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ACTUARIAL SOCIETY  
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Sir David Tweedie  
Chairman  
International Accounting Standards Board  
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E-mail: CommentLetters@iasb.org

Dear Sir David

### IASB Exposure Draft ED/2010/8

The Actuarial Society of Hong Kong ("ASHK") is the sole professional body for actuaries in Hong Kong. We have over 700 members, over 400 of which are qualified actuaries. A significant number of our members are involved in financial reporting for Hong Kong companies under IFRS 4 Insurance Contracts.

We are pleased to submit our comments in the following pages to the proposals set out in the Exposure Draft ED/2010/8.

Whilst we are supportive of the standards proposed in the ED in general, we would highlight two key issues that we feel are particularly important in the context of Hong Kong insurance industry:

- The Hong Kong government bond equivalents have limited liquidity and if used to calculate the risk free discount rate, the liability will have large volatility. We would like to clarify whether alternative assets can be considered.
- We do not agree with the propose transition requirements as assuming zero residual margin will mean greatly reduced profits for Hong Kong insurers and also mean inconsistency with the way profits will be reported on future new business.

We would be happy to discuss any of the comments made in this letter. Please feel free to contact Foong Sai-Cheong or Jeremy Porter.

Yours sincerely

Simon Walpole  
President

Foong Sai-Cheong  
Co-chair, Life Committee

Jeremy Porter  
Co-chair, Life Committee

## **Measurement**

### **Question 1 – Relevant information for users**

*Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?*

We think the proposed measurement model will produce relevant information that will help users of an insurer's financial statements. However, certain aspects of the proposed measurement model will introduce unnecessary P&L volatility to Hong Kong insurers, particularly the proposed methodology for setting discount rates. The Hong Kong government bond equivalents are the Exchange Fund Notes (EFN). The EFNs have low liquidity and movements in yields can be huge, so using it to set discount rate will cause volatility to the liabilities from year to year. IASB should clarify whether other assets with high credit quality and high liquidity should also be considered in setting discount rates.

Other areas which we think need to be reconsidered and improved are detailed in our response below.

### **Question 2 – Fulfilment cash flows**

*(a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?*

We agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract. All cash flows related to an insurance contract, including those from embedded options and guarantees, will be reflected in the measurement and thus gives a holistic view of the true obligations of the insurance contract.

*(b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?*

We think the IASB should provide more guidance and give examples on estimate of future cash flows. More specifically we think that the IASB should clarify whether "expected present value of the future cash outflows less future cash inflows" is the same as "best estimate liabilities".

B38 mentioned that "The starting point for an estimate of cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome." Assigning a probability to a particular outcome can be subjective and more guidance on methodology is needed.

### **Question 3 – Discount rate**

*(a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?*

We agree that discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability only and not those of the assets backing that liability. The cashflows from the liability are independent of the cashflows from the backing assets. While asset selection is naturally driven by the liabilities through asset liability management we recognize that reflecting this may decrease comparability among insurers despite the fact that inclusion with appropriate charge for any associated asset credit risk may better reflect the economic value of the overall position.

*(b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?*

We agree with the proposal to consider the effect of liquidity. However more guidance is needed to calculate the liquidity premium on top of the risk-free discount rate to ensure consistent application of the standard.

*(c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?*

The Hong Kong government bond equivalents are the Exchange Fund Notes (EFN). Using the EFNs in getting the discount rate is a major concern as the EFN has low liquidity and no liquidity beyond the 15 year maturity. We think the IASB should provide guidance to allow for liquidity and to extrapolating the yield curve. IASB should clarify whether alternative assets e.g. the swap rates and corporate bonds with high credit quality and high liquidity can be used as well.

Also, IASB should provide more guidance on how to deal with liabilities denominated in currency of geographical area whereby there is no risk-free asset available, e.g. Macau.

In addition, the ED stated that the discount rate should not reflect the characteristics of the assets backing insurance contract liability, which infers that the liquidity adjustment should not be based on illiquidity of the underlying assets. As such, it is not clear what should be referenced to when calculating the liquidity adjustments.

The concern around the possibility of significant losses at inception of some contracts when using risk-free rate as discount rate is valid as most insurers price at a rate higher than the risk-free rate.

#### **Question 4 – Risk adjustment versus composite margin**

*Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.*

We support using a risk adjustment and a residual margin over a single composite margin. Having risk adjustment and residual margin as two components enable us to understand the amount due to uncertainty of the cash flow and the gain at the initial recognition of an insurance contract. However, we believe that the current guidance is insufficient to ensure comparability among insurers and as a result may create spurious comparables among insurers. For the inclusion of a risk margin to add value in the comparison of insurers, further testing and guidance is necessary.

#### **Question 5 – Risk adjustment**

*(a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?*

We agree that the risk adjustment should depict the maximum amount the insurer would pay for the uncertainties on the cash flow. The risk adjustment provides information on the risk undertaken by insurers and the method is consistent with Risk Based Capital frameworks in Asia.

