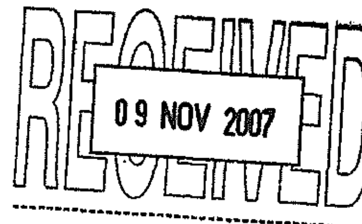
LEMBAGA PIAWAIAN PERAKAUNAN MALAYSIA
MALAYSIAN ACCOUNTING STANDARDS BOARD



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14 November 2007

The Chairman
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Dear Sir David,

IASB DISCUSSION PAPER: PRELIMINARY VIEWS ON INSURANCE CONTRACTS

The Malaysian Accounting Standards Board (MASB) is pleased to provide its comments on Discussion Paper – Insurance Contracts, as set out in the accompanying pages.

Generally, we believe the implementation of the 'current exit value' concept could be challenging especially in emerging markets as the focus is very much on a market participants perspective although in reality, the required depth and maturity of the market may not exist.

It is a more pragmatic approach for IASB to consider an alternative treatment, such as the 'current entry value' when current exit value is typically not observable, rather than to mandate the use of current exit value in all circumstances. Details of this suggestion are elaborated in response to Question 21 below.

We believe that the project on Fair Value Measurement (FVM) Guidance should be concluded before the finalisation of the section on the measurement of insurance liabilities, as it is expected to be based on the fair value concept.

We understand that IASB is currently revising certain Standards, for example IAS 37 and IAS 39, affecting the measurement of liabilities. These revisions should be duly considered in the finalisation of the IFRS on Insurance Contracts.

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We suggest IASB undertake field-tests to assess whether the proposals in Phase II are practical and workable in all environments, in particular, emerging markets.

We thank you for the opportunity to give our comments. If you need further clarification on the response, please feel free to contact the undersigned at +603 2715 9199 or e-mail at nordin@masb.org.my.

Yours sincerely,

Dr. Nordin Mohd Zain
Executive Director

Chapter 2

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?

Yes, the recognition and derecognition requirements for insurance contracts should be consistent with IAS 39. This will reduce 'accounting mismatches' resulting from the inconsistency in the recognition and derecognition principles between insurance liabilities and financial assets held by insurers.

Chapter 3

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?

Yes, insurance liabilities shall be measured using the three building blocks. However, there could be practical difficulties especially in the following areas:

(i) Determination of explicit, unbiased, market-consistent cash flows for the purpose of valuation on the insurance contracts.

Due to the lack of a market to transfer insurance contracts and the absence of a substantial volume of such transfers, estimates of cash flows based on hypothetical transfer to a market participant may not provide useful information in estimating the required cash flows. In addition, cash flows based upon entity specific strategy and efficiency provides more relevant and faithful information to reflect the economics of the insurance contracts under the valuation.

(ii) Determination of the margin that market participants require for bearing the risk and also the requirement to segregate the margin for bearing risk (risk margin) and providing other services (service margin).

Question 3

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?

There is fair guidance on cash flows and risk margins in Appendices E and F respectively.

We believe that guidance within the Standard should be focusing on the principles on which the estimates of future cash flows and the determination of margins would be based. It should not be prescriptive but aim to provide clear objectives and principles for the underlying measurement attributes.

In addition, we suggest that field-tests be conducted, inclusive of emerging markets, to determine whether additional areas ought to be included in Appendices E and F to facilitate the effective implementation of the Standard.

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.

(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).

We support alternative (c) as this is consistent with the current practice.

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?

On the premise that we accept the definition of fair value in this Standard, any method that subscribes to market participants' view will be deemed better than any method that gravitates towards the entity's specific view.

The term "transfer" implies greater emphasis on market participants' expectation of the price they would accept in order to ultimately settle the obligation with the counter party, while the term "settlement" implies greater emphasis is placed on entity specific conditions such as efficiency or inefficiency of the entity. Conceptually, if the market is perfect, measuring fair value via the concept of "settlement" and "transfer" should yield the same result.

However, in practice there isn't always a perfect market and in a lesser than perfect market an entity's specific efficiency and inefficiency may not be discounted into the market. In such circumstances the "settlement" notion would not provide better fair value measurement as it is biased towards entity specific values. Notwithstanding the above, it must not be ignored that in reality the focus is on the cash flow settlement, ie the amount the insurer would expect to pay at the reporting date to settle its remaining contractual rights and obligations. Insurance liabilities are generally not settled by means of a transfer to another entity.

(b) Is 'current exit value' the best label for that measurement attribute? Why or why not?

No, the term 'current exit value' is not the best label for that measurement attribute. Although it is not the spirit of the Standard, the term may give the perception that the insurer can, will or should transfer the liability to a third party. Since the large majority of insurance contracts are not expected to be exited through transfer to another entity, a description of the measurement attribute as current exit value is likely to be confusing to the users of financial statements.

