



Preliminary Views Field Testing March 13, 2008

One of the recurring themes from the extensive comment letters sent to the IASB on its Insurance Contracts Discussion Paper is that many respondents contend that field-testing is necessary for proper implementation of an accounting standard for insurance contracts. These views can be seen in the Overview of Comments (Agenda Paper 2A) prepared for the February IASB Meeting:

“Many respondents urged the Board to carry out field tests before adopting new accounting approaches.” (Paragraph 45, p.16)

This point is expressed even more strongly in the Summary of Comment Letters on IASB Discussion Paper (To be released this week) prepared by Ernst & Young:

“**Virtually all** respondents call for field testing.” (p.69) (Note. The words “virtually all” are highlighted in red in the E&Y document!)

The Project Plan (Agenda paper 2D) prepared for the February IASB Meeting makes note of the comments received regarding field testing, and suggests plans for field testing as follows:

“Many respondents asked the Board to carry out field tests. At this stage, the staff is considering whether there are opportunities to carry out targeted field testing on specific issues, using information that is already available, or obtainable easily. The timetable does not yet allocate time for the Board to consider reports back from such testing, if any.” (Paragraph 3, p.1-2)

Criteria for field testing are addressed in the Due Process Handbook for the IASB (3/06) as follows:

“Field tests normally require collaboration with interested companies that are willing to be involved in testing the proposed standard, sometimes over an extended period. During field tests, the IASB staff work closely with participating companies in data collection, preparation of financial reports using the proposed standard, and evaluation of the results of the tests.” (Paragraph 101, p.23)

“The IASB recognizes the high costs of field tests, the financial resources and staff arrangements required from the IASB and the participating entities, and the possibility that the tests will delay the timely introduction of new standards. As such costs may exceed the benefits, the IASB expects to conduct field tests in rare circumstances. If the IASB decides to omit this step, it will state its reasons.” (Paragraph 102, p.24)

GNAIE and (we presume) the other respondents who recommend field testing are very much aware of the potentially large commitments of resources that may be required from companies and from the Board. We understand that if field tests are to be conducted, they should be focused on specific issues, with full consideration of both the potential costs and benefits, and

should make use of information that is already available or that is easily obtainable to the extent possible. We are also aware of the Board's stated intention (as quoted above from the Due Process Handbook) to conduct field tests in rare circumstances. However, we believe that the insurance contracts project is one for which efficiently designed field testing is absolutely essential, for the following reasons. If the standard that emerges is anything similar to what is proposed in the Discussion Paper:

- 1) It would require radical changes in accounting for insurance contracts in most of the world.
- 2) Especially for non-life insurance contracts, most companies would have to develop methods, assumptions, and models that are vastly different from those they use today. Some of the changes would also be significant for life insurance contracts (e.g., expanded use of hypothetical market assumptions and of probabilistic modeling).
- 3) There are wide variations in views of dislocations that are likely to result (e.g., whether the proposed standard would result in very substantial reported gains or losses at issue that are likely to be inconsistent with long term expectations of economic results from insurance contracts).
- 4) There are also wide variations (between the Preliminary Views of the Board and the views of many respondents) of the relevance, complexity, costs and benefits of proposed features such as unbundling components of insurance contracts, limiting expected cash flows that could be considered (e.g., those that may be dependent on beneficial policyholder behavior), and consideration of the insurer's credit standing in valuing the liabilities.
- 5) There are particular concerns about how results that are so dependent upon assumptions about hypothetical transactions that do not occur in actual markets could be verified and audited.

We are aware that field testing, even on a targeted basis, is likely to add some time to the development of a global standard for insurance contracts. However, we believe that to proceed with a standard without such testing, without collecting information to assess the validity of concerns such as those listed above, would be a recipe for potential disaster. Based on our reading of the comment letters, we believe that most of the respondents share our concerns, to a large extent. We, and apparently many other respondents, believe that the costs of implementing the proposed measurement would exceed the benefits, that the measurement would be inconsistent with underlying economic values, and therefore would not be relevant and reliable information for users of financial information. We also believe that the measurement proposed in the Discussion Paper would be extremely complex, which would be contrary to the emphasis that bodies such as the Securities and Exchange Commission in the US are putting on simplifying financial reporting.

In addition, concerns about due process for IFRS have been widely reported, such as in the recent (February 5, 2008) report to the European Parliament from its Committee on Economic and Monetary Affairs. If the IASB were to proceed to develop an Exposure Draft and then a standard for insurance contracts without field testing to address the kinds of concerns listed above, we believe that it would receive, and frankly would very much deserve, more criticism of this kind.

We note also that the Trustees of the IASC Foundation have announced a series of reviews of the organization's governance arrangements, to reinforce public accountability and to prepare for the review of the organization's constitution which is scheduled for this year. In view of increased focus on the IASB's due process and governance, we believe it is essential for the Board to address the overwhelming support for field testing expressed in the comment letters it received.

Below, we list a series of topics that we believe are reasonable candidates for field testing. We would like to work with the IASB, its staff, and with other interested parties (including the FASB if it should decide to become part of a joint project with the IASB) to refine appropriate topics and work plans for field testing. We understand that some of the subjects listed below may not qualify for field testing based on further assessment of costs and benefits; but we believe that assessment is essential now to identify where field testing is most needed in advance of an Exposure Draft.

GNAIE believes that field testing is essential to determine whether there are "fatal flaws" in the proposed measurement – i.e., whether there are critical issues that must be addressed and clarified before a standard is released. Results of field testing should be used to assess whether (or the extent to which) the information that is produced: 1) would be useful in making business decisions; 2) would be transparent and understandable (and less complex); and 3) would reliably reflect the economics of the business. We note that several of the topics listed below are inter-related. The most meaningful way to test such inter-related subjects may be to pursue field testing with a small number of entities on the combined effects of several of the changes listed.

Information that is already available, or that could be obtained easily, could be used to supplement field testing of some of the subjects below. Work by other organizations to model accounting for insurance contracts could be relevant and ripe for further development. Possible sources include a recent research report of the Society of Actuaries (on Financial Reporting for Insurance Contracts under Possible Future International Accounting Standards, 1/29/08), continuing work on current estimates and risk margins by the International Actuarial Association (the most recent "working draft" is dated 10/10/07), Quantitative Impact Studies that have been conducted in development of Solvency II (QIS 4 is currently in development), and work by the CFO Forum (e.g., to quantify potential gains at issue based on views in the Discussion Paper).

Field Test Topics Related to the Cash Flows "Building Block"

(Note. We are concerned that cash flow amounts that would be considered in the measurement proposed in the Discussion Paper would be inconsistent with the best estimates of what is

expected, as in the case of hypothetical market assumptions (#3 below), limits on premium payments that may be dependent on beneficial policyholder behavior (#4 below), and consideration of the insurer's own credit standing in ways that would assume that there could be changes in estimates of whether and how much in policy benefits will be paid as they come due (#7 below).)

- 1) Feasibility and cost/benefit of applying the cash flow building block to non-life contracts for which the amount and timing of future cash flows is highly speculative.
- 2) Assess both the practicality of quantifying potential gains and losses at issue, and the relevance and reliability of such information. We note that some observers and some Board members believe that potential gains at inception would be small, while others contend that they could be enormous. The SOA report and the work of the CFO Forum cited above may be useful existing sources of information on the potential size, variability, and reliability of such reported gains.
- 3) Bases for estimating assumptions that market participants would use, which are not observable. It may be easiest to focus on expense assumptions; but inter-relationship between expenses and other assumptions (e.g., contract persistency for life insurance, claim costs for non-life) should also be assessed. Consider whether most companies would have to resort to using entity-specific information as a basis for such assumptions, if market based information proves to be unavailable or not sufficiently relevant.
- 4) Policyholder behavior – Practical issues of identifying (and quantifying, if necessary) policyholder behavior that might be beneficial to the insurer. Identify any situations in which the proper treatment of renewal premiums cannot be determined by looking at the contract terms.
- 5) Unbundling – How to identify contract components that could be measured separately in ways that aren't arbitrary, the cost of separately measuring such components, and the potential benefits and improvement (some would say, if any) in the resulting measurement?
- 6) How to determine when a particular contract ends (and thus determine when to end estimates of future cash flows). In a field test, language for life, health, and property & casualty insurance, as well as investment, contracts from around the world could be collected to determine whether there would be problems in determining when a contract ends. GNAIE believes that criteria it has proposed would effectively determine when an existing contract ends; but (at least) IASB staff believes that such determination would be more difficult in actual practice.
- 7) How to estimate effects of the insurer's "own credit standing", with no observable market, regulatory constraints/prohibitions against settling with policyholders for anything less than

the full contract benefit amounts, and impact of protection mechanisms such as guarantee funds.

- 8) Assess the scope and frequency of stochastic modeling and other probability weighted concepts that would be applied, including cost/benefit considerations and implications for timeliness and reliability of reporting.

Field Test Topics Related to the Discounting “Building Block”

- 9) Feasibility and cost/benefit of applying the discounting building block to non-life contracts for which the amount and timing of future cash flows is highly speculative.
- 10) Clarification of the discount rate to be used, including in situations where market risk free rates aren't available as a starting point (e.g., for very long duration liabilities), government bond rates vs. swap rates, liquidity premiums, and uncertainty of duration and amount of liability cash flows.

Field Test Topics Related to the Margins “Building Block”

- 11) Feasibility and cost/benefit of applying the explicit margins building block to non-life contracts for which the amount and timing of future cash flows is highly speculative.
- 12) Diversity in application of cost of capital – How to calibrate the amount of capital needed, the use of capital over the term of long duration liabilities, and the cost of capital rate? Such calibration, and whether it can be applied consistently and reliably, may be particularly important if the cost of capital becomes a key methodology for estimating risk margins.
- 13) Practicality of estimating risk margins based on the proposed standards – The concept of “margins that market participants would require” is difficult to implement consistently, in view of the general absence of observable markets. As noted above, the continuing work on by the IAA could be a starting point for further development.
- 14) Cost, benefits, and practical implementation issues that must be addressed to quantify service margins as proposed in the Discussion Paper. Would quantification of such margins result in “double counting”, as is indicated in some comment letters?

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