*(b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?*

We do not agree that these three techniques should be allowed at the same time and we do not agree with the restriction to a number of methods. We think the methods allowed should be consistent, e.g. estimating to the confidence level and conditional tail expectation is not consistent with each other. Consistency is crucial in comparing financial statements.

*(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?*

We think it is important for the insurer to disclose the confidence level. The disclosure will enable users to evaluate and compare financial performance of different insurers. However, this will only be the case if further testing and guidance around the inputs to the confidence level calculation such as correlations and variances is provided.

*(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?*

We do not agree that an insurer should measure the risk adjustment at a portfolio level of aggregation. IASB should allow diversification benefits to be taken across portfolio

as the benefits are real and can be significant. In general we think that risk adjustment should be relatively lower for an insurer that provide a wide range of insurance coverage compared to an insurer writing only a single line of insurance. This is particularly relevant for general insurers.

*(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?*

Appendix B has provided sufficient details under current standards.

### **Question 6 – Residual/composite margin**

*(a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?*

We think that an insurer should be allowed to recognise any gain at initial recognition of an insurance contract. The approach of not recognising is in contrary to the measurement of economic value of the insurance contract, which was the initial aim of the IFRS framework.

*(b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?*

We agree that the residual margin should not be less than zero. We think that recognising a loss at inception is appropriate if the amount received is insufficient to pay for benefits as well as to compensate the insurer for accepting the risk.

*(c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?*

We agree that the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period. In principle, the aggregation should be performed at the lowest level possible, such that it inhibits some impairments to be concealed, by effectively offsetting losses against profitability gains by different groups of insurance contracts. We consider that the aggregation level suggested is appropriate. Further breakdown of aggregation level such as premium term would result a more optimal portfolio if access to increasingly granular data is made available.

*(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?*

We agree in general the proposed methods of releasing the residual margin as it is easy to understand and straight-forward to implement. It would be helpful if more examples are shown for different cases where the residual margin is released based on the passage of time or pattern of claims and benefits, or in cases where policyholder exercise non-forfeiture option, or reinstated from non-forfeiture option.

*(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?*

Similar to 6(d). It would be helpful if more examples are shown for each of the proposed method of releasing the composite margin.

*(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?*

We agree that interest should be accreted on the residual margin to cater for the unwinding of the residual margin from previous reporting period to the next reporting period.

We think the composite margin should reflect the time value of money.

### **Question 7 – Acquisition costs**

*(a) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?*

We agree with the treatment of acquisition costs proposed in the ED. The approach of including incremental acquisition costs in the initial measurement is similar to the concept of DAC, allowing part of the initial costs to be recognised in future years. Compared to the DAC, this approach is a better reflection of the insurers' effort, as acquisition costs are recognised as reduction in profits rather than cost of an asset.

The categorisation of incremental acquisition expense requires certain level of judgement. For individual life insurance, commission is clearly incremental, whether other acquisitions expenses (e.g. underwriting, administration) are incremental depends on the sales structure of individual insurer. For large reinsurance transactions, one-off expense (e.g. legal) is more easily identified. We think more clarity on the classification of incremental costs should be provided.

The treatment of acquisition costs is also related to the proposed transition requirement, whereby existing business does not include a residual margin. When insurers first adopt IFRS 4, this would involve adjustments of the existing liabilities (now valued at risk-free rates) flowing through into the P&L, with zero profits from new business. Advice should be provided on how to treat such fluctuation of profits for first-time adoption of the IFRS 4.

## **Short-duration contracts**

### **Question 8 – Premium allocation approach**

*(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?*

*(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?*

We think the premium allocation approach is a reasonable proxy for the proposed measurement model. We suggest that the IASB permits but not require such modified measurement approach. However, it will provide users of financial statements more useful information if the approach used for the pre-claims liabilities of short-duration contracts is disclosed.

Paragraph 60 describes tests for onerous contracts. We think it could be further clarified whether risk adjustments should be considered in the testing. Also, it is stated that insurers shall aggregate the insurance contracts into a portfolio. However, different insurers can have different interpretation of “portfolio”, e.g. total company level, line of business level, product level.

## **Cash flows that arise from future premiums**

### **Question 9 – Contract boundary principle**

*(a) Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?*

We agree with the proposed contract boundary principle. Insurers should be able to apply the principles consistently as the principles are clear on the treatment of existing contracts and future contracts.

## **Participating features**

### **Question 10 – Participating features**

*(a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?*

We agree that participating benefits should be included in the measurement of insurance contracts on an expected present value basis. The measurement basis should include the probability that the discretionary payments will be made so as to reflect policyholders’ reasonable expectation and the company’s usual practice. The

illustrations for the discretionary payments should form the basis for the expected amounts under different scenarios.

