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Dear Paul

The Groupe Consultatif Actuariel Européen (the "Groupe ") welcomes this opportunity to comment on EFRAG's draft response to ED5. In general the Groupe supports the response that EFRAG has proposed. However, there are comments that the Groupe believes should receive greater weight in EFRAG's response and these are discussed below.

We also believe that there are two key principles that underlie EFRAG's concerns but which are not stated explicitly. We believe it is helpful that these principles are stated clearly and that EFRAG should propose these principles for inclusion in ED5. This would improve the interpretation of Phase 1 and also the IASB's deliberations on Phase II.

The principles are:

- that the measurement approach taken to matching assets and liabilities, whether in terms of invested assets or in terms of reinsurance should be consistent; and
- that future policyholder behaviour, assessed on the basis of empirical past evidence, with suitable margins to reflect uncertainty, is taken into account when determining insurance assets and liabilities.

The areas to which the Groupe believe EFRAG should give greater emphasis are (For each topic reference is made to the IASB-questions on its Exposure Draft 5):

1. *The need for a comprehensive approach (Question 4 - Question 7)*

   The Groupe appreciates the IASB efforts in seeking in ED5 a pragmatic solution to the conflicting pressures of (i) the need to develop a properly integrated, relevant and reliable accounting standard for insurance companies and (ii) the EU's deadline of 2005.

   As EFRAG observes, ED5 is only acceptable in this context, namely as an interim standard. Given this situation, namely that ED5 needs to be seen as a pragmatic solution giving rise inevitably to a range of conceptual anomalies, it is unfortunate that the IASB has used ED5 to seek to address, in an ad hoc fashion, a number of individual accounting issues which they regard as unacceptable. This has compounded the conceptual anomalies to the extent that ED5 will markedly distort the equity and income of insurers.

We note two particular areas where this is a difficulty:

a. The proposals to modify reassurance accounting leads to significant distortions in earnings. As now, an insurer will incur a loss on writing the direct insurance due to the need to establish provisions under local GAAP, on a prudential basis reflecting the risks in the policy. If the insurer then reinsured a proportion of the direct business, the insurer would be able to pass across the risk to a reinsurer but would not be able to release the prudential margins established to support the risks. This is inappropriate. While EFRAG recognises this issue, we believe EFRAG's letter should give the matter greater prominence. **EFRAG should state that it would find it difficult to support the adoption of ED5 while this approach to reinsurance is proposed.**

b. A second area of concern, and more controversial, is the treatment of contingency and equalisation reserves. While the Groupe recognises that these reserves do not meet the definition of liabilities within the IAS Framework, we recognise some merit in retaining the reserves for the duration of Phase I. Current practice in many insurers is to carry some of the margin for risk and uncertainty in the assessment of the liabilities in the equalisation reserve. It is expected that in Phase II these margins will, in some way, be fully allocated to the technical provision as part of the introduction of a fair value measurement approach. However, during Phase I, there is a possibility that the margins within the equalisation reserve will be released to equity leaving the technical provisions without sufficient margin

   The release and subsequent re-capture of margins at the start and end of Phase I will distort earnings and equity. Given the pragmatic nature of Phase I, it seems to us that the integrity of the financial reporting is not significantly undermined if the equalisation reserves are retained through Phase I and the income and balance sheet would be more relevant.

2. *Measurement of investment contracts under IAS39*

Paragraphs BC115 to BC117 helpfully discuss some aspects of the application of IAS39 to long term investment contracts, noting in particular in BC116 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.

We note, however, that the subsequent discussion of the fair value of these investment contracts, notably in BC117(e), 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 deeply concerned that the imposition 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 manner the observed values at which contracts are traded between third parties. We therefore believe that the deposit floor does not meet the IASB's own definition of 'fair value'

As noted in the introduction to this letter, we believe strongly that expected policyholder behaviour should be reflected in the determination of the fair value of a contract and that future policyholder behaviour should be assessed on the basis of empirical past evidence with margins to reflect uncertainty. We base this on the belief that policy-holders effect and discontinue policies for many reasons that extend well beyond the narrow concerns of financial economics and that this behaviour is best captured by use of empirical evidence. We are aware of the considerations of the Joint Working Group on the accounting for financial instruments that concluded that all assets or reductions in liabilities arising from policyholder behaviour represented intangible assets. We would draw a distinction between circumstances where there is currently no commitment by the contract holder to act in a manner that gives rise to an asset and circumstances where the contract holder has made such a commitment, for example by effecting a long term contract. While we accept the former circumstance as giving rise to an intangible asset, we believe the latter should lead to a recognisable asset or, in the case of a deposit floor a reduction in liability

We request that EFRAG strongly rejects this position of the 'demand deposit floor' as long term investment contracts and request that EFRAG does not recommend the endorsement of IAS39 until such time as the imposition of the deposit floor is removed from fair value measurement.

3. *Definition of an insurance contract (Question 2)*

Insurers seeking to apply ED5 to their portfolios have placed emphasis on the reference in paragraph B21 to the 'present value of the insurer's net cash flows' as being the benchmark against which adverse change should be assessed. They have concluded that, because the 'present value of the net cash flows' can be a very small amount close to or at zero, then very low levels of death benefit, say death benefits equal to 101% of the underlying fund values, should be assessed as insurance contracts.

Further, the discussion in paragraphs B22 and B23 taken together, suggests that a contract which offers a return of funds on death at all times but which applies an early termination penalty related to the initial investment, say 50% of the initial investment, for a short period of, say, six months, should be classified as an insurance contract.

In both the cases described above, the contracts would not normally be regarded as insurance but rather as investment vehicles.

Moreover, many commercial contracts not associated with insurance will waive early termination penalties in the event of death. For example, mobile phone rentals will seek the return of handsets in the event of the contract holder ceasing to pay rental premiums but will waive this procedure in the event of death. Theoretically, these contracts could be regarded as insurance contracts in the terms of paragraphs B22 and 23. This suggests that the discussion in paragraphs B21 to B23 does not capture the 'commonsