**ED 5 'Insurance Contracts'**

**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?*

**Response**

**a)** The proposed approach would cause a mismatch between assets and liabilities, since assets measured under IAS 39 (fair value) will not match insurance liabilities (local GAAP). We do not believe that this is appropriate in view of the fact that, in many cases, the assets and liabilities are economically matched. This approach will potentially result in significant distortions in the financial statements which would not be representative of the underlying performance of the business. There is also a lack of clear guidance on how insurance liabilities should be measured, under either a fair value or amortised cost approach.

This approach also raises issues of consistency of accounting treatment, as certain long term financial contracts would be accounted for under IAS 39 and others under ED 5. Further, IAS 39 currently does not include all necessary features to take account of long term financial contracts correctly, and allows different interpretations and options which may result in inconsistent approaches. We consider that all contracts having the legal definition of insurance should remain under local GAAP until a consistent approach is developed for all contracts in Phase II.

We are also concerned that the approach proposed will create less reliable, less relevant and more volatile results. There is a risk that a new measurement will make many contracts appear unprofitable or require an increase in cost of capital.

**b)** We agree with the IASB's proposed approach.

**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?*

**Response** Whilst we support the definition detailed in ED 5, we believe that there is still too much scope for differences in interpretation as to whether contracts should be classified as insurance or investment. The IASB should consider the provision of clearer implementation guidance including examples, particularly for marginal cases.

**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?*

**Response**

a) We support the IASB's view that embedded derivatives should be at fair value, as this is in line with the approach proposed for Phase II. However, we believe the need to identify and separate out embedded derivatives may only be a temporary requirement given that the Phase II proposals may require the whole contract to be fair valued. Therefore, to avoid significant time and effort in Phase I, we would propose that the Board consider an exemption for insurance contracts and instead place reliance on the loss recognition test to ensure that the level of provisions is adequate in Phase I.

b) We agree with the IASB's proposals and welcome the Board's decision that GAOs and GMDBs should be regarded as having insurance features which would not require them to be fair valued in Phase I. We agree, however, that note disclosure should still be required, detailing their existence and potential impact.

c) It appears that ED 5 will require fair value disclosures and sensitivities in respect of embedded derivatives not separated out from their host contracts. We would recommend that these disclosures are eliminated from the requirements until all Phase II measurement issues have been fully addressed.

d) We do not believe that any other embedded derivatives should be exempted.

**<u>Question 4 – Temporary exclusion from criteria in IAS 8</u>**

*(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?*

**Response**

a) We agree with the proposed exemption from applying the hierarchy detailed in IAS 8, but we disagree with the inclusion of the sunset clause as it makes no provision for any delay in the development of Phase II beyond 1 January 2007. We believe that introducing such an element of uncertainty into the likely future accounting requirements in this area is unhelpful. We believe that the sunset and the sunrise should be synchronized; Phase I arrangements should subsist until Phase II is introduced.

b) We agree with the proposals detailed in the draft IFRS, although the IASB should consider providing further guidance in respect of the loss recognition test.

**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?*

**Response**

a) We do not support these proposals and consider that prior to the finalisation of the Phase II proposals, the Board should not seek to restrict changes in accounting policies.

We are also concerned that the requirements of IAS 27, which requires a line-by-line consolidation of subsidiaries, may trigger a change in accounting policy for those bancassurers who currently consolidate the results of their insurance businesses using a single-line, embedded value approach. We consider that a change in accounting policy of this type, which is merely presentational and unrelated to the actual accounting for insurance contracts, should not constitute a change in accounting policy for insurance contracts.

In the event that the Board retains these proposals, we would like clarification from the Board that such a change would not constitute a change in accounting policy for insurance contracts, as provided for in ED 5 BC76-BC88.

In addition, given the uncertainty concerning Phase II, we would like confirmation that if an insurer changes one of its accounting policies, it should not be required to change all its accounting policies.

b) We agree with the IASB's proposed approach, as long as the move to fair value remains optional at this stage.