If the intention of the Standard is to require the insurance liabilities to be measured at fair value, the label should reflect the intent and in this respect, we suggest the term 'fair value' be used.

Chapter 4

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:

(c) 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?

We support alternative (b) as this is consistent with the current practice. It is practically difficult and very complex for an insurer to detach economic benefits resulting from beneficial policyholder behaviour from the amount of insurance liabilities. In addition, such economic benefits cannot be sold separately.

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 policyholder 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 (ie have a discernible effect on the economics of the contract by significantly modifying 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).

We believe the future cash flows under a contract should be allowed in the measurement of the insurance liabilities to the extent that they are integral to the fulfillment of obligations under the contract. As a result, we believe option (c) would be the most appropriate as it would also include the provisions in option (d) wherein it allows for the recognition of the financial guarantee elements which are not significant to be treated as a non-insurance product.

Question 8

Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

Yes, the insurer should recognise the acquisition costs as an expense when incurred.

Question 9

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

We believe for a business combination entailing a merger and acquisition of insurers, the relevant IFRSs should apply. However, for portfolio transfers involving the vesting of rights and obligations of insurance assets and insurance liabilities of the new 'insurer', the fair values of the various insurance assets and insurance liabilities should apply.

Chapter 5

Question 10

Do you have any comments on the measurement of assets held to back insurance liabilities?

The measurement of assets held to back insurance liabilities should be consistent with the measurement of the related insurance liabilities so as to avoid undesirable accounting mismatches.

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?

Yes, the risk margins should be determined for groupings of similar risks or characteristics in a portfolio of insurance contracts as per IFRS 4. This would be consistent with the current practice of insurers where risk management is on a portfolio basis.

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

No, the risk margins should not reflect the benefits of diversification between portfolios. This would be consistent with the measurement of asset values, which does not change due to diversification.

Question 12

(a) Should a cedant measure reinsurance assets at current exit value? Why or why not?

Yes, on the premise that if the insurance liabilities are measured at current exit value, the reinsurance assets should be consistently measured. Please also see our response to questions 5 and 21.

(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.

Yes, we agree.

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

Yes, we agree. The expected loss model may be preferred by market participants (to be used for defaults and disputes) as all expected cash flows arising from an insurance contract will be considered in determining the consideration that they will accept a transfer of insurance liabilities from another entity. This would be in line with the current exit value model advocated, although this may be inconsistent with IAS 39 on impairment of financial assets.

(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.

Yes, we agree.

Question 13

If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?

Yes, we agree that the separate components should be unbundled. However, there is practical problem because insurance contracts are designed, priced, managed and regulated as packages of benefits, and hence, it is not a straightforward task to identify those components separately. The measurement of the deposit components might be arbitrary in most cases.

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?

Yes, it neither improves nor impairs its credit characteristics.

(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?

Yes, the measurement of an insurance liability should reflect its credit characteristics at inception as well as subsequently. This would then be consistent with the measurement basis in IAS 39. Also, because financial statements are prepared on a going concern basis, credit risks need to be taken into consideration as it affects the value at which liabilities could be repurchased or settled.

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?

Generally, we believe the accounting treatment for insurance contracts should be consistent with existing requirements in IAS 39 unless such prerequisites will not faithfully represent the transactions or events that result in financial liabilities being recognised by the entity. For example, an insurance contract that contains both an insurance component and a deposit component should be unbundled if, and only if, the components can be measured separately on a basis that is not arbitrary. Otherwise, the whole contract should be treated as an insurance contract.

However, we believe that the IASB should determine whether the proposed definition of 'current exit value' is the same as that of 'fair value' to address the inconsistencies between the proposed accounting treatment of insurance liabilities and accounting treatment under IAS 39.

Chapter 6

Question 16

(a) 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?

Yes, for participating contracts we believe the cash flows should incorporate an unbiased estimate of the policyholder dividends payable.

We understand that policyholders of participating contracts are willing to pay a higher premium because of the expectation that the insurer will share favourable performance in the form of dividend payments even though the insurer has some discretion over the distributable amounts. Therefore, the cash flows should take into account this expectation by the policyholders when measuring a participating insurance liability.

(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?

Yes, we believe the guidance provided is adequate. Besides IAS 37, all developments to extant IFRSs should be duly considered in the development of this Standard.

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?

Due to lack of clarity in the question, our response is based on the assumption that the assets of the unit-linked business are commingled with other assets of the entity whilst the unit-linked liabilities are considered individually.

(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).

No, to permit or require insurers to recognise treasury shares as an asset would be inconsistent with the Framework.

