, we suggest that the general concept of measuring reinsurance assets with reference to the underlying direct insurance liability be considered for those contracts which the cedant has already issued.

<p><b>Question 13:</b> If an insurance contract contains deposit or service components, should the insurer unbundle them? Why or why not?</p>
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**IAA Response:** We do not believe that an insurance contract that contains deposit and service components should be unbundled, except when it is appropriate to do so because of a substance-over-form situation. An example of an exception is where two types of benefits have been provided by a single contract through a rider and for which there is no interaction of expected cash flows and where the measurement objective of each is different. Unless the components are independent of each other, we do not favor unbundling. Note that, as time goes on, we believe that the IASB should strive to reduce the differences in measurement between the components and thereby to make unbundling less of an issue.

In particular, we do not believe the treatment suggested in paragraph 228(c) in the Discussion Paper will provide understandable and meaningful information to a user. The residual value produced may, in fact, provide misleading information. Paragraph 228(c) states that: “if the components are interdependent but can be measured separately on a basis that is not arbitrary, IAS 39 should apply to the deposit component. The whole contract would be measured by applying the phase II standard. Consequently, the insurance component would be measured as the difference between the measurement of the whole contract and the measurement of the deposit component.” The implication of this treatment might be that the deposit component is measured on a basis not consistent

with the Phase II insurance standard, implying that the remaining part would no longer be measured in accordance with any recognizable standard, let alone the Phase II standard.

In fact, unbundling should not be a pertinent issue in the long-term, since both IAS 18 and IAS 39 are expected gradually to converge to a recognition and measurement basis that may be similar to the method proposed in the Discussion Paper, a convergence that in general we support. Further, the measurement approach for insurance contracts is sufficiently similar to those of IAS 39 and IAS 18. The resulting implementation costs associated with introducing unbundling, namely the costs to the insurance industry arising from significant system changes, outweigh the limited benefits of such a requirement. Due to their size, such costs would eventually be borne by policyholders. In DP225(b), a similar argument is used for unbundling, i.e., to avoid sharp discontinuities in the accounting between a contract that transfers just enough insurance risk to be an insurance contract, and another contract that falls marginally on the other side of the line. However, we do not expect to see such discontinuities over time. Any short term differences could be provided for by disclosure requirements. A similar line of argument can be found in IAS 39.11(c).

The IAA agrees with the requirement in paragraph 228(b) of the Discussion Paper. However, we believe this is already covered by the Framework (35) through “substance over form” and therefore we do not see a particular need to emphasize this in the standard for insurance contracts. The scope for unbundling can be described as follows: a legal contract should be divided into two or more contracts as defined in IAS 32.13 for accounting purposes, if it is simply a bundle of separable rights and obligations that also could be sold as individual contracts without any economic difference.

Paragraph 226(b) of the Discussion Paper mentions pricing, management and regulation as arguments for unbundling. We believe that these are particularly valid arguments for not unbundling the contracts. For example, measurement of the unbundled components based on rational policyholder behavior may lead to a different result than measurement of the whole contract reflecting rational policyholder behavior.

The Discussion Paper proposes that contracts with interdependent components that can only be measured on an arbitrary basis should not be unbundled (paragraph 228(a)). However, the Discussion Paper does not provide any further information as to how the term “arbitrary” should be interpreted. This is crucial in distinguishing between unbundling in paragraphs 228(c) and 228(a). Below we provide some examples to illustrate the related issues.

- Example 1. A pensions contract.  
A deferred annuity contract with regular payments made to the insured beginning upon retirement and with a disability cover until retirement occurs. The separate measurement of the investment component and the disability component would lead to a higher liability than a measurement of the contract as a whole. Measurement of the contract as a whole would reflect the reluctance of policyholders to surrender the contract when renewal underwriting is also taken into account.

- Example 2. A traditional endowment contract.  
A single premium endowment contract with a premium of 100 and a death benefit of twice the maturity value. Assuming that the current exit value measurement of the components is 80 for the deposit component, 10 for the insurance component and 8 for the service component, the allocation of the profit margin of 2 to the various components is necessarily arbitrary unless a rule for measurement priority is given. In other words, the small amount of 2 cannot be allocated to the components other than in an arbitrary manner. However, if arbitrariness is measured, for example, in terms of significance compared with the total cash flows, prohibiting the approach in c) would not be seen as arbitrary).

The results would be:

- a. The total current exit value would be minus 2, which means the contract would create an initial gain of 2.
- b. If the contract is unbundled and 2 is allocated entirely to the deposit component, according to IAS 39.AG 76, and the deposit component would probably not show an initial gain. Hence, the liability is measured at 82 and the outcome for the insurance component would be 8.
- c. If the 2 would be allocated entirely to the service component, the liability would be 10 and the insurance component would again be 8.
- d. If the 2 is allocated entirely to the insurance component, according to the Discussion Paper, there would be an initial gain.

