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TO THE ATTENTION OF THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

31 October 2003

COMMENTS ON EXPOSURE DRAFT 5 – INSURANCE CONTRACTS BY CEA (COMITE EUROPEEN DES ASSURANCES)

General Comments

The Comité Européen des Assurances (CEA) representing the European insurance and reinsurance sectors is pleased to comment on Exposure Draft 5 – Insurance Contracts issued publicly on 31 July 2003.

CEA would like to reiterate its support for the principles underpinning the EU-initiated process aiming at a strong, consistent and workable set of accounting standards. Consequently, we are keen to participate actively in the development of the IASB projects.

To prepare our responses to the questions of the Exposure Draft (ED 5), we considered the EFRAG's draft comments on ED 5 – Insurance contracts. Though we refer to this document in our comments to indicate whether we agree or disagree with the views contained therein, our position paper was prepared independently from EFRAG's.

It is not within the scope of this document to provide comments on the tentative conclusions included in the Basis for Conclusions (BC 6 – 8) regarding Phase II. We believe it is premature to issue such comments before having started a comprehensive reflection on Phase II.

In addition, all observations regarding the application of IAS 39 linked to the activities of insurance companies have been integrated in this position paper and will not form part of a separate paper.

CEA values the IASB's initiative to have an interim standard in the absence of a comprehensive final standard (Phase II). This interim standard is to be in place by the 2005 implementation date for the use of International Financial Reporting Standards by companies listed in the EU. However, **CEA is concerned about the timetable** of all the different IASB projects affecting the insurance and reinsurance industries.

Phase I is to represent a transitional standard while the final standard for Phase II is to be developed. We therefore agree that a basic guiding principle for Phase I should be to avoid changes which will have to be reversed by the time Phase II is initiated. However, there is a concern that the Phase I proposals might require significant systems modifications without knowing what the final Phase II model and system requirements will be. This already tight timeframe is complicated by the other successive changes the industry might have to implement:

- End of Sunset clause as of 1st January 2007
- IFRS Phase II
- Performance reporting consistent with Phase II

All major changes should be concentrated into one single point in time to avoid misleading situations for preparers and users of financial statements. Therefore, where there are uncertainties or lack of clarity in Phase I, pragmatic solutions and answers should be found considering the fact that it is an interim standard.

We strongly encourage the Board to make all major changes coincide with the implementation of Phase II insurance contracts along the following approach:

- Phase I: ensure that changes possibly affecting IT systems are kept to the bare minimum;
- Phase II: new model of valuation of insurance contracts which should include a new template (Performance Reporting) with no other intermediary transition (sunset clause) than Phase I

Such an approach would allow the development of high quality standards enhancing transparency and comparability, to which CEA is strongly committed.

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Executive Summary

The main issues in ED 5 addressed by CEA's position paper are summarised hereafter:

1. **Scope** (Question 1, page 8)
Concerning the treatment of the long-term savings contracts not qualifying as insurance contracts, the IASB has recognised that IAS 39 does not address discretionary participating features in some of these contracts issued by insurers. Moreover, IAS 39 does not include all the necessary features to take into account adequately the specificities of other types of contracts not qualifying as insurance contracts and issued by insurers. As a consequence, the IAS 39 requirements lead to several open questions which, until now, have not received adequate answers. Indeed, much of the interpretation relating to the application of IAS 39 has been tailored to banking products – rather than insurance products. This can result in features which are inappropriate for long term investment contracts as sold by insurers. One of the areas of major concern is the proposed introduction of a demand deposit floor to the measurement of financial liabilities. In addition, applying IAS 39 to these contracts will require costly changes to IT systems.

2. **Mismatch issue** (Question 13 page 21)
This issue arises from the fact that during Phase I, different measurement basis will be used for the assets backing insurance liabilities and for the technical liabilities themselves. There are differences throughout the world and particularly in Europe in the measurement of technical liabilities. In some countries, accounting techniques allow the catch-up of part of the volatility created by the valuation of the assets at fair value, whilst in other countries these techniques do not exist. Since the purpose of insurance is to provide benefits or reimbursement for losses, recognition and measurement issues should be addressed first by considering the obligation with its associated liabilities, rather than the assets held to back those liabilities. Therefore, we suggest that assets be valued in a manner consistent with the basis selected to value the liabilities. This would mean to have the option either to follow strictly IAS 39 classification and measurement if the technical liabilities allow catch-up techniques, or to use cost or amortised cost if technical liabilities are valued on a basis conceptually similar to amortised cost.

3. **Reinsurance** (Question 7 page 14)
Certain aspects of the proposed accounting treatment of reinsurance within Phase I would lead to misleading results. Indeed, the proposed accounting treatment introduces piecemeal changes which do not take into account the fact that a reinsurance contract is, in substance, an insurance contract – e.g. prohibition for an entity from setting up an asset in respect of rights under a reinsurance contract that is greater than the premium paid for the contract. Under Phase I, as few changes as possible should be imposed. Therefore, the treatment of all aspects of reinsurance accounting should be addressed under Phase II only. This would also allow reinsurance accounting to be changed consistently with the approach

adopted for direct business in Phase II, thereby avoiding the creation of anomalous results and the need to modify reporting systems solely for Phase I.