Allowing insurers to recognise treasury shares as an asset would also be inconsistent with the IASB's approach taken in IFRS 2 *Share-based Payments* where the Board concluded that jurisdictions that had previously treated treasury shares as an asset should change their accounting policy and apply the requirements of IAS 32 *Financial Instruments: Presentation* regarding treasury shares in connection with employee share plans or other share-based payment arrangements. Therefore we believe the Board should apply a consistent approach for this unit-linked liability as well.

(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).

No, we do not believe insurers should be permitted or required to recognise internally generated goodwill of a subsidiary. Paragraph 49 of IAS 38 *Intangible Assets* disallowed the recognition of internally generated goodwill as an asset because it is not an identifiable resource (ie it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost. Unless insurers can measure the internally generated goodwill reliably, we do not believe it is justifiable to accord insurers the special treatment just because the investment is held to back a unit-linked liability.

We believe allowing insurers to recognise internally generated goodwill of a subsidiary, if the investment in that subsidiary is held to back a unit-linked liability, would alter the underlying principle and recognition criteria of IAS 38. The Board would need to re-examine its arguments to support such basis.

(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).

No, we do not believe insurers should be permitted or required 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). Such exceptions would undermine comparability of financial statements of insurers with other entities.

(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).

Yes, the current exit value of a unit-linked liability should exclude any differences between the carrying amount of the assets held to back that liability and their fair value. We believe this is a more pragmatic approach than changing the treatment of some assets so that they can be recognised and measured at fair value through profit or loss.

Chapter 7

Question 18

Should an insurer present premiums as revenue or as deposits? Why?

The Discussion Paper does not define premiums but revenue is defined in IAS 18 *Revenue* as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

We believe that the nature of the insurance contracts would determine whether premiums are recognised as revenue or otherwise. Premiums received by an insurer that would result in increases in the insurer's equity should be presented as revenue and if otherwise, it should be accounted for as a deposit.

In this respect and to prevent any ambiguity in applying the Standard for insurance contracts in the future, it would be appropriate for the Standard to define "premiums".

Question 19

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

The items of income and expenses that an insurer should present separately on the face of its income statement should amongst others, include the following:

(a) Life Business

	200X RM'000	200Y RM'000
Gross premium	xxx	xxx
Benefits paid and payable		
Death	xxx	xxx

Maturity	xxx	xxx
Surrender	xxx	xxx
Annuity	xxx	xxx
Cash Bonus	xxx	xxx
Others	xxx	xxx
	(xxx)	(xxx)
	xxx	xxx
Commission and agency expenses	(xxx)	(xxx)
Management expenses	(xxx)	(xxx)
	xxx	xxx
Investment income	xxx	xxx
Other operating income/expenses	xxx	xxx
Profit from operations	xxx	xxx
Finance costs	(xxx)	(xxx)
	Xxx	xxx
Taxation	(xxx)	(xxx)
Profit after taxation	Xxx	xxx

(b) Non-Life Business

	200X RM'000	200Y RM'000
Gross premium	xxx	xxx
Reinsurance	(xxx)	(xxx)
Net premium	xxx	xxx
Decrease/(increase) in unearned premium reserves	xxx	xxx
Earned premium	xxx	xxx
Net claims incurred	xxx	xxx
Net commission	xxx	xxx
Underwriting surplus before management expenses	xxx	xxx
Surplus/(deficit) transferred from underwriting account	xxx	xxx
	xxx	xxx
Management expenses	(xxx)	(xxx)
Underwriting surplus/(deficit)	xxx	xxx
Investment income	xxx	xxx
Other operating income/expenses	xxx	xxx
Profit from operations	xxx	xxx
Finance costs	(xxx)	(xxx)
Transfer to income statement	xxx	xxx

Question 20

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

Yes the income statement should include all income and expenses arising from changes in insurance liabilities because it indicates the financial performance of an entity for any specified period.

Question 21

Other matters

Do you have other comments on this paper?

Whilst the proposed three building blocks (referred to as 'current exit value') would lead to a measure of fair value in concept, we are concerned that applying the concept in practice may not be easy especially in emerging markets where it is difficult to readily attain the attributes in the building blocks, such as the discount rates and risk margins from a market perspective.

The concept of 'current exit value' advocated in the Discussion Paper is based on the premise that the amount an insurer expects to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. However, to apply this concept of 'current exit value' in emerging markets would be challenging, as it leads to an unnecessary search for a hypothetical market which is unrealistic and hence, undermine the reliability and value of the insurance liabilities. Furthermore, we believe this is not in line with the Board's intention to address the need for users of an insurer's financial statements to receive relevant and reliable information, capable of preparation at a reasonable cost, as a basis for economic decisions.

IASB should consider an alternative treatment, such as the 'current entry value' when current exit value is typically not observable. We support the views expressed in paragraph 96 where some believe that an insurer should measure its insurance liabilities at a current value that reflects prices charged to policyholders, rather than the price for a hypothetical transfer of the liability to another entity.