**(b)** *Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?*

We agree that financial instruments with discretionary participation features should be within the scope of the IFRS on insurance contracts. This will ensure that contracts with similar economic consequences are treated in a consistent manner for accounting purposes.

**(c)** *Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?*

We agree with the proposed definition of DPF, i.e. the investment contract must share the same pool of assets/company/fund/other entity with the insurance contract.

**(d)** *Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?*

We think the modifications will introduce inconsistencies between the definitions or treatments between insurance contracts and financial instruments with discretionary participating features. The definition of boundary for an insurance contract refers to the entire contract while paragraph 64 bases the definition on the participating feature. The recognition of residual margin for an insurance contract uses expected timing of incurred claims and benefits as a basis if that pattern differs significantly from the passage of time. However, paragraph 65 uses fair value of assets under management. Recommend that paragraph 64 refers to the entire contract and paragraph 65 uses expected cash outflow.

## **Definition and scope**

### **Question 11 – Definition and scope**

**(a)** *Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?*

We agree that the term “compensation” is adequate in describing insurance contract benefits. However, “benefit payment” can eliminate some inappropriate implications. We also agree with the concepts of the role of timing risk and the notion of a loss. Either one or both of these risks can be present in an insurance contract.

**(b)** *Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?*

We generally agree with the scope exclusions in paragraph 4. Given that most of the exclusions are also covered by other International Accounting Standards (IAS), these contracts should be treated consistently across all IASs.

*(c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?*

We agree that financial guarantee contracts should be included within the scope of the IFRS for insurance contracts. Both financial guarantee contracts and insurance contracts provide financial security to contract holders leading to similar economic consequences. Hence it is appropriate to treat them consistently for accounting purposes.

## **Unbundling**

### **Question 12**

*Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?*

Unbundling of insurance contracts into insurance and investment components is difficult to carry out in practice. Existing computational and actuarial systems will not be able to separate the cashflows into insurance and investment cashflows. Also, unbundling will inevitably introduce a new layer of judgement. From users' of financial statements' perspective, the method used in unbundling will be difficult to understand.

## **Presentation**

### **Question 13 – Presentation**

*(a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?*

The proposed summarised margin presentation is completely different from existing presentation and hence users might find it difficult to understand. The premium approach is easier to understand.

*(b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?*

We agree that all income and expense arising from insurance contracts should be presented in profit or loss. Usage of other comprehensive income is arbitrary and would add complexity to the presentation.

## **Disclosures**

### **Question 14 – Definition and scope**

*(a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?*

We agree with the disclosure principle. The financial statement of insurance companies should include not only the past performance but also the company's view of future risk as well as the current risk undertaken by the companies. It is important to give users a clear view of the profit and loss recognized in financial statement; and nature and extend of the risk arising from insurance contracts.

*(b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?*

We think the proposed disclosure requirements will confuse users. For example, in reconciliation of contract balances, premium received and payment are included as part of items but in income statement presentation these items are not included. General readers may find it difficult to relate the contract balance, how it affects income statement and how to reconcile this with same item in last period. IASB should provide more guidance on requirement on measurement uncertainty analysis of input (90d) and the difference between this and effect of change in inputs (90c).

*(c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.*

We have no further proposal.

## **Unit-linked contracts**

### **Question 15 – Unit-linked contracts**

*Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?*

We agree to presenting assets and liabilities under unit linked contracts separately. However, we believe income statement presentation requires further exploration.

## **Reinsurance**

### **Question 16 – Reinsurance**

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

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

We generally support an expected loss model for reinsurance assets as the method is consistent with the proposed measurement model, where expected value approach is used. However, expected loss model is subjective and is not widely used in the Hong Kong insurance industry. We think more guidance in this area will be beneficial.

## **Transition and effective date**

### **Question 17 – Transition and effective date**

*(a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?*

We do not agree with the proposed transition requirements. While we recognise the difficulties of determining the remaining amount of the residual margin on transition to the new model, assuming zero residual margin will mean greatly reduced profits for Hong Kong insurers and also mean inconsistency with the way profits will be reported on future new business. We recommend calculating residual margin using a standardised approach specified by IASB which provide a fair profit measurement to existing business.

*(b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?*

We agree with the approach proposed.

*(c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?*

We think it is essential for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9. Ideally both standards should be considered and implemented together as any misalignment will be a source of earning volatility and provide confusion to users of the financial statements.

*(d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.*

Substantial effort and resources are needed to implement the proposed ED. We think that we need at least 2 years to implement. Many areas including experience studies, (expected value, variance and skewness), modelling etc need to be developed substantially.

## **Other comments**

### **Question 18 – Other comments**

*Do you have any other comments on the proposals in the exposure draft?*

We have no further comments.

## **Benefits and costs**

### **Question 19 – Benefit and costs**

*Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.*

We agree with the main benefits of the amendments that IASB has suggested. However, we do not believe that the cost of the proposal is “minimal”, given the amount of development work need to be carried out to implement the requirements under the ED.