Thus, the arbitrary decision would significantly affect the initial measurement.

In general it is difficult to understand how ordinary contracts like those with bundled services, participating features or reinsurance (for example, quota share) can be unbundled without making assumptions about the split between the components; assumptions that were not made when pricing the contracts. Further, in making such assumptions, the uncertainty associated with an allocation to the various components may be greater than the expected profit margin. Hence, the split may display a spurious degree of accuracy that is not realizable in practice and could lead to different liability measurement for different entities for the same type of contracts. That would not necessarily improve the information provided to users of accounts that they might use to make economic decisions.

Under the assumption that insurance contracts are not generally unbundled and would not normally be transferred or priced separately on an unbundled basis, we emphasize that, in case of cash flows or risks for which observable market prices are available, these would be measured at these prices rather than applying the three building block approach. In such cases, we would rather see measurement based on observable market input; for example, the market value of funds for a unit linked contract. However, that applies here only to those units that are expected ultimately to be paid to the policyholders, not to units needed later to finance fees or risk premiums. Application of the three building blocks for such a contract would lead to a lower value than the observable value of the units.

We recognize that it would be ideal for comparisons to financial instruments and service contracts (particularly for revenue purposes) to be separated. However, though for many insurance contracts unbundling into their component parts may sound good in theory, nevertheless, in practice, it may result in misleading results because of the bundle of components provided. We believe that the best approach to solving this problem is to make the approaches to measurement of the elements that constitute insurance contracts consistent, so that there is no advantage that emerges from unbundling. In addition, it should be recognized that the most significant concern regarding comparability between financial services entities (e.g., between insurers and banks) can be achieved by separation of insurance and investment contracts.

**Question 14:**

- (a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?
- (b) Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?

**IAA Response:** To the extent that market participants reflect the credit characteristics of the contract, they should be reflected. However, where they are not so reflected, i.e., where measurement is determined on a mark-to-model basis, such an approach is not appropriate.

Where reflection of credit characteristics of the contract is required, discounted cash flows should reflect any potential change in its credit characteristics. The following should be noted:

1. This has been a controversial issue.
2. Applying asset valuation approaches to liabilities presumes consistency in measurement approaches between assets and liabilities. The owner of an asset has the option of accepting impairment or the credit risk of an asset, especially where liquid. For insurance liabilities, there are no such options, and thus this may not apply.
3. The question arises as to what base should be used to determine the credit characteristics. Some commentators believe that it would be appropriate to use AA or AAA risk ratings (rather than a risk-free rate), since that would reflect the credit characteristics inherent in the hypothetical purchaser in a market over the contract term, rather than that of the individual contract.
4. It has been argued that when an insurance contract is first issued, its price reflects its credit characteristics. This is only to a limited extent supported by observed pricing, although its effect is often mitigated by the expected effect of regulatory sponsored guarantee funds and the lack of price sensitivity in many insurance markets. The situation that seems most obvious is when a particular entity (rather than the contract) is on a credit watch, where there may be an observable shift to more financially sound insurers, and even to comparable products that are priced higher. Some have observed that this only arises in extreme cases and thus should be considered in

measuring liabilities only in these cases that may not meet the definition of a going concern.

5. The IAIS has been quite adamant that it will not allow credit risk adjustments in regulatory liabilities. The preliminary view of the IASB is that there will be an explicit adjustment, possibly accompanied by disclosure of the adjusted amount. Since we consider convergence of general purpose and regulatory accounting to be quite important, we welcome a resolution of this difference in views.
6. In most cases, such an adjustment would not be significant, in that the expected effect of a guarantee fund would be expected to mitigate this effect, though in the case of a non-insurance contract, e.g., a guaranteed investment contract (GIC), such an adjustment could be significant. Note that it may be difficult to assess the expected effect of this guarantee. In the market place, when an entity's credit standing changes, the likelihood of the amount expected to be paid regarding an obligation may also change. However, even when implementing the expected risk of non-performance in a cash flow model, non-performance may not apply equally to all components of cash flows, e.g., the expected non-performance on death benefits would likely be less than the non-performance on surrender benefits, while the likelihood of acceptance of renewal premiums might be problematic. This is another situation in which the unit of recognition should be the entire contract rather than its separate components. Also note that when there is a credit downgrade, it may be appropriate to reflect adverse selection (those policyholders who remain will likely be worse risks), thus increasing the liabilities.
7. The major effect of this issue in most cases results from the effect of changes in the market assessment of risk. This will likely cause more volatility in liability measurement than changes in the contract's credit characteristics (e.g., measured through changes in the market yield spread). This difference can be quite significant. Since it is unrelated to the performance of the entity or its insurance contracts, its separate disclosure may be appropriate.

Most of the concern regarding this issue has been raised regarding the apparent effect of a change in the credit characteristics of a contract. Where there has been an observable shift in the credit characteristics of a contract, we acknowledge that values elsewhere in the balance sheet may also be affected, in part mitigating such a change. Nevertheless, the practical problems of measuring the effect of such a change may be such as to make such measurement unreliable. If it is deemed reliable and this is required, it is suggested that the amount of this adjustment be disclosed separately, with its effect being reflected in comprehensive income rather than through profit and loss.

**Question 15:** Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

**IAA Response:** We believe that the Board should move toward the elimination of the inconsistencies that are identified in Appendix B of the Discussion Paper. This should be accomplished primarily by undertaking changes to IAS 39 (and other standards as appropriate) that eliminate the availability of a mixed measurement approach for financial instruments and other financial items.

We believe that financial liabilities currently measured on the basis of fair value should be measured at current exit value or its equivalent, and that corresponding financial assets should be measured at their fair value. Under the current definitions of these terms, this will result in an enhanced degree of consistency between the measurements of assets and liabilities within a financial entity, a condition that would reduce the presentation of misleading financial information. Adopting these protocols and applying them in IAS 39 will promote both consistency and comparability in financial reporting, not only for insurers but for other financial institutions as well.

To the extent that amortized cost is required for some IAS 39 contracts and that a fair value option does not exist for recognition of service revenue, certain of these differences will continue nevertheless. We suggest that a subgroup consisting of representatives of the Insurance Working Group and of the Financial Instruments Working Group as well as other interested parties be convened to evaluate the desirability and the effect of these differences to ensure a minimum of unintended consequences.

The following is a brief discussion of each of the major factors that differ:

1. Initial measurement. To the extent that contracts included are not measured by an amortized cost objective, the difference can be eliminated by changing the IAS 39 approach to recognizing day 1 gains and removing the deposit floor rule, consistent with our response to question 4.
2. Gain at inception. We suggest that this be permitted, in principle, where supported by relevant market and other information, consistent with our response to question 4.
3. Subsequent measurement. Although a direct comparison is valid only for instruments measured at fair value through income, the elimination of amortized cost for certain of these instruments would be appropriate.
4. Surrender value or demand deposit floor and policyholder behavior. We consider the imposition of a floor to be inappropriate and inconsistent with the measurement attribute and urge it be abandoned. Removal of that constraint together with recognition of expected policyholder behavior that can be reliably measured, should lead to enhanced presentation of economic reality and representationally faithful

results. It has been argued that this change would recognize an internally generated customer intangible. However, as discussed above, we believe that this does not reflect an internally generated customer intangible where there is a direct inter-linking of contractual rights and obligations, since it is generated by a benefit that is paid for by the customer and it is more appropriate to be consistent with the IASB Framework on this issue.

5. Unit of account. Unit of account guidance in IAS 39 is somewhat unclear for other than instruments quoted in active markets. Where pertinent to measurement, bases in both standards should reflect a portfolio of similar risks or instruments.
6. Revenue recognition and presentation. Any difference should be addressed in the Revenue Recognition project. Until we are certain of the objective of revenue, we cannot comment further on this.
7. Service fee revenue. We believe that IAS 18 service contracts and service components should be permitted to be measured at their fair value. Although further deliberation would have to be given to this suggestion, the underlying thought is that insurance components measured under IAS 18, IAS 39 and Insurance Contracts measurement should result in more consistent measurement among contracts.
8. Investment management origination costs. In IAS 39 these should be expensed as incurred.

<p><b>Question 16: (a)</b> For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?</p>
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**IAA Response:** This question should be broken down into its two parts. First, one should ask whether policyholder dividends/bonuses/non-guaranteed elements should be recognized, exclusively based on whether they constitute legal or constructive obligations. Second, one should ask whether their measurement should be based on cash flow expectations consistent with the corresponding expected scenarios.

Regarding recognition, we believe that the unit of recognition should be the whole contract rather than the individual features within it and further that all of the cash flows arising from the contractual terms should be included in the measurement of the liability to the extent that they have commercial substance. This approach has the advantage of being consistent with the views of relevant market participants. We believe that most users of financial statements are interested in the total expected contractual cash flows, even if they do not represent a legal or constructive obligation as currently defined in IAS 37, but nevertheless they comply with the definition of a liability given in the Framework, paragraph 60.