4. **Disclosure of fair value of insurance assets and insurance liabilities** (Question 10 page 18)
The requirement to disclose the fair value of insurance liabilities as of 31 December 2006 (and for long-term investment contracts with or without participation features falling under IAS 32 as of 31 December 2005) is not acceptable. Currently, it is clear that there is no common interpretation of the "fair value" concept for insurance contracts. As such, it could be difficult for preparers of financial statements to prepare this information; for auditors to audit an element for which there is no common interpretation; and for the users to understand the information properly. Therefore, in the absence of any clear fair value concept for insurance liabilities, CEA does not support the proposal to require fair value disclosure of insurance contracts as of 31 December 2006 (and for long-term investment contracts with or without participation features falling under IAS 32 as of 31 December 2005). The Board should either remove this requirement entirely from Phase I, or restate that disclosure of the fair value of insurance assets and liabilities will be required only when Phase II Standard is adopted, or when the IASB has concluded on a system or method to calculate fair value.

5. **Other Disclosures** (Question 11 page 18)
CEA generally support the need for adequate disclosure to enhance transparency and comparability of the financial statements. However, such disclosures should be balanced between qualitative and quantitative information. Furthermore, the Board should avoid requiring retrospective data such as for example claims developments as from the date of implementation without a transition period. This transition period is necessary to produce the data, which is not necessarily currently available in the required format.

Some of our main concerns are:

- Additional costs, which outweigh any benefits for users
- Important disclosures obscured by a mass of details
- More details than users want or need
- More guidance needed for certain aspects
- Judgements required that could reduce relevance and reliability of the disclosures
- Commercial sensitivity of information

6. **Temporary exclusion from criteria in IAS 8** (question 4 page 12)

Paragraphs 5 and 6 of IAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors" specify criteria for an entity to use in developing accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in ED 5 would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for insurance contracts and reinsurance contracts (Sunset Clause). The question remains as to what will happen if the hierarchy is reinstated in 2007. To what accounting principles would the hierarchy lead?

Therefore, CEA cannot agree with the limit of 1 January 2007 and proposes to maintain the exemption until completion of Phase II. However, it is crucial for the European insurance industry to have a final, high quality and field-tested standard for Phase II as soon as feasible and ideally for 2007.

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Contents

Question 1 – Scope

(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting by policyholders (paragraphs 2-4 of the draft IFRS and paragraphs BC40-BC51 of the Basis for Conclusions).

The Exposure Draft proposes that the IFRS would not apply to other assets and liabilities of an entity that issues insurance contracts. In particular, it would not apply to:

(i) Assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*.

(ii) Financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts (paragraphs BC115-BC117).

Is this scope appropriate? If not, what changes would you suggest, and why?

(b) The Exposure Draft proposes that weather derivatives should be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract (paragraph C3 of Appendix C of the draft IFRS). Would this be appropriate? If not, why not?

CEA Comments on Scope

Question 1 a (i) refers to the requirement that assets held to back insurance contracts must be accounted for using IAS 39 Financial Instruments: Recognition and Measurement (and IAS 40 Investment Property). This requirement leads to some important comments which are further discussed in Question 13.

We do not agree with the IASB proposal referred to in question 1 a (ii). Indeed, we have concerns about the accounting for financial instruments issued by insurers that fail to meet the definition of an insurance contract. We support the IASB in striving to achieve consistency of accounting for similar products issued by different type of entities. However, we are concerned that parallels may not exist for many financial products issued by insurers and that there will be a continuing lack of consistency between entities. Indeed, IAS 39 was not specifically designed for the measurement of long-term savings contracts. Therefore, it is understandable that the principles and guidance available to insurers on the measurement of such contracts are insufficient. An example of class of contracts which causes problems is unit linked business. For this class of business the industry is experiencing difficulty on reaching a view as to how such contracts should be accounted for under IAS 39. One of the major areas of concern relates to the proposed introduction of a demand deposit floor to the measurement of financial liabilities. CEA believe that the IASB objective for Phase II will be to try to achieve consistency in accounting for individual products across entities, but should also strive to ensure that within an entity, there are consistent accounting policies available for dealing with similar products falling on each side of the insurance contract and investment product divide. CEA therefore believes that for Phase I, pragmatic solutions may be necessary in those circumstances where IAS 39 does not provide adequate solutions for valuation and accounting for such products. This point is further discussed in Question 13.

Question 1 b concerning weather derivatives – we have no specific comments on the Board proposal.

Question 2 – Definition of an Insurance Contract

The draft IFRS defines an insurance contract as a ‘contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary’ (Appendices A and B of the draft IFRS, paragraphs BC10-BC39 of the Basis for Conclusions and IG Example 1 in the draft Implementation Guidance).

Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?

CEA Comments on the Definition of insurance contracts

We broadly support the definition as tentatively agreed by the Board and welcome the effort of clarification provided by the implementation guidance (IG). However, we are concerned, certainly in the light of the Implementation Guidance, that there may be a wide range of interpretations of the definition leading to a different accounting basis for similar contracts but also to the exclusion of the certain contracts which clearly are “insurance contracts”.

This problem may be due to the fact that the IG appears to be worded in a more restrictive way than the main body of the draft standard. Indeed, the flexibility contained in the main body of the standard is important and we are concerned that the appendix might be overly restrictive in its application of the main standard.

