

THE GENERAL INSURANCE ASSOCIATION OF JAPAN

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November 14, 2007

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

Dear Mr. Clark,

We are pleased to have an opportunity to comment on Discussion Paper Preliminary Views on Insurance Contracts prepared by the International Accounting Standards Board. Our Association, the General Insurance Association of Japan, was originally established in 1917 and reestablished in 1946 by all the domestic non-life insurance companies. The objective is to promote the sound development of the non-life insurance industry in Japan.

The Association set up a special project team for the International Financial Reporting Standards in its Accounting Committee. Since the Discussion Paper was published on May 2007, the team has been concentrating upon the preparation of comments to represent the position of the Association. We believe that the comments attached reflect viewpoints of the non-life insurance industry in Japan. We would much appreciate it if you would take our views into consideration in preparing the International Financial Reporting Standard on Insurance Contracts. If you would like to clarify points discussed in this letter, please feel free to contact me at keiri@sonpo.or.jp.

Yours sincerely,



Toshiyuki Hanazawa

Chairman

Accounting Committee

The following are comments from the General Insurance Association of Japan with respect to the Discussion Paper Preliminary Views on Insurance Contracts published by the International Accounting Standards Board (IASB) on 3 May 2007.

Overall Comments

1. We recognise that the IASB's project on insurance contracts is trying to introduce the concept of exit value measurement to insurance liabilities. It would enhance the consistency and comparability of financial statements and the usefulness of them for their users. We highly respect the IASB's project on insurance contracts.

We would much appreciate it if you would take our views in the following comments into consideration in preparing the exposure draft of insurance contracts, since there are still many practical issues to be resolved if we are to achieve a widely accepted solution.

<p>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?</p>
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2. In general, under current insurance accounting practices, an insurance liability is recognised when the effective date of an insurance contract starts. We are concerned that the drastic change of recognition criteria may result in extensive revision of the existing accounting systems and procedures, and the benefit would not be worth the cost in doing so.
3. In principle, we agree with the Board's view that the insurance accounting standard should be consistent with IAS39. However, we would like the Board to develop the insurance accounting standard with due consideration to prevailing transaction practices. We believe the existing effective date could be the reasonable choice for recognition of contracts for following reasons:
 - (a) As is the case with a practical approach in IAS39 (paragraph38 / AG53 to 56 of IAS39), which permits not only trade date accounting but also settlement date accounting, effective date accounting would be permissible on condition that the method selected is applied consistently.
 - (b) It is difficult to identify the timing when both contracting parties have clearly and mutually agreed to enter into the contract in a unified manner.
 - (c) The binding date may not always fully meet the recognition criteria of the *IASB's Framework*.
4. We believe that a periodical profit or loss in series does not differ so much between the case of trade date accounting and that of effective date accounting as long as the same recognition criteria is applied consistently and continuously, and the benefit of users of financial statements is not seriously suffered by either method.

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?

5. We agree with the concept of measuring insurance liabilities using the three building blocks in principle.
6. We agree with the Board's preliminary view that risk margins are compensation for bearing risk. However, we understand that there remain many areas where the measurement practices have not been established yet and many issues are to be solved. Also, we recognise that "risk" is the variability of future cash flows directly and indirectly related to the obligations under insurance contracts, and it includes a broad range of risks as follows:
 - (a) variability in claim amounts
 - (b) variability in timing of claim payments
 - (c) variability in expenses required to provide services inherent in insurance contracts, such as payment of claims handling costs and maintenance costs
 - (d) estimation errors in models and parameters used

We would like to confirm that risk margins are designed to cover a wide variety of risks as above.

7. On the other hand, regarding service margins, only the investment management service is taken as an example. We believe the services inherent in insurance contracts other than investment management service, if any, to be included in the scope of service margins should be explicitly specified.
8. Also, we agree with the Board's view that, for short-duration contracts, the unearned premium may be a reasonable approximation to current exit value (paragraph 112). From a practical point of view, we believe that the unearned premium can be used as the basis of current exit value, as long as premium rating is not revised after the issuance of the insurance policies under the highly competitive market. Reinsurance contracts should be treated the same way.

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?

9. Since IFRS is principle-based, we do not think that an excessively detailed guidance should be necessarily developed. However, a standardised practical guidance prepared by professionals, who are familiar with insurance accounting practices, will serve interested parties for consistent application in terms of world wide comparability. Also, some feasibility studies would be beneficial for the development of the guidance. We believe that these preparations are essential to the development of accounting standards with high transparency and comparability.
10. We think that the measurement based on the three building blocks is appropriate as a basic concept. From a practical point of view, however, we recognise that the data and calculation methods may not be conveniently available at a reasonable cost for the following measurements, and insurance companies should be allowed to select the most relevant and feasible method under such restrictions:
- (a) measurement of market-consistent, probability-weighted estimates of the cash flows
 - (b) measurement of ceded reinsurance assets and assumed reinsurance liabilities

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).

11. In principle, we support (c), which is consistent with the measurement based on the three building blocks.
12. In connection with Question 2 regarding the three building blocks, since the measurement of margins directly influences an initial profit or loss, measurement practices should be explored along with the development of the accounting standards. Like Solvency II in the EU, it would be necessary that the related parties agree on how to reliably estimate margins that may cause an initial profit or loss, based on the results of sufficient impact studies.

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

13. (a) We believe that the Board’s view is appropriate, on the premise that the measurement of “the amount the insurer would expect to pay” is based on the three building blocks and the unearned premium may often be a reasonable approximation to the current exit value for many short-duration contracts.
- (b) We currently can not think of any alternatives.

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?

14. We support (b).

Considering the consistency with pricing practices, the behavior of all policyholders, regardless of beneficial or unfavorable, should be included in the measurement. We believe that the expected future premium inflows from and the future payment outflows to policyholders arising from the same insurance contracts are inseparable.

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 (ie 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).

15. We support the approach of the “guaranteed insurability”. However, long-duration insurance contracts generally include financial risk elements and, if any, other service elements, regardless of the applicability of unbundling. The “guaranteed insurability” should also be applied to these elements even in the option (a).
16. That is, because, as we answered in Question 13, all future cash flows including those related to financial risk elements or other service elements should be recognised in case insurance contracts with such elements are not unbundled, the description that the “guaranteed insurability” is applied solely to insurance risks does not seem appropriate. Also, we believe that the conclusion of excluding future cash flows related to financial risks according to IAS 39 is inappropriate even when they are unbundled, because that portion should also be treated as an inseparable contractual obligation.

Question 8

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

17. Acquisition costs should be recognised as expenses when incurred.
- If insurance liabilities are measured at current exit value, there is no reason why acquisition costs should be included in the estimation of future cash flows, or why they are recognised as assets and amortized. Moreover, we think the recognition as expenses is appropriate because it can avoid arbitrary treatments in both identification of acquisition costs and practices in amortizing them.

Question 9

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

18. No comments.

Question 10

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

19. Measurement attributes of the assets held to back insurance liabilities should be consistent with that of insurance liabilities. If insurance liabilities are measured at current exit value, related assets also should be measured at fair value, in order to avoid the accounting mismatch. Also, in association with financial statements presentation, the Board should place emphasis on the objective that financial statements need to provide their users with accurate information regarding economic mismatching.
20. When phase II is introduced, change of the asset classification by holding purpose would be necessary. Also, if IAS 39 is revised in terms of asset classification, we would like the Board to give due consideration to the appropriate presentation of the result of risk management, such as interest rate ALM, by insurers.

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

21. (a)

Risk margins should be determined by a portfolio of insurance contracts.

Insurance business is, in the first place, based on the formation of the contract portfolios. It is not assumed that insurance liabilities be transferred and risk-assessed on a policy-by-policy basis. When insurance liabilities are transferred, risk assessment and pricing will be generally performed on a portfolio basis. Moreover, from a viewpoint that financial statements should provide useful information to their users, it would be appropriate to measure the insurance liabilities based on the same units as those by which the management controls insurance contracts, such as a block of contracts which the management sets up in rating products.

A portfolio should be defined the same as that in IFRS 4, “a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio”, which corresponds to a block of contracts above as a matter of practice.

22. (b)

Theoretically, risk margins should reflect the benefit of diversification or negative correlation between portfolios. However, from practical points of view, risk margins, should not reflect the benefit.

We believe that the possibility of dual value by a transfer and a transferee or arbitrary measurement could not be ruled out if the diversification or negative correlation is reflected when the insurer uses portfolio-based current exit value in the measurement of insurance liabilities.

Moreover, we believe that excessive stress on market consistency may require the assumption and modeling of the unified market-representative transferee insurance company, and this is expected to be difficult in practice. Arbitrary measurement could not be ruled out in such cases.

