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22 October 2013 By post and email: commentletters@hkicpa.org.hk

Mr. Simon Riley
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East
Wanchai
Hong Kong

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Dear Mr. Riley

IASB's Exposure Draft of Insurance Contracts

We refer to the International Accounting Standards Board's Exposure Draft of Insurance Contracts.

Our comments on the specific questions raised in the exposure draft are attached. Should you have any questions, please do not hesitate to contact our Assistant Manager Mr. Timothy Tam at 2526 6080.

Yours sincerely

Boey Wong
Secretary

Enc.

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Vice Chairmen Bank of China (Hong Kong) Ltd
The Hongkong and Shanghai Banking Corporation Ltd
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Appendix

Response of the Hong Kong Association of Banks to the specific questions in the International Accounting Standards Board's revised Exposure Draft on Insurance Contracts – June 2013

Question 1 – Adjusting the contractual service margin
Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if: (a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and (b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss? Why or why not? If not, what would you recommend and why?

We agree with the proposal in the Exposure Draft ("ED") to adjust the contractual service margin ("CSM") for the differences between the current and previous estimates of cash flows that relate to future coverage and other future services. Given the long-term nature of insurance liabilities, estimates will necessarily require adjustments as a result of evolving circumstances. Since the CSM reflects profits on a long-term contract which have not yet been released into P&L, it is reasonable that adjustments to these estimates, to the extent that they relate to future services and future coverage, are adjusted against the CSM provided the CSM is not negative. This approach is also consistent with other IFRS's which require prospective recognition of changes in estimates and expected losses on onerous contracts to be recognized in P&L immediately.

Question 2 – Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items
If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity: (a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items? (b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other

requirements of the [draft] Standard (i.e. using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfilment cash flows as follows:
(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;
(ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and
(iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

Whilst we support the principle that the "mirroring" approach can reduce the accounting mismatch for certain types of insurance contracts, and we appreciate the Board's attempt to reduce mismatch within the financial statements, we believe that the proposals as drafted are too narrow in scope as a result of which the proposals at times create, as opposed to help eliminate, accounting mismatch which is counter-intuitive. Our reasons for this view are as follows:

- the scope and prescriptive language, as drafted, will not cover a number of participating contracts in different jurisdictions especially those where only a part of the returns on the underlying items are contractually linked to policyholder liabilities and the distribution of the remainder is discretionary (and thus accounted for as part of shareholders' equity till distribution to policyholders takes place).
- as part of their usual risk management, insurers try and match cash flows between assets and liabilities for many products. The liabilities are not contractually linked to the returns of the underlying items for a number of these products and each product is not necessarily managed / backed with assets as a separate pool.
- it may be practically difficult to break down cash flows into different components as specified in the proposals. Whilst this may be technically possible in individual simplified examples, when it comes to application within many portfolios, the proposals only serve to increase accounting and operational risk.

Question 3 – Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

Why or why not? If not, what would you recommend and why?

We agree with the presentation approach advocated in the current ED and believe that this will enhance comparability among different industries and provide useful information. Presentation of insurance contract revenue and expenses provides more useful information to users of the financial statements about the underlying operations and their profitability as opposed to information on changes in components of insurance contracts. We believe the disclosure should be extended to also include returns on investments since this source of revenue is an integral part of an insurer's operations.

It should, however, be acknowledged that currently volume based measures of business performance (for example, premiums) are widely used and understood by most users of financial statements and the proposals should encourage entities to provide and reconcile, in the notes to the financial statements, income and expenses from insurance contracts to volume based key performance indicators.

Question 4 – Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between:
   (i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and
   (ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

Why or why not? If not, what would you recommend and why?

We do not agree with the proposal to split the effect of the movements in the discount rate so that the income statement shows as part of operating profit the effect of the unwind of the liability using the original discount rates determined at the inception of the contract.

Under the proposals, the effect of the movements in the discount rates (difference between the current rate and the rate determined at inception) which arises purely due to market movements would be accounted in OCI. Whilst this attempts to isolate business performance from short-term market fluctuations and achieve a degree of "matching", it may not work in practice when derivatives (not eligible for FVOCI classification – for example, structured notes or derivatives) are used to manage interest rate risk, or interrelated embedded derivatives are involved which cannot be bifurcated. At a portfolio level, if a portfolio of insurance contracts is matched with

assets and discount rate has been managed / hedged economically, the effect of the movement in discount rates cannot be accounted consistently with the results of hedging. Hedge accounting will also not enable this. At the same time, it may also be difficult to quarantine assets related to such portfolios.