For example, we disagree with the fact that, in the Implementation Guidance, the contract type 1.4 (IG2 Example 1) “pure endowment” is not considered as an insurance contract unless there is a significant probability that the holder will not survive until the specified date. Indeed, such policies make no payment unless the policyholder survives to the maturity of the policy. The pricing of such a policy is made based on the assumption that a proportion of policyholders will fail to survive until the maturity of the policy. If a larger than expected proportion does survive until maturity of the policy, then the insurance company will make a significant loss. On the contrary, if a smaller proportion survives the company will make a significant profit. This is clearly a contract with an insurance nature. This understanding is also supported by paragraph B17 d) of ED5 relative to life-contingent annuities and pensions.

To address this specific issue, the implementation guidance could specify that the definition also covers cases where the amount or timing of the benefits under the policy is life contingent.

CEA strongly believes that, for comparability and transparency reasons, it is of outmost importance that the definition be interpreted as accurately and as consistently as possible.

We see it as essential that the Board clarify in the IFRS the examples contained in the Implementation Guidance are non-exhaustive and are not part of the draft IFRS – and therefore not mandatory.

Question 3 – Embedded derivatives

(a) IAS 39 *Financial Instruments: Recognition and Measurement* requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:

   (i) Meets the definition of an insurance contract within the scope of the draft IFRS; or

   (ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

   However, an insurer would still be required to separate, and measure at fair value:

   (i) A put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and

   (ii) An option to surrender a financial instrument that is not an insurance contract.

   (paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)

   Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). Is it appropriate to exempt these embedded derivatives from fair value measurement in phase I of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase I?

(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs IG54-IG58 of the draft Implementation Guidance). Are these proposed disclosures adequate? If not, what changes would you suggest, and why?

(d) Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?

CEA Comments on embedded derivatives

Question 3 (a) and (b)

The Board contemplates two exceptions to the bifurcation of derivatives embedded in insurance contracts:

- if the derivative meets the definition of an insurance contract within the scope of the draft IFRS;
- if the derivative is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

In principle, we support the view that all embedded derivatives should be reflected at fair value. However, we also support the Board's view to apply the current principles under IAS 39 and agree that because of significant implementation problems, the embedded derivatives which meet the definition of an insurance contract need not be separated. This means that during Phase I, insurers need not recognise some potentially large exposures to items such as guaranteed annuity options and guaranteed minimum death benefits. These items create risks that many regard as predominantly financial, but because the payout is contingent on an event that creates significant insurance risk, these embedded derivatives meet the definition of an insurance contract.

In addition, we suggest that there should be a third exception, which would be for derivatives embedded in unit linked contracts.

Furthermore, we would like to stress the fact that the risk linked to the embedded derivatives included in insurance contracts will be captured by the loss recognition test as described in paragraphs 11 to 13 of ED 5 which will ensure that the level of provisions is adequate.

(c) Although not clearly stated in the proposed IFRS, paragraph IG58 of the Draft Implementation Guidance indicates that disclosures about embedded derivatives retained in the host contract could require sensitivity analysis on interest and market risks, the fair value of embedded derivatives, and information about the levels when the exposures begin to have a material effect on the fair value of insurance liabilities. CEA foresees potential problems with this guidance as the Board has not currently determined any models or systems to calculate the fair value of an insurance liability. As such, disclosures regarding the fair value of the embedded derivatives (considered as insurance contracts) and the effects of the fair value of the insurance liabilities will be arbitrary and possibly misleading to users of the financial statements.

Without a consistent calculation of insurance liabilities, reliable comparability of these financial statement disclosures will be impossible. In order to prevent misinterpretation, the fair value disclosures should not be required until the Board has thoroughly addressed the Phase II measurement for insurance contracts.

(d) We did not identify other embedded derivatives which should be exempted from the IAS 39 requirements.

Question 4 – Temporary exclusion from criteria in IAS 8

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for:

(i) Insurance contracts (including reinsurance contracts) that it issues; and

(ii) Reinsurance contracts that it holds.

(paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions).

Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?

(b) Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:

(i) eliminate catastrophe and equalisation provisions.

(ii) Require a loss recognition test if no such test exists under an insurer's existing accounting policies.

(iii) Require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC58-BC75 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you propose, and why?

CEA Comments on the temporary exclusion from criteria in IAS 8

(a) We consider that the exemption is appropriate given the current state of the Board's development of Phase II of the project on insurance contracts. However, we would like to emphasise that the Board decided, because of the exceptional situation, to specify a limited life for the exemption. Indeed, the exemption should apply only for accounting periods beginning before 1 January 2007. We fully understand and concur with the objective of the Board to set a deadline for the completion of Phase II. However, the question remains as to what will happen if the hierarchy is reinstated in 2007. To what accounting principles would the hierarchy lead? It is therefore paramount that the Phase II standard be finalised on schedule, to prevent the industry being unfairly penalised. Because of these uncertainties, CEA does not agree with the limit of 1 January 2007 included in paragraph BC57 of the Basis for Conclusions, as CEA foresees important problems in the event that Phase II is delayed.

Indeed, the exposure draft does not contain guidance as to what extent the "hierarchy" will override Phase I provisions. As an example, Phase I of the insurance contracts project explicitly permits insurers to measure insurance liabilities on an undiscounted basis - which the Board has stated to be inconsistent with the Framework provisions. Will the expiration of the IAS 8 exemption revoke this privilege? To avoid these uncertainties, CEA proposes to maintain the exemption until completion of Phase II. However, it is strategic for the insurance industry to have a final, high quality and field-tested standard for Phase II on insurance contracts as soon as feasible – ideally for 2007.

(b) We consider the proposals in (i), (ii) and (iii) as acceptable in the context of the IAS Framework definitions. However, our concern is that certain elements of current practice reflecting the long-term feature of insurance business - most importantly catastrophe and equalisation reserves - are already categorically rejected in Phase I. As long as there is no clear view on a measurement method reflecting correctly the long-term nature of insurance business, changes resulting in artificial perturbations should be avoided. The major target of Phase I should be to keep changes to a minimum and not disturb the economics of the accounting entries.

Question 5 – Changes in accounting policies

The draft IFRS:

(a) Proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).

(b) proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss (paragraph 35 of the draft IFRS).

Are these proposals appropriate? If not, what changes would you propose and why?

CEA Comments on the Changes in accounting policies

We have no specific comments regarding these proposals.

Question 6 – Unbundling

The draft IFRS proposes that an insurer should unbundle (i.e. account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet (paragraphs 7 and 8 of the draft IFRS, paragraphs BC30-BC37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).

(a) Is unbundling appropriate and feasible in these cases? If not, what changes would you propose and why?
(b) Should unbundling be required in any other cases? If so, when and why?
(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

CEA Comments on unbundling

(a) In principle we are opposed to unbundling as most of the products are comprehensive packages and this treatment would not reflect their economical reality. Indeed, the design, pricing and management of these products are done as a package and the accounting unbundling would not give an adequate view of the product valuation. Therefore, CEA welcomes the current Board proposals as stated in paragraph 7 of ED 5 and considers it as an improvement compared to the previous positions. In ED 5, unbundling is only required when the product design and accounting treatment lead to the non recognition of obligations to repay amounts received under the insurance contract, or rights to recover amounts paid under the insurance contracts.

Our understanding is that unbundling is for example required in the case of financial reinsurance contracts when a failure to unbundle could lead to the complete omission from the balance sheet of material contractual rights and obligations.

When this is the case, we consider that, to avoid misinterpretation, the criterion to determine if unbundling is required should be that "the cash flows of the insurance components and the investment component do not interact" and not as stated in ED 5 paragraph 7 "if the cash flows from the insurance component do not affect the cash flows from the deposit component".

(b) We do not believe that unbundling is required in other cases. We further agree on the fact that surrender values should not be unbundled from traditional life contracts.

Question 7 – Reinsurance

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).

Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?

CEA Comments on reinsurance

Certain aspects of the proposed accounting treatment for Phase I as detailed in ED 5 will lead to misleading results (e.g. the application of paragraph 18 which concerns the use of the net amount paid to determine the right of the cedant under the reinsurance contract). Indeed, the proposed accounting treatment introduces piecemeal changes in the reinsurance accounting schemes. These changes do not respect the fact that a reinsurance contract is in substance an insurance contract for which under Phase I, as few changes as possible should be imposed. This remark can be illustrated by the following points:

- paragraph 18 (d) of ED 5 states: “if the net amounts paid by the cedant are less than the carrying amount of the related portion of its liability under the direct insurance contract (for example, because that liability is measured on an undiscounted basis), the cedant shall recognise that difference as income on a systematic and rational basis over the period of the underlying risk exposure”.

  This requirement can be illustrated by the following example:

  Direct premium: EUR 200,000
  Prudent technical reserve: EUR 210,000
  Reinsurance ceded: 50% of the risk for a premium of EUR 100,000
  Reinsurance asset under ED 5: EUR 100,000 with EUR 5,000 to be spread over the life of the contract
  Reinsurance asset under current GAAP: EUR 105,000, which corresponds to the portion of the reinsurer within the technical liabilities.

  Concerning this point, we fully concur with the explanation contained in EFRAG’s draft comment letter, which is that currently, in many existing GAAPs for insurance, the insurer’s liability for direct insurance contracts is based on a prudent assessment of the future claim costs. This approach leads to losses being reported at outset. If a reinsurance treaty subsequently takes a proportion of that liability and the cedant accounts for that treaty on a consistent basis, then the loss at outset is partially reversed on the same proportionate basis.

  The current ED 5 proposal will lead to the loss at outset on direct business being recognised but not the subsequent partial reversal if the business is reinsured. This will lead to the creation of losses at the issue of the contract, which do not reflect the economics of the transaction and the increase of the earnings in subsequent periods for reinsured contracts.

  As supplemental remark, the proposed spreading of profits for reinsurance contracts over future periods will represents system changes which will only be required for Phase I.

  As one of the objectives of the Board is to give adequate information to the users of financial statements, in this context the amounts recorded as a consequence of these reinsurance transactions, this information could be disclosed in the notes to the financial statements. However, if the companies systems are not designed to isolate these amounts this will anyway require system changes.

- Paragraph 19 of ED 5 mentions that "a cedant shall apply IAS 36 Impairment of assets to its rights under a reinsurance contract".

  This requirement is a change compared to current accounting policies adopted by European insurance companies. In general, for property and casualty business, claims liabilities are currently not discounted and reinsurance recoveries are measured on a consistent basis reflecting insurer's rights to recover in full the matching liability, by means of the reinsurance arrangement, upon settlement of the claim.

