FAR

FAR is the institute for the accountancy profession in Sweden

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

6 November 2003

Exposure Draft ED 5, Insurance Contracts

In response to your request, FAR has the following comments on the Exposure Draft ED 5, Insurance Contracts.

General comments

FAR supports the efforts to create a standard for the uniform financial reporting of insurance contracts and believes that the issuance of the Phase I proposed standard is an important stepping stone in this process. The issuance of Phase II will be necessary to ensure that consistency is finally accomplished, and FAR recommends that this process be addressed as expeditiously as possible.

FAR suggests that the Board should reconsider the proposal in paragraph 33 to exempt an insurer from disclosing the fair value of its insurance assets and insurance liabilities for dates before 31 December 2006. Such sunset clause may result in embarrassment if the Board is confronted with a need to allow for more time for Phase II.

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 to (a) (i):
We believe that it is appropriate to exclude the treatment of assets held to back insurance contracts from the IFRS, as they are already covered by other IFRSs. However, there is an inherent risk of a mismatch between assets – many of which are carried at fair value – and insurance liabilities – normally carried at amortised cost. This potential mismatch may be eliminated during Phase II, but will lead to volatility during Phase I, volatility caused by reporting requirements rather than the economic substance of the transactions. The benefits of creating an IFRS for insurance contracts to obtain uniform financial reporting is partially negated by the risk for volatility in equity, and we urge the IASB to consider what steps can be made to reduce the risk for volatility in Phase I. EFRAG has proposed a number of potential solutions in their response to Question 13, "Other comments", and we feel that these should be evaluated further.

Response to (a) (ii):
We believe that it is appropriate to exclude investment contracts issued by insurance entities from the scope of the standard as they are covered by IAS 39, but recognise the need to accomplish uniformity between long-term contracts, whether they are insurance contracts and other long-term investment contracts issued by insurance entities.

Response to (b):
We agree with the proposal regarding weather derivatives contained in the Exposure Draft.

Question 2 – Definition of 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:
The foundation of the draft IFRS is the proposed definition of insurance contracts, including ample guidance in Appendix B and IG Example 1, and in general terms FAR believes that the definition chosen is the appropriate one to distinguish between insurance contracts and investment contracts. However, FAR believes that even considering all of this guidance there

remains a risk that different entities will interpret "significant insurance risk" differently, and that further guidance or clarifications of existing guidance appear to be called for.

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:
FAR believes that a requirement to separately measure the fair value of derivatives embedded in insurance contracts will require the development of existing systems for valuation and reporting, and that these costs may well exceed the benefit derived from reporting the information obtained in this manner. We believe the exceptions to be appropriate and have not identified other embedded derivatives to be exempted from the requirements in IAS 39.

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?

Response:
FAR believes it is appropriate to grant exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8, but that despite this temporary exemption from the criteria in [draft] IAS 8 the exemption should not apply to the contents of paragraphs 10–13 of the draft IFRS.

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?

FAR

Response:
FAR believes that these proposals are appropriate.

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 to (a):
Paragraph BC33 of the Basis for Conclusion contains a number of relevant objections to unbundling and paragraph BC34 states that unbundling in Phase I is only required when it is easiest to perform and the effect is greatest. FAR believes that with this limitation the requirement to unbundle is appropriate and feasible. FAR notes however that the issue of unbundling is one where the two-phase approach will entail implementation effects on two occasions.

Response to (b):
FAR does not believe that unbundling should be required in other cases.

Response to (c):
The draft IFRS is clear as to when unbundling would be required.

Question 7 – Reinsurance purchased

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:
FAR believes these proposals are appropriate.

FAR

Question 8 - Insurance contracts acquired in a business combination or portfolio transfer

IAWS 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:
FAR believes the proposals are appropriate.

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:
The proposals are appropriate, subject to one amendment. Paragraph 24 (b) states that it "does not specify how the issuer determines whether the unallocated surplus is a liability or equity". FAR believes that any legal or constructive obligation resulting from the unallocated surplus should be recognised as a liability, and not as equity.

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:
FAR does not believe that it is appropriate to require disclosures of fair values of insurance assets and insurance liabilities during Phase I. The timing of the introduction of the requirement should be such that entities are able to prepare and report comparative numbers also.

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:
FAR has not identified any proposed amendments or deletions related to disclosures themselves, the approach thereto or the transitional relief.

Question 12 – Financial guarantees by the transferor of a non-financial asset or liability

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:
FAR believes that it is appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities.

Question 13 – Other comments

Do you have any other comments on the draft IFRS and draft Implementation Guidance?

Response:
No other comments identified.

Yours sincerely,

Jan Buisman
Chairman, Accounting Practices Committee

Björn Markland
Secretary General