The entity's historical experience and dividend/non-guaranteed element policy should be considered in determining whether a liability exists. Thus, we believe that a participating contract should be viewed as a single unit of measurement and that all of its expected cash flows should be reflected. This would be consistent with Concept Statement 6 (U.S. GAAP).

If the IASB opts to apply Implementation A, to the extent that expected policyholder dividends/bonuses/non-guaranteed elements are anticipated in the premiums and charges in a contract and to the extent that they are considered in the premiums, they would implicitly be reflected in measurement in the premium margin. If the IASB opts to apply Implementation B, market participants not intending to run off the business (unless they are already in run off mode) would be expected to continue the current participating/non-guaranteed element approach.

Regarding measurement, we agree that all assumptions for measurement of the insurance contract should be consistent, and this is especially appropriate in the case of performance-linked assumptions. Due to diversity in practice worldwide, facts and circumstances should determine whether expected dividends/bonuses/non-guaranteed elements should be considered. Alternatively, where applicable, the measurement should be based on policyholders' share in the currently reported performance.

We observe that the contents of the Discussion Paper in this regard are less clear than has been expressed in prior Board decisions. In particular, to be useful the Board should emphasize principles. The different measurement approaches based on expected cash flows or recognized performance should be clarified. The contractual nature of the obligations should be considered, reflecting the variety of existing features on a worldwide basis. They can be categorized as:

1. Guaranteed benefits, either according to a premium or benefit adjustment clause or as a required share of distribution, expected to be paid in the normal course of events, but which in certain scenarios are subject to alteration. The appropriate measurement technique should be based on the three building block approach. Note that special investigation is needed to consider adequately those scenarios which would result in alteration in low probability scenarios (financial distress).
2. Benefits in excess of those guaranteed, paid in the normal course of events as a certain share of performance, according to contract or law or for other reasons requiring recognition of that obligation as a liability. The amount may be subject to deviations from that share in performance depending upon future conditions and contractual or legal guarantees, but the expected amount would be treated as analogous to a cession, i.e., the measurement of the obligation would reflect that share in performance recognized under IFRS until the reporting date, considering a margin for asymmetry imposed by contractual or legal minima or maxima.
3. Borderline cases between 1) and 2) might use one of these approaches. Both approaches would be expected to converge, except for consequences of accounting

mismatches. We recognize that deviations might result in times of the financial distress of the insurer, but to the extent that this can be estimated, this should also be reflected.

**Question 16 (b)** An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247-253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?

**IAA Response:** We believe that this IAS 37 guidance, accompanied with specific insurance-oriented guidance similar to that in the Discussion Paper for participating and universal life insurance contracts, would be adequate. We refer especially to the criterion in paragraph 251(b) of the Discussion Paper, which represents an appropriate criterion in most, if not all, cases. However, the wide variety of such contract features world-wide dictates more principle-based guidance, especially to describe more precisely the terms of the Framework in defining liabilities.

We also believe that the issues associated with accounting for participating contracts are linked with the definitions and classifications of liabilities and equity. The use of constructive obligations would introduce a new model for this classification. The Board's deliberations on this separate project should also be incorporated into its consideration of its liabilities and equity project.

We believe that IAS 37 should be changed to allow reflection of settlement in due course of obligations.

**Question 17:** Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?

- (a) Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the *Framework's* definition of an asset).
- (b) Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).
- (c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).
- (d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).

**IAA Response:** Where the obligation refers directly to the performance of the insurer (or a given set of assets), a more in depth description of the items involved is appropriate. In those cases, the measurement of that performance or the associated investment returns should not be affected. In any case, to the extent possible, the measurement of the liability should be consistent with the measurement of the linked items. That is, alternative (c) and (d) are appropriate since both would remove these inconsistencies.

These are two additional related observations:

1. As mentioned in our response to question 5, we believe that the liability for insurance contracts should be based on the current economic value of the rights and obligations of the insurance contracts, represented by their expected future cash flows reflecting economic reality.
2. As stated in our response to question 10, the business of insurance relates to the transfer of insurance risk, resulting in obligations that create liabilities. Consequently, the key focus should be on the measurement of insurance liabilities. The valuation of assets backing these liabilities should be consistent with the valuation basis of the liabilities.

Consideration of both of these observations would suggest that it would be more appropriate to measure the assets on a basis consistent with the measurement basis of the liabilities, hence alternative (c) is preferred.

In cases where, because of the overall legal construction, the effective situation is similar (e.g., since the contract refers to the fair value of specific investments without specifying whether they are held by the insurer, but there is a legal requirement to own them and they are held in a separate (ring-fenced) account which is protected against bankruptcy and theft), the same solution should apply.

Where the contract is merely index-linked (referring to an external index and the insurer holds matching assets just for risk-reduction purposes), the situations should involve normal asset/liability matching considerations. However, we believe that, similar to hedge accounting and the application of the fair value option, it would be appropriate to require a demonstration of the matching position by applying consistent measurement of assets and liabilities. There might be good reasons for not allowing recognition or even fair value measurement of certain items. However, the question is whether those reasons should also apply to an obligation to forward exactly the same items or amounts to another party. If, for example, the IASB typically does not allow recognition of internally generated goodwill, mainly due to the subjectivity of the measurement involved, the same subjectivity would apply to the measurement of a corresponding obligation. Furthermore, in that case the obligation can only be a cession, since the self-generated goodwill is, by definition, an asset of the insurer. Hence, (d) should apply in that special case.

Regarding treasury shares, it is possible to forward to a policyholder any change in value of the entity's own shares. To that extent, the policyholder is in the same position as a stockholder. Then why should that "obligation" be treated in a similar manner, i.e., as equity rather than as a liability, disregarding whether the insurer actually holds the treasury shares or not? To the extent that the insurer holds the shares, recognition of the linked treasury share and the related insurance obligation should again be consistent. If not, that part of the insurance obligation should not be recognized also. However, since we believe that the obligation should always be recognized and the treasury shares will be

distributed if called upon, we believe that the fair value of the treasury shares should also be recognized.

We believe that the IASB may be focusing too much attention on these extraordinary cases that affect only a limited number of jurisdictions, rather than discussing the underlying principle, where the participation feature has the character of a cession referring to normal investments and other performance of the insurer.

We believe that it may be appropriate for the IASB to revisit the underlying questions involved, as we would prefer not to have a rule-based exception for insurance contracts.

Similar issues involve participating business where the same arguments apply.

<b>Question 18:</b> Should an insurer present premiums as revenue or as deposits? Why or why not?
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**IAA Response:** In its Discussion Paper, the Board suggests that an insurance premium can be split into three elements to (a) meet policyholder benefits (claims) including claim handling costs, (b) cover acquisition costs, and (c) cover risk and service margins. The usefulness of this split of revenue will depend on the outcome of the IASB's Revenue Recognition project. Assuming that the outcome of this project will be useful to users of financial statements of financial services industries, including insurers, a consistent approach should be applied.

The Discussion Paper suggests that some might view payments under a) as repayments of deposits and thus there might be an argument for presenting the premium in respect of a) as a deposit. The implication is that the premiums in respect of (b) and (c) would then be accounted for separately in a meaningful manner.

While many might implicitly consider premiums in this manner for at least some products, few (if any) insurers currently report premiums split in this manner. This approach also ignores the reality of cross-subsidization between the three elements in a bundled contract undertaken, in part, because of marketing pressure. That is, there is no clear methodology to allocate between the uses of the premium, even though one approach may be in common use. From a conceptual viewpoint, we believe that the presentation of premiums as revenue or deposits should be consistent with the unbundling of components of the contract for liability measurement (see our response to question 13). Therefore, we believe that, for reporting purposes, the premium should be considered as a whole and not split into the three indicated elements.

In deciding whether premiums should be considered as revenue or deposits, we believe the following issues must be addressed:

- (i) whether there should be consistent (i.e., similar) treatment between life and non-life insurance
- (ii) whether there should be consistent (i.e., similar) treatment across all product types

- (iii) whether there should be unbundling, i.e., to apply different accounting standards to each part of the contract
- (iv) whether it is more appropriate to be consistent with the treatment of financial instruments or with the treatment of service contracts.

In our opinion, the aim of the financial statement presentation should be to provide users the ability to compare company's presentations easily, while also minimizing undue complexity imposed upon preparers.

With these aims in mind, we believe that:

1. In consideration of the definition of an insurance contract, which has generally had the effect of "removing" savings/investment contracts from these considerations and accounting for them in a manner consistent with similar financial instruments offered by other entities, there appears to be little reason for treating any insurance contract differently from any other just because of differences in the nature of the insured event.
2. The decision regarding the presentation of premiums as revenue or deposits should be based on consistent principles for all product types. To do otherwise would, as the Board argues, undermine comparability and also create the risk of different interpretations by auditors, with some firms allowing contracts to be treated in a manner different from others. This would assist neither the users nor the preparers of financial statements.
3. There should not be a split of the premium for a portfolio purely for presentation purposes, since this would merely add cost and provide no practical benefit. In addition, technical questions arise, for instance, whether a rule-based order of calculation would have to be imposed to ensure consistent results.