  The impairment test for reinsurance as stated in ED 5 appears to be based around the IAS 36 test. This would require a discounting of reinsurance assets, regardless of whether the related gross provisions are discounted or not. We consider that a better impairment test for reinsurance assets would be an IAS 39 impairment test, treating the assets as financial receivables, focusing on the default risk. This is already the current practice by insurance companies.

For the above reasons, we recommend in general that the treatment of all aspects of reinsurance accounting be addressed under Phase II and not Phase I. This would allow reinsurance accounting to be changed consistently with the approach adopted for direct business in Phase II, thereby avoiding the creation of anomalous results and the need to create financial IT systems solely for Phase I.

Question 8 – Insurance contracts acquired in a business combination

IAS 22 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 *Business Combinations* proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

(a) A liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and

(b) An intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. Its subsequent measurement would need to be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.

The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you suggest and why?

CEA Comments on Insurance contracts acquired in a business combination

We have no specific comments regarding this proposal.

However we would like to highlight the fact that this not only concerns insurance contracts but also other contracts covered by ED 5 such as investment contracts with participating features.

Question 9 – Discretionary participation features

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.

Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?

CEA Comments on discretionary participation features

We support the temporary exemption for contracts with discretionary participating features as an interim measure until Phase II is implemented and we agree that the unallocated surplus arising from the discretionary participation feature shall be classified either as liability or equity. We concur with the fact that ED 5 as an interim standard does not specify how an issuer determines whether the unallocated surplus is liability or equity.

However, we request that the Board clarify whether investment contracts containing discretionary participation features are exempted from IAS 39 (other than the requirements that are stated in paragraph 25 of ED 5) and clarify that the revenue recognition of such contracts should follow local GAAP during Phase I.

Furthermore, we do not believe that it is appropriate to require the fair value disclosure of financial instruments with discretionary participating features as the treatment of such features is unclear under IAS 39 as described in BC 104.

We would also like clarification on the fact that the re-evaluation at fair value of owner-occupied properties linked to participating contracts can also be considered as unallocated surplus.

Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).

Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?

CEA Comments on the disclosure of the fair value of insurance assets and insurance liabilities

CEA does not support the current proposal to begin requiring fair value disclosure of insurance contracts as of 31 December 2006. The Board should either remove this requirement entirely from Phase I, or restate the requirement to indicate that whenever Phase II is adopted, or when the IASB has concluded on a system or method to calculate fair value, disclosure of the fair value of insurance assets and liabilities will be required. Until then, CEA foresees important problems.

Currently, it is clear that there is no common interpretation of the “fair value” concept for technical liabilities, as it is not well developed or defined. As such, it is difficult for preparers of financial statements to prepare this information and it will also be difficult for auditors to audit the required disclosures. Until a well understood measure of fair value for insurance contracts has been developed and agreed, CEA considers that any mandatory disclosure would not meet the criteria of relevance and reliability (see IAS Framework).

As mentioned by EFRAG in its draft comment letter, one direction the Board could envisage on a voluntary basis would be the disclosure of value-based information (e.g. embedded value) including information about the key assumptions and the methodology used to calculate those values.

In addition, there is also a disclosure issue regarding contracts not meeting the definition of insurance contracts (including contracts with participation features) and which therefore fall within the scope of IAS 32. Indeed, this latter standard imposes the disclosure at fair value of those contracts by 31 December 2005. This would be especially problematic in the case of contracts which are measured at amortised cost and for which the interpretation of the fair value concept is still not precisely defined.

Question 11 – Other disclosures

(a) The Exposure Draft proposes requirements for disclosures about the amounts in the insurer’s financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of the draft Implementation Guidance).

Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.

To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.

(b) The proposed disclosures are framed as high level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements.

Is this approach appropriate? If not, what changes would you suggest, and why?

(c) As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS (paragraphs 34, BC134 and BC135).

Should any changes be made to this transitional relief? If so, what changes and why?

CEA Comments on other disclosures

(a), (b) and (c)

Overall, we would generally support the need for disclosure provided that such disclosures are balanced between qualitative and quantitative information. It is also to be noted that some data will be handled at local level in different manners during Phase I. The consolidation of this data can be questioned from a point of view of meaningfulness and therefore usefulness for the end user. For example, the disclosure of claims development (BC 134) and especially that of volatile business is certainly relevant information. However, the need to go back 5 years is an onerous requirement. A prospective basis should be permitted in order to build up claims development information over time. This will enable companies to alter systems to collect the required information for the future and avoid costly work to recreate coherent historic data.