A high level modelling exercise shows that while the proposals as drafted can lead to a smoother result in the short term, in the event of a duration mismatch, the P&L impacts are severe and the overall volatility over the life of a portfolio is potentially even greater than with a pure P&L approach. One IASB Board member has already demonstrated this as part of his dissenting views.

We are all aware that the proposals within the Phase 2 project will dramatically increase short-term equity and earnings volatility for all insurers, often procyclically. Since insurers usually take steps to manage long-term volatility, it is questionable how useful financial statements would be if they reflected short-term volatility (especially that which arises from accounting mismatches) which would only reverse in the longer term.

Insurers primarily manage insurance liabilities and decisions to invest usually follow the profile and characteristics of the underlying insurance liabilities. The ED seeks to link the measurement of liabilities to assets, which is the opposite of an insurer's business model. We appreciate the ED cannot seek to prescribe the measurement and accounting of assets since these are addressed by other standards. Consequently, the proposals should enable the insurer to account for liabilities in a manner consistent with how assets have been accounted for. Not all assets an insurer will hold (to back insurance liabilities) will be categorised as Fair Value through OCI ("FVOCI") and remeasured through equity; the needs for many insurers, and portfolio's, would at times be better served by using the FV through P&L option. The proposals will, in these cases, create accounting mismatch even in those situations where there is no economic mismatch.

Insurers often use various hedging instruments as part of their risk management techniques which will necessarily have to be accounted for through P&L. Other insurers may use property as assets backing insurance liabilities, which under the proposals, would be remeasured through P&L. In both these instances, the proposals as drafted would create accounting mismatch.

As an alternative, we advocate providing insurers with a choice to account for certain portfolios of contracts through either equity or through the income statement. The choice should be made available at the portfolio level because similar products may have different characteristics in different markets, and risk management strategies may differ (due to market limitations) even amongst insurers in the same group of companies offering similar or the same products. This would provide insurers with the necessary flexibility to follow the spirit of the rules without penalizing them by creating accounting "noise" as a result of using existing risk management techniques. The language used for the scope should also be less prescriptive. We understand the Board's concern that providing accounting policy choices reduces comparability, however the diversity can be limited by linking it to business models, risk management strategies, elaborating the principles to be applied and providing illustrative examples supported with appropriate disclosures.

Implementation of this method, in practice, will also be very challenging. Additional data points will need to be captured for each portfolio (discount rate at inception and current discount rate). Maintaining this additional information, and separately accounting for and presenting its effects, will require considerable systems changes incurring both time and cost. It is thus questionable

whether the additional costs will outweigh the benefits this proposal will provide to users of financial statements. It is also questionable whether business performance can be clearly explained to the users of the financial statements, especially in the case of bancassurers who would not apply a similar approach to other assets and liabilities.

Question 5 – Effective date and transition
Do you agree that the proposed approach to transition appropriately balances comparability with verifiability? Why or why not? If not, what do you suggest and why?

We agree with the proposed modified retrospective approach for transition since it is practicable and does not penalize insurers with a zero CSM upon transition. We do note, however, that retrospective application will require an extensive amount of work on existing portfolio's and require a number of subjective decisions on the number of cohorts / portfolio's an insurer would recognize upon transition, how would historical long-term discount rates (for emerging markets) be determined, etc. The result will not only be difficult to audit but will also result in significant increased costs. The transition effort will be exacerbated for entities that have to comply with SEC requirements to provide additional years of comparative financial information.

In terms of timing, we strongly support the IASB's stance to provide companies at least 3 years to implement the proposals after they are published and before they are effective.

We also support the possibility under the proposals which enable entities to redesignate financial assets which have been classified under IFRS 9. The proposals also allow an insurer to measure properties at fair value through P&L and exempts the accounting for treasury shares under paragraph 33 of IAS 32, however, it is unclear how or when would the entity be able to transition this change in accounting policies.

Question 6 – The likely effects of a Standard for insurance contracts
Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1–5? How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft? Please describe the likely effect of the proposed Standard as a whole on: (a) the transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and (b) the compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

We welcome the Board's proposal to develop this comprehensive accounting standard for the insurance industry. Implementation of the standard will not only involve significant costs and

efforts for the entire industry, but the revised key financial performance indicators (a new way of recognizing income, the absence of volume based indicators, the splitting of performance between P&L and equity) will not necessarily result in reducing complexity nor enhancing users' understanding of insurers' financial statements. In addition, the often conflicting regulatory requirements will put a considerable strain on the industry as a whole.

Additional mandatory disclosures required by the standard, especially reconciliations of movements between opening and closing balances for virtually each figure on the statement of financial position, will not necessarily help users of financial statements better understand the performance of insurers. Users should be permitted to provide only those disclosures which would enhance users' understanding of the entity's business.

Question 7 – Clarity of drafting
Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB? If not, please describe any proposal that is not clear. How would you clarify it?

Given that these proposals are expected to evolve into the IASB's comprehensive guidance for the accounting for insurance contracts, we would advocate the inclusion of additional guidance and illustrative examples as part of the proposals to enable consistency in interpretation and application. When compared with US GAAP, the extent of guidance for different types of products (especially reinsurance), is clearly inadequate.

We also list below certain areas where further clarification could be beneficial.

Statement of financial position

Paragraph 54 requires separate presentation of the carrying amount of portfolios which result in a net asset position or a net liability position. Since the "carrying amount of a portfolio" comprises the net present value of fulfilment cash flows plus the remaining portion of the CSM, it would be helpful to illustrate situations where a net asset position for a portfolio would result.

Risk disclosure

Paragraph 90 does not require disclosure about the development of claims for which uncertainty about the amount and timing of the claims payments is typically resolved within one year. We suggest revising the timeframe as "within the same financial reporting year".

Unbiased estimates

Paragraphs B40 - B42 describe the concept of unbiased estimates to measure the fulfilment cash flows. A number of situations are discussed and it is difficult to determine which situations should be applied in different entities and circumstances. More illustrative examples would be helpful.

Directly attributable costs

Directly attributable costs form part of the fulfilment cash flows and would be amortized to P&L on the pattern which best reflects the remaining transfer of services.

Paragraph B66 (l) considers fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent and maintenance and utilities) are directly attributable to fulfilling the entity's obligations under the portfolio.

Paragraph B67 (d) considers product development and training costs are not directly attributable to the portfolio.

- It is unclear why fixed costs of accounting and human resources can be determined as directly attributable. We assume the accounting cost in paragraph B66 (l) represents the staff's time spent on preparing the results of sales of insurance portfolio. The training costs incurred to train staff for sales of the insurance contracts (e.g. compliance training) is of a similar nature and can be directly attributable to the portfolio. More guidelines to distinguish directly attributable versus non-directly attributable are necessary.
- The phrase "directly attributable" is widely used in similar ways throughout different standards. It is often defined as "the incremental costs directly attributable to the transaction that otherwise could be avoided". The standard on Leases specially excludes general overheads such as those incurred by a sales and marketing team. We recommend the Board avoid the phrase "directly attributable costs" if it intends to extend the fulfilment cash outflows to include these fixed and general expenses.
- For example, a staff paper presented to IFRIC in July 2008 "Transaction Costs Deducted from Equity (Agenda Paper 6C)" defines "directly attributable costs" differently than what is included in the proposals.

<u>Discount rate</u>

Paragraph B74(b) states that while equity investments are considered in determining the discount rate, more significant adjustments are required to eliminate the factors that are not relevant to an insurance contract. Additional guidance in the form of illustrative examples are suggested to illustrate how these adjustments can be made.

<u>Recovery of onerous contracts</u>

It would be helpful to clarify how subsequent recovery of an onerous contract should be accounted for. For example, it could be credited to P&L to the extent of the previous recognized loss, or included as part of the CSM.

<u>Segregation of portfolios</u>

- Paragraph 60(h) interest expense on insurance contract liabilities determined using the discount rates specified in paragraph 25 that applied at the date that the contract was initially recognized. Since the initial recognition date for each individual contract varies, and discount rates do change frequently, we suggest the Board to illustrate how this discount rate presentation can be achieved without assessing the fulfilment cash flow at individual contract level.
- The CSM can be assessed and measured at portfolio level. However, there may be instances where the coverage period for an individual contract within a portfolio has legally expired but the portfolio's CSM has not yet been fully amortized to P&L. Paragraph 50 states that an entity shall derecognize an insurance contract (or part of it) from its statement of financial

position when, and only when, it is extinguished (i.e. when the obligation specified in the insurance contract is discharged, cancelled or expires).

The Board should provide more illustrative examples on measurement in portfolios basis.

Risk adjustment method

The proposals require an entity to determine the risk adjustment and convert the same into a confidence level for disclosure purposes. Whilst we support the requirement to determine the risk adjustment using an appropriate technique, and explain both the technique and the results as part of the disclosures in the financial statements, we see no point in converting the same to a confidence level especially if the entity does not use the confidence level technique in practice. Furthermore, the guidance provided in paragraphs B76 to B82 can be enhanced by providing some additional illustrative examples.