Paragraphs 317 and 318 suggest that presenting all premiums as deposits would be consistent with how banks and fund managers account for customer funds. While this may be a valid argument in respect of savings/investment contracts, the premiums under discussion here relate to insurance contracts which banks and fund managers do not, in general, offer. Thus, this argument may not be relevant.

As the Discussion Paper acknowledges, for most insurance contracts, premiums are currently accounted for as revenue with claims being accounted for as expense. Such a presentation does allow easy comparison/construction of important ratios such as expense (claim) ratios, etc. It also allows a reader to quickly assess the size and success of companies.

The Discussion Paper suggests that example 15 (the margin presentation) is similar to the Embedded Value presentation adopted by many insurers around the world. While correct, that information tends to be provided *in addition* to the premium and expense presentation shown in examples 10 and 11. We believe that, although this presentation

provides valuable additional information, it may not be suitable for use as the face of the income statement, since no revenue information is provided in it.

Bearing all of this in mind, we believe that all insurers, providing both life and non-life insurance contracts, should present premiums as revenue for all insurance contracts. As well as being consistent with how many currently construct their financial statements, this gives meaningful information to users on the face of the accounts. It also distinguishes insurance business from savings/investment (deposit) business.

Nevertheless, from a purely conceptual viewpoint and with a goal of achieving consistency with the reporting approach of other financial services industries, each premium payment could be considered to be an advance payment with the actual related services being provided later. Hence, the entire premium could be seen as a deposit up to the time when the insurer is actually obliged to provide the services. The “price”, based on the assumptions underlying current exit value, for each service is released at the beginning of each accounting period in which the service is to be provided. Then, in the income statement, price would be compared with the actual cost of providing the service, and the unwinding of discount would be compared with actual investment income. Although, for non-life insurance, such an approach is the norm, currently there are few countries applying such an approach for life insurance, e.g., Germany and to some extent the Netherlands.

Although a margin presentation can provide meaningful information, it may be better presented as a source of earnings analysis in the Notes on a product segment basis. However this is decided, premium can be a very useful metric, as it has served a useful purpose in many areas. In any event, it should be made available within the financial statements, whether in a cash flow statement or in disclosure, in order to permit such a useful indicator to be available for users.

<p><b>Question 19:</b> Which items of income and expense should an insurer present separately on the face of its income statement? Why?</p>
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**IAA Response:** In paragraph 325, the Board asks whether it should require insurers to present separately any specific components of the change in carrying amount of the insurance liabilities. As was the case for question 18, we believe consideration should be given to,

- (i) the need for consistent (i.e., similar) treatment between life and non-life insurance, and
- (ii) the need for consistent (i.e., similar) treatment across all product types.

Additionally, consideration should be given to whether the detail provided should be reported by product groupings (and if so how) or be provided for each individual product.

As always, consideration should be given to providing the proper balance between the needs and capabilities of users and preparers. As well, care should be taken to avoid the public disclosure of particularly sensitive (competitive) corporate information.

While including a lot of information on the face of the accounts (e.g., the level of detail implied by paragraph 325) might provide users with a better understanding of how the entity is performing, it might well, through the use of prescriptions and rules, end up making the statement “cluttered” and even less transparent as a result.

Although an alternative would be the use of a “single line” item, such as “change in insurance liabilities”, together with a detailed disclosure note in financial statements, we do not favor this approach. This could provide the information envisaged in paragraph 325, which is akin to information provided in EEV presentations as envisaged by the CFO Forum. This also allows a degree of freedom (within a defined set of principles) to enable relevant information that may differ for different types of business to be disclosed. In any case, a comparison of the unwinding of the discount rate and investment earnings is needed.

If the single line item approach is adopted, consideration should then be given to “how much” information is to be provided and at what level of detail. This could range from a full analysis of earnings by product down to broad headings across the company as a whole. Users indicate the need for basic cash flow information. We would strongly favor the use of disclosure principles rather than specific rules, both because of our general philosophy regarding standard setting and because such rules are ill-adapted to the dynamic nature of the insurance business and its contracts.

Suggestions for such principles may include aligning the presentation in the income statement according to the quality of the inputs used in measurement, for example distinguishing information which is directly observable in the financial markets from the inputs which are derived from modeling. Also, the current national reporting practices for non-life insurance provide useful information to users of the financial statements, for calculating key performance indicators (e.g., loss, expense and combined ratios).

Additionally, the Board should develop, as part of its project on the presentation of financial statements, principles regarding the disclosure required for changes in insurance liabilities. In any event, it is important that the Exposure Draft present the principles that the Board believes are appropriate for a standard that addresses insurance contracts, along with specific implications for the income statement and disclosure.