The concept of the risk margin is unique to insurance accounting, and its significance as a component of the current exit value can be justified by assuming that there exists the effective market by the portfolios of contracts of a certain scale. In actuarial theory, margins may differ depending on the size or diversification of portfolio held by insurers. Therefore, common understanding among related parties regarding the concept of a reference portfolio or acceptable deviance from that portfolio should be established through sufficient impact studies.

Question 12

- (a) Should a cedant measure reinsurance assets at current exit value? Why or why not?
- (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
 - (ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.
 - (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.

23. (a)

On the assumption that reinsurance assets correspond to direct insurance liabilities and cannot be recognised independently, then if insurance liabilities are measured at current exit value, reinsurance assets should also be measured at current exit value in order to ensure consistency.

24. (b)(i)

Basically we agree.

Since a reinsurance contract is a means for hedging against underlying insurance contracts, risk margins for reinsurance contracts are conceptually considered to be equal to those for the corresponding part of the underlying insurance contracts.

25. (b) (ii)

We understand that the incurred loss model may not be consistent with the concept of current exit value, and the expected loss model would be desirable.

26. (b) (iii)

No comments.

Question 13

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

27. We agree that insurance contracts should be unbundled if possible, but the criterion of interdependence in the discussion paper is so ambiguous that the insurer cannot understand how interdependence would be determined (whether by a constituent of premiums, cash flows, or current exit value). Also, the difference in the interpretation may occur in the actual application, by the current description in the discussion paper only, and further examples would be necessary, although we understand that the development of a uniform criterion is difficult because it relates to the principle of materiality.

28. In addition, according to paragraph 228(c), the insurance component would be measured as the difference between the measurement of the whole contract and the measurement of the deposit component. We think that, at this point where measurement attributes are different between insurance accounting and IAS 39, the distortion must be included in the value of insurance liabilities calculated as the difference (such as the problem that the profit or loss inherent in the deposit component would be recognised as the profit or loss inherent in the insurance component). Also, we do not think there is interdependence enough to have material influence on the measurement as a whole, in case insurance contracts can be unbundled without arbitrariness. Therefore, such a next-best treatment should not be adopted because it might cause misunderstandings to users.

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?

29. As described in paragraph 31, the Board's objective is to select a measurement model that gives users useful information about the amount, timing and uncertainty of the future cash flows resulting from the contractual rights and obligations arising from insurance contracts. However, if credit characteristics are reflected on the measurement of insurance liabilities, insurance liabilities held by insurers whose credit rating is damaged would be underestimated, and financial statements might not present their real financial positions.

30. Therefore, in the light of the essential objective that financial statements provide useful and comparable information to users, the value of liabilities should not be the price for a transfer that neither improves nor impairs their credit characteristics, and subsequent changes in the credit characteristics should not be reflected on the measurement.

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?

31. As described in our answer to Question 13, we believe that insurance contracts should be unbundled unless the interdependence of cash flows is material. The treatment of the deposit components, in such a case, should be consistent with that of insurance components.

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?
- (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?

32. No comments.

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).

33. No comments.

Question 18

Should an insurer present premiums as revenue or as deposits? Why or why not?

34. Premiums should be presented as revenue. Net income or comprehensive income would be the same regardless of the way to present premiums, but we believe that it would impair the understanding of users of financial statements if premiums are not presented as revenue, for the following reasons:

- (a) Premiums correspond to sales in other industries, and a trend of annual premiums is one of the most important factors for users to evaluate the insurer's performance.
- (b) Premium-based performance indicators such as loss ratio, expense ratio, and combined ratio are widely recognised by users, and this view is commonly shared among insurers' managements.

Question 19

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

35. Please refer to the answer to Question 20.

Question 20

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

36. We think that it should be discussed in Financial Statements Presentation Project currently in progress, but the form of financial statements for insurers should be determined with due consideration to the characteristics of insurance business. Insurers, in general, conduct the asset-liability management, and the variance in the elements common in assets and liabilities (such as interest rates) should be presented consistently.

Question 21

Do you have other comments on this paper?

37. Insurance Contracts Project is very advanced compared with existing accounting practices for insurance contracts, although other projects seem to adopt measurement attributes based on or derived from current accounting practices. We think this gap is significant. In order for this project to be successful, we would like the Board to pay close attention to providing insurers with a sufficient preparation period and coordinating with related parties, so that the insurers will be well ready to measure insurance liabilities with enough reliability by the time the final standard comes into effect.