For the above-mentioned reasons, we view the disclosure requirements as one of the major issues in ED 5 that must be addressed. Some of our concerns can be summarised as follows:

(1) Additional cost which outweighs any benefits for users
(2) More details than the users want or need
(3) Important disclosures obscured by a mass of details
(4) More guidance needed for certain aspects
(5) Judgements required that could reduce relevance and reliability of the disclosures
(6) Commercial sensitivity

Some specific examples are given below with an indication of which of the above categories applies to them:

- Paragraphs 29 (b) requirement for disclosure of terms and conditions of material insurance contracts **(1)** and **(2)**
- Paragraph 29 (c) disclosure of insurance risk **(6)**
- Disclosure of insurance liabilities and reinsurance recoveries based on estimates of future cash flows (IG 39) **(1)** , **(2) and (6)**
- Need to disclose whether lapse behaviour sensitive to interest rates (IG 51) **(5)**
- Sensitivity analysis (IG 41 – 43) **(4)** and **(5)**
- Disclosure of policies for accepting and managing risk (IG 37) **(6)**
- Disclosure of levels at which guarantees of market prices and interest rates are likely to alter insurers' cash flow significantly (IG 38) (**6** – could reveal insurers' investment strategy and hedging position)

We support principal based standards and so welcome the general guidance within paragraph 26 – 29 on disclosure, subject to our comments above. However, we consider that the status of the Implementation Guidance (IG 7 to IG 59) is unclear and we believe that the Board should explicitly state within the standard that the implementation guidance is a non-exhaustive list for example purposes and that compliance with it is not mandatory.

Question 12 – Financial Guarantees

The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS 39 *Financial Instruments: Recognition and Measurement* to a financial guarantee that it gives to the transferee in connection with the transfer (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or liabilities.

Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

CEA Comments on Financial Guarantees

We concur with the EFRAG draft comment letter, which states: "We agree with the Board's proposal that provides a clear distinction between financial guarantees given by a transferor of non-financial assets or liabilities and a credit insurance given by a credit insurer. As a result, the genuine activities of credit insurance, which meets the definition of insurance, will be covered by the proposed Standard on Insurance Contracts and therefore will be treated as other insurance contracts. " We welcome the position taken by the Board concerning insurance against credit risk.

Question 13 – Other comments

Do you have any other Comments on the Exposure Draft and Implementation Guidance?

CEA Comments on the mismatch issue - Measurement basis for the assets backing the insurance liabilities

CEA disagrees with the decision not to include an optional specific rule for assets backing insurance liabilities within Phase I Exposure Draft.

As noted by the Board in paragraph BC 110 of the Basis for Conclusions, using a different measurement basis for insurance assets (IAS 39) and liabilities (IFRS Insurance Contracts – Phase I) will result in volatility in insurers' equity. To summarise the issue, as from 2005 the application of IAS/IFRS will be mandatory. As a consequence on the one hand, insurance companies will be valuing their assets according to IAS 39, essentially based on a fair value approach. On the other hand, until the IASB produces a Phase II standard on insurance contracts, technical liabilities will largely be measured under national GAAP, which in many cases do not reflect current market rates and, more importantly, are quite different throughout Europe. The key issue is the existence in some countries of catch-up techniques for the volatility arising from the valuation of assets at fair value – and the absence thereof in other countries. Because of this, for countries where catch-up techniques are not allowed under national GAAP, this would create an "artificial volatility" within equity. For the companies which will be in this situation, even under a perfect matching assumption, movements in equity will occur solely due to the different measurement basis.

However, even with this insight, the Board still concludes that the benefits of altering the current method of accounting for assets backing insurance liabilities during the Phase I project could not be justified by the effects of a possible mismatch in the financial statements.

CEA considers that to ensure consistent treatment, the valuation method for the assets backing technical liabilities should take into account the method used to value those liabilities. This basic principle should always be followed when discussing valuation of insurance business.

It is important to note that the impact of this mismatch may be significant, as explained in an example quoted in the EFRAG draft comment paper (see page 14) and illustrated in the report "Joint Research Project by the American Council of Life Insurers (ACLI) and the International Actuarial Association (IAA)" dated 3 June 2003 and completed by a "Supplement to the Second Report of the ACLI – IAA Research Project" dated 11 August 2003. Whilst we do not endorse the report's comments in their entirety, we believe that the examples provide a good illustration of the potential impact that interest changes will have on equity if the mismatch is allowed to remain.

If the fair value of assets is introduced without taking into account the way the liability side is valued, the presentation of equity will depend on the company's localisation and on the used GAAP. CEA is convinced that this situation will bring a lot of confusion and misinterpretation for the users of financial statements (press, supervisors, policyholders, shareholders, etc.). This misunderstanding could lead users to make wrong economical decisions.

Equity as well as the income statement result are important elements for the understanding of financial statements. This is also confirmed by the Board in the "performance reporting" project. A system whereby similar circumstances appear differently in equity does not contribute to enhance comparability and transparency.

CEA is convinced that the situation resulting from the current Board's proposals would certainly not enhance transparency and comparability for the users. Indeed, some countries which have adopted a fair value approach on the asset side have done so on the basis of the valuation methods for technical liabilities. Those countries allowed for accounting techniques, such as provisions called "future fund for appropriation", or like in Denmark, for the use of a valuation close to a fair value concept. In this last case, the development of the valuation method required years of analysis by the industry and the financial authorities. Also, US GAAP has specific accounting techniques - "shadow accounting" - which allow to take into account the fact that the assets are fair valued. In addition, it is important to stress the fact that the US situation is quite different from the European situation, as the Phase I IRFS for insurance contracts will apply to a more diverse range of insurance contract types than those found in the US. Furthermore, the range of local accounting policies used to value technical liabilities is also much broader.

In its draft comment paper, EFRAG is proposing to resolve the mismatch issue by a very restricted relaxation of the tainting rules that constrain the held-to-maturity category within IAS 39. We only partially concur with this proposal for the following reasons:

- It is only a partial solution
- To represent a real solution to the problem, any relaxation of the criteria has to be workable to ensure that the specific issues raised under Phase I are addressed.

Another option which has been discussed is to adjust the discount rate used in the valuation of technical liabilities. Such an adjustment would not be in line with many of the current local accounting policies that would continue to be applied for insurance contracts liabilities and there is no current guidance on how such an adjusted discount rate should be determined. Furthermore, this adjustment would have limited impact on contracts with discretionary participation features where part of the discretionary element has not been reflected in the measurement of the liabilities. Moreover, adjusting through discount rate with such a short period of implementation would cause serious system issues.

Because of the importance of the impact described above and to guarantee the relevance of the presentation of the financial statements, the following proposed approach should be considered: the creation within Phase I of a specific treatment for assets backing insurance liabilities. Those assets should comply with the requirements of IAS 39 for the following points:

- Initial measurement of financial assets
- Impairment and uncollectability of financial assets
- Hedge accounting
- Disclosures
- Embedded derivatives to be bifurcated

However, concerning the subsequent measurement of those assets the insurers should have the option either to follow strictly IAS 39 classification and measurement if the technical liabilities allowed catch-up techniques, or to use the amortised cost method if the technical liabilities are valued on a basis conceptually similar to an amortised cost basis. Concerning the creation within Phase I of a specific category of assets, two possibilities could be envisaged:

- The optional creation, within the "Phase I standard", of a specific category of assets for investments backing technical liabilities. This specific category should concern all the assets backing technical liabilities and it should be determined based on the assets authorised by local regulation. All the assets pertaining to this category would be measured based on current local GAAP. No cherry picking would be allowed. This approach would fully respect the principle to derive the assets valuation from the valuation of technical liabilities, which is essential with regards to the business fundamentals.
- The optional creation within the "Phase I standard" of a specific category of assets for the bonds backing technical liabilities. Those bonds would be valued at amortised cost. Cherry picking would also be prevented and the entire bonds portfolio would be valued at amortised cost if this option were chosen by the company.

In order to avoid the mismatch for entities already using current market rates on the liability side, we consider that there should be an option to value property held by insurance companies at fair value or at cost depending on the liabilities they back.

CEA comments on long-term savings contracts not qualifying as insurance contracts

We expect that a number of long term contracts currently issued by insurers will not qualify as insurance contracts under the definition in ED 5, and therefore will need to be accounted for as financial instruments under IAS 39. This will lead during Phase I to some contracts being valued under IAS 39 and others under the Phase I IFRS. This will also probably lead to inconsistencies between insurers in the interpretation of IAS 39 resulting from the absence of clear guidance relating to certain specific features of these contracts.

Apart from the points mentioned above, there are some conceptual and practical concerns which call into question whether it would be appropriate and feasible to apply IAS 39 to some contracts issued by insurance undertakings (in particular unit linked contracts) from 1 January 2005. These are set out in more detail below.

Our principal concerns can be summarised as follows:

- The revised IAS 39 provides companies with the options to value liabilities at amortised cost or at fair value. Both methods lead to several open questions due to the fact that the standard is not sufficiently addressing the factors related to long-term savings contracts not qualifying as insurance contracts.

- Especially, how should acquisition costs be treated under both methods?

Amortised cost valuation

According to our understanding, the amortised cost model in IAS 39 was primarily designed to account for contracts that involve deposits and borrowings on which interest is paid or received. Investment contracts issued by insurers typically contain features that are not addressed in IAS 39 (e.g. significant transaction costs, annual management charges, renewal and surrender options etc.). Although the revised IAS 39 will provide some clarification of the treatment of these features under the amortised cost model and does allow the implicit deferral of some transaction costs, its application will, in practice, be extremely complex and open to different interpretations. For example, the following points do not have a clear answer:

- Which transaction costs should be deducted?
- How do you estimate the final maturity value, for example does this take into account future surrenders?
- How do you account for surrender penalties or investment guarantees?

Fair value

With this option, the following points have to be taken into consideration and do not have answers:

- No clear interpretation of the fair value concept for the liabilities linked to this type of products
- The application of a “deposit floor” - as stated in ED 5 – Basis for Conclusions paragraph 117e. Paragraph BC 115 to BC 117 discuss some aspects of the application of IAS 39 to long term investment contracts, noting in particular in BC 116 the “long maturities, recurring premiums and high initial transaction costs” that are features of these plans and that are less common in other financial investments. However, we note that the subsequent discussion of the fair value of these investment contracts, notably BC 117e, gives no recognition to these features and, instead, overrides the “expected surrender pattern” to impose a minimum liability (sometimes referred to as a demand deposit floor) equal

to the amount available on demand to the individual policyholder. We are concerned that the requirement of a demand deposit floor on the fair value seriously distorts the reporting of the economic operations of insurers. It does not reflect in any ways the observed values at which contracts are traded between third parties.

Deferred acquisition costs

Where liabilities are measured at amortised cost, IAS 39 will allow deferral of acquisition costs implicitly. Where fair value measurement is used, it may not be permissible to achieve an equivalent of deferral by recognising future annual management fees as an intangible asset. This is the result of paragraph 117e referred to above, which states: "IAS 38 Intangible assets apply to intangible assets, if any, associated with investment contracts. In practice, internally generated intangible assets associated with those contracts are unlikely to qualify for recognition as assets under IAS 38."

It is unclear why the treatment of acquisition costs should vary according to which liability valuation method is used. There could also be variations in practice between contracts falling under IAS 39 and those covered by ED 5 in the treatment of acquisition costs.

Possible way to resolve part of the issue

The right to service a financial instrument has a value to the provider of the service, providing that the service fee received covers all related costs (otherwise the right to service constitutes a liability to the company). The same goes for the right to service many for the long-term savings contracts not qualifying as insurance contracts. There are two possible accounting techniques to mirror this. Either by capitalising related transactions costs deferring them over the lifetime of the corresponding service fees, which is made in current insurance GAAP, or by taking the related transaction costs implicitly into consideration when measuring the value of the liabilities. One analogy of the latter can be made with the proposed amendments of IAS 39 where in the suggested new paragraph 43 it is suggested that; If an entity transfers all or a portion of a financial asset and retains the right to service the financial asset for a fee, it shall recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognised for the servicing right at an amount determined on the basis of an allocation of the consideration received in accordance with paragraph 47.

Concerning the accounting model for these types of contracts based on future cash flows, we suggest as a first alternative that when IASB ultimately finalises the amendments to IAS 39, paragraph BC 117e in ED 5 should be deleted. The paragraph should not be included in the final standards or implementation guidance. Instead the guidance should be amended to reflect that the right to service these contracts constitutes an asset to the company similar to the assets (or if related costs exceed the future service fees – liabilities) accounted for according to the suggested new wordings of p 43 in IAS 39.

As a supplemental change, we propose wordings in the implementation guidance allowing the treatment of acquisition costs (i.e. treatment in a deferral and matching model for long-term savings contracts not qualifying as insurance contracts) that are basically the same as those of many other industries based on the arguments developed below.

An insurer typically earns fees on its unit-linked investment contracts over the term of the contracts. These fees are designed to recover both transaction costs and maintenance costs (including administration and investment management costs), and to provide a profit for the insurer. Both the transaction costs and maintenance costs associated with these investment contracts tend to be significantly higher than the similar costs for deposit type investment contracts. The additional costs arise because the servicing element is a significant component of these investment contracts. We believe that the servicing element could be accounted for separately from the financial instrument.

The measurement of the servicing element, comprising the transaction costs and all fees earned (and any maintenance costs) would then fall within the scope of IAS 18 Revenue. The measurement of the financial instrument, which comprises a deposit component and an equity-linked embedded derivative, would fall within the scope of IAS 39.

Although IAS 18 does not specifically deal with the recognition of costs, paragraph 21 of IAS 18 states that the requirements of IAS 11 Construction Contracts are also generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services. IAS 11 requires contract revenue and contract costs to be recognised as revenue and expenses by reference to the stage of completion of the contract.

Paragraph 21 of IAS 11 requires costs that relate directly to a contract and which are incurred in securing the contract to be included as part of the contract costs. We believe that this could be applied to investment contracts as well.

Paragraph 27 of IAS 11 permits costs incurred that relate to future contract activity to be recognised as an asset. We believe that this would allow costs incurred in securing an investment contract (i.e. transaction costs) to be deferred and spread over the estimated life of the contract. In addition, we could mention IAS 17 amendments for the spread of transaction costs over the life of leases.

We do not envisage that this requires any changes to be made to existing standards. IAS 11 does not prescribe a basis that must be used to determine the stage of completion of a contract. The overriding principle is to produce a financial statement that measures the true value of the contracts.

We suggest that fees should be recognised when earned, and that transaction costs should be matched with fees earned and estimates of future fees to be earned and that maintenance costs should be recognised when incurred. This would enable profits to emerge on a basis that more closely represents the economics of the contracts.

Conclusion for the long-term savings contracts not qualifying as insurance contracts

Considering the fact that for Phase I, the IASB has not yet concluded on how fair values of insurance contracts should be established in the absence of liquid markets, we consider it as highly questionable to address the measurement issue of investment contracts (i.e. contracts that in some cases actually contain insurance risk, but not enough to qualify as insurance contracts for accounting purposes) already in Phase 1. Since there should be an underlying assumption that the measurement principles used for insurance contracts and investment contracts should produce approximately the same accounting/measurement answers for contracts with similar risk characteristics, but where the contracts may fall on different sides of the dividing line of "significant risk transfer", there is an obvious risk that insurers will have to make changes in accounting policies for investment contracts in Phase I that will need to be reversed in connection with the implementation of the Phase II standard.

Furthermore, the change from a "form-over-substance" regime in present EU Insurance Accounting GAAP to a "substance-over-form" accounting regime according to IAS, will constitute a major change from a theoretical perspective for European insurers, but will also have practical implications that are considerable both in numbers and in complexity. From insurers' perspective, it does not make sense to make this kind of drastic changes in two steps. A two-step approach as being proposed by the board will cause great confusion both internally and to users of insurers financial statements. Since the dividing line between significant and insignificant insurance risk transfer will be very thin and interpreted in different ways by different insurers at least in the short term, it becomes even more inappropriate to make radical accounting changes to some contracts and not to some others.

We believe that consistent accounting principles should apply to the common features of contracts issued by insurers irrespective of whether or not they meet the IASB definition of an insurance contract. Accordingly, it would be preferable that no change be required to the accounting of such contracts falling outside the definition until Phase II is agreed.

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