We recommend that information be shown separately for life insurance (with perhaps a split between participating, unit linked and other) and non-life insurance (perhaps also split between certain discrete lines) and that preparers provide information about the change in insurance liability. The following list includes some suggestions to consider:

- actual experience differing from expected experience – split between economic and other
- change in demographic (for life) assumptions
- change in experience assumption (appropriately defined for non life)
- change in economic assumptions
- change in calculation methodology

- change in value of embedded options and guarantees, if measured separately
- change in (risk and service) margins
- change in risk characteristics of the contracts if any
- new business written and gain at issue
- claims made
- other
- required interest / unwinding of discount.

Although it may not be appropriate to include a source of earnings analysis in the entity's income statement, something similar should be included where it would provide useful information, possibly as part of disclosure.

**Question 20:** Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?

**IAA Response:** Overall, we agree with the Board's conclusion that the income statement should include all income and expense arising from changes in insurance liabilities. However, we note that the statement in paragraph 337 that "Profit and loss should include all changes in the carrying amount of insurance liabilities" should not imply that if the effect of credit characteristics of the liability is included in the measurement of the liability, the change in this item should flow through profit and loss.

We note the concerns of the industry regarding volatility of earnings resulting from changes in discount rates. This is an important issue, since instantaneous reflection of the effect of changes in discount rates at each reporting date may not contribute to the usefulness of the financial statements and, in fact, may result in considerable confusion for the users of the financial statements.

A way to resolve this concern is to identify the effects on the liabilities of changes in the discount rates in other comprehensive income. This approach would be consistent with the approach applied in IAS 39 for assets categorized as "available for sale". This suggestion would imply that a definition of an "available for sale" category for liabilities is needed. Another argument for this treatment is that currently many insurers have adopted the classification "available for sale" for significant parts of their investment portfolio. If the movements in insurance liabilities resulting from interest rate changes are reflected in earnings, this will result in an accounting mismatch. Defining a category "available for sale" for liabilities would result in a consistent reporting of the effects of changes in interest rates.

Some additional comments:

1. One of the purposes of this question may relate to shadow accounting. In the case of participating features, all changes in the fair value of assets may not be reflected through profit and loss. Because of the importance of consistent measurement of

assets and liabilities, we believe that, to the extent that this occurs, the shadow accounting concept would be pertinent.

2. The same reasoning applies to the cession of those assets, not only because the outcome would not be particularly useful, but also because there is no significant economic difference between an item and its cession.
3. In paragraphs 329 to 335, the Board sets forth its thoughts on the extent of the amount of profit and loss that should be presented in financial statements, in contrast with some being taken into equity through the use of shadow accounting. This might in part arise because of changes resulting solely from a change in the value of the assets backing the liabilities.
4. Any change in the movement in insurance liabilities arising solely from the change in underlying asset value could be determined from appropriate disclosure following from question 19, allowing users to determine for themselves the extent to which that aspect had contributed to the profit/loss in the reporting period. However, we believe that where there is a direct linkage of the obligation and the corresponding cession, these should move in tandem. For example, if the changes in the fair value of an asset are not included in income, the cession of that change should also not be considered to be an expense.

<b>Question 21:</b> Do you have other comments on this paper?
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**IAA Response:** The following are additional issues that we wish to address that are not specifically dealt with in a particular question above:

- **Unit of account.** The use of “unit of account” has proven, in the context of this and other financial reporting discussions, to be confusing at best. It may be useful to discuss this issue separately and decide upon the most useful unit of recognition (the contract) and the unit of measurement (the portfolio in the case of insurance contracts). In that respect, we also note that it should not be taken for granted that the sum of the individual claims liabilities when considered in isolation is equal to the total liability for the portfolio, because the claim handling strategy for a claim in isolation might differ from the claim handling strategy for the portfolio in its entirety and because of the diversification effect that we discuss in response to question 11. We suggest that it be applied carefully, both in an insurance contracts standard and in other IASB projects, including discussions regarding its application as part of the Conceptual Framework.
- **Universal life, particularly its non-guaranteed elements** (although non-guaranteed elements also apply to certain other contract types). Universal life insurance contracts in many parts of the world are very important. The various factors underlying universal life insurance contracts, such the treatment of flexible premiums and non-guaranteed insurance and expense elements, can more appropriately be

treated separately or, specifically for universal life insurance, with other contracts and contract features in mind. Additional consideration should be given regarding how to address variable features in insurance contracts, ensuring that they are consistent with the participation feature in other contract types. The IAA would be pleased to work with IASB staff to move this forward.