**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?*

**Response**

a)/b) We do not believe that unbundling of insurance contracts should be required, especially given that the developments of Phase II should eliminate the Board's concerns. If the Board maintains this requirement, this may mean that systems changes will need to be made for Phase I for something which may not be required in Phase II. We believe that this is contrary to one of the Board's objectives for Phase I.

c) We do not feel that it is clear when unbundling should apply, and the lack of guidance means that it is still unclear as to what the practical impact of unbundling will be.

**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?*

**Response** The proposals of the draft IFRS prevent a reinsurance asset from being greater than the premium paid, which will result in inconsistent measurement bases for insurance and reinsurance contracts, and may cause significant problems for the insurance industry. For example, the initial cash flows of premiums are not necessarily reflective of the value of the asset being acquired. We consider it more appropriate to defer reinsurance issues until Phase II, along with the accounting for directly written insurance contracts.

These Phase I proposals would also require significant systems development and would be superseded by the requirements of Phase II, contrary to the Board's objectives 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?*

**Response** Although we agree with the IASB's proposals, we note that IAS 22 (and ED 3, its replacement) does not appear to permit entities that recognise an asset on their balance sheet for the value of the in-force business to include this asset in determining goodwill. We would recommend that ED 3 be amended to specifically refer to this type of asset in the determination of goodwill in a business combination, otherwise the acquirer would not be following the accounting policies of the acquiree.

**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?*

**Response** We request that the Board clarifies whether investment contracts containing discretionary participation features are exempted from IAS 39 (other than those discussed in ED 5) and in particular that the issuer of such contracts should continue to follow its existing accounting policies in relation to revenue recognition. We believe that it is inappropriate to require disclosure of the fair value of these contracts, as the treatment of discretionary participating features is unclear under IAS 39 and the fair value requirements for long-term investment contracts remain ill-defined.

**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?*

**Response** We consider that the requirement to disclosure the fair value of insurance contracts in 2006 is premature given that the Board has not yet finalised how the fair value of insurance contracts, in particular insurance liabilities, will be measured. If a date is to be set for these disclosures, it should allow sufficient time from the issuance of the fair value guidance to allow companies to develop and implement a methodology that leads to the presentation of accurate and reliable information. We would therefore recommend that the form of the fair value disclosures required for 2006 should not be mandatory at this stage.

**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?*

**Response**

a)/b) Although we generally support these proposals as long as the information disclosed is relevant and the quantification only necessary where it is practical to do so, we are concerned that that the requirements will impose a far heavier workload in terms of data collection procedures and systems, but not actually provide useful information to the users of the accounts. Internationally, insurers maintain a wide range of information bases on which management runs the business. It is too early, in such an evolutionary area, to specify which sort of information should be disclosed. We consider the proposals on sensitivity analysis to be broadly acceptable, although, as differing practices may emerge in respect of the ranges and variables disclosed, the IASB should consider providing more guidance in this area.

c) We support the proposals for transitional relief in respect of claims development disclosures.

**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?*

**Response** The absence of examples in this area makes it difficult to respond to the proposals. This area requires further clarification.

**Question 13 – Other comments**

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

**Response** We are concerned that the proposed approach under ED 5 will result in a mismatch between the measurement bases for insurance assets and liabilities. Under Phase I, insurance liabilities will continue to be measured under existing GAAP, which usually adopts some form of amortised cost approach, whilst under IAS 39 the assets backing these insurance liabilities will, in most cases, have to be measured on the basis of fair value. This will result in volatility, often for artificial reasons, in equity – even if the assets and liabilities are perfectly matched, movement in equity would occur solely due to the different measurement bases.

We believe that the mismatch issue is sufficiently important that it should be further addressed. We therefore believe that the Board should reconsider a solution which would allow the measurement of assets held to back insurance contracts to be measured, during Phase I, at amortised cost – possibly under specific criteria.

**The British Bankers' Association (BBA)**