- **Surrender value floors.** We agree with the Discussion Paper's position that it is inappropriate to impose a surrender value floor in the measurement of insurance contracts. The introduction of a liability floor would bring with it some distinct drawbacks. Pricing and management of portfolios of policies, as opposed to individual contracts, indicate that a liability floor is not necessary for the development of a robust accounting model. In fact we believe this to be inconsistent with the unit of account notion, as well as with a current exit value principle. We do not believe that an internally generated customer intangible is involved.

We believe that it is important to note that many insurance contracts grant the policyholder the right to surrender for a cash payment, the surrender value. We believe this is different from a demand deposit. The payment of the cash surrender value represents compensation by the insurer to the policyholder for the release of the risks and obligations which the insurer had undertaken, and which is extinguished upon surrender. On surrendering an insurance contract, the policyholder forgoes insurance coverage for the remainder of the policy term as well as, for some contracts, the right to renew the contract on terms, all of which options are beneficial to the policyholder and may be unfavorable to the insurer. As such, the surrender value is the transaction value of the whole contract and not of a distinct part of it. The surrender value cannot be measured separately from the rest of the contract since payment of this value results in the whole contract becoming void.

- **Treatment of participating investment contracts.** We believe that the financial reporting principles underlying the recognition and measurement of insurance contracts with participating features also apply to other contracts (primarily financial instruments) with similar participating features. If treatment of a contract as the unit of recognition is also applicable to investment contracts, question 16 with policyholder dividends/bonuses/non-guaranteed elements also applies to those contracts. We suggest that for such contracts IAS 39 should refer to the Phase 2 standard for insurance contract liabilities.
- **Pre-claims liability for short-duration contracts, especially non-life contracts.** We believe that the application of a prospective building block approach is sound. Nevertheless, because of practical considerations, we suggest that for cancellable non-life (or other short-duration) insurance contracts the pre-claims liability should be permitted to be based on a current unearned premium liability accounting model, as long as it is subject to appropriate testing on a regular basis to ensure consistency with a prospective building block approach.

Under an unearned premium approach, the liability would defer recognition of revenue over the unexpired portion of the contract (assuming that premium is revenue), an annual re-estimation for those contracts whose terms are longer than 12 months would be appropriate. Of course, if expected costs are not expected to be level over the contract period, that characteristic of the expected cash flows would have to be recognized appropriately.

This practical, rule-based approach is, at best, a surrogate for a more refined calculation based on the three building blocks (or reliable observed prices if available). For it to remain appropriate, regular testing would have to be conducted which, if done at an aggregate level, seems reasonably practical. Certainly, a calculation performed on the basis of the three building blocks prospective approach should also be acceptable.

The contracts referred to in these comments represent those contracts or contract periods for which no pricing or underwriting constraints with commercial substance exist.

- **Scope of an insurance contracts standard and definition of insurance contracts.** We suggest that it is very important for the IASB to confirm the scope of the emerging accounting standard for insurance contracts and to affirm the definition of insurance contracts early in its deliberations leading up to an Exposure Draft. Discussions of phase 2 should be held recognizing the types and scope of the contracts to be covered. For instance, the Board previously has indicated that it would consider the approach to be taken to account for financial guarantee contracts in this project. This expansion of the scope should be understood earlier rather than later in the project's lifetime. Another example is the inappropriate phrase ", but permits the insurer to deny payment if it is not satisfied that the event caused an adverse effect in IFRS 4.B14.
- **Approach to disclosure.** We believe that disclosure will form an important element in the financial reporting of phase 2. It will be appropriate that current disclosure principles be reviewed in the course of developing an Exposure Draft to determine what changes will be needed. Based on the experience with the implementation of IFRS 4 and 7, and the need to provide meaningful and not voluminous disclosures, we encourage the IASB to discuss the disclosure approaches for a new Phase 2 standard during the next stage of the project.
- **Discounting of future tax balances** (if exit value is determined on a before tax basis). Part 2 (page 20) of the Discussion Paper indicates that "The DSOP proposed that an entity whose primary business is issuing insurance contracts should use discounting in measuring its deferred tax assets and deferred tax liabilities. However, the Board decided tentatively in February 2002 not to consider in this project whether discounting is relevant for deferred taxes." Because some insurance liabilities have an extremely long duration, the timing of any tax differences may be material. We believe that some jurisdictions fail to fully take into account timing differences and

therefore fail to discount deferred taxes in a manner consistent with current market interest rates, which may result in a material distortion of the overall financial statements. As a result, to the extent, if any, that time value of money has not been appropriately or consistently reflected in deferred tax assets and liabilities, although it would not directly affect a new insurance contracts standard, we believe the Board should discuss this as part of the insurance contracts project and provide further guidance to prevent distortion of financial statements.

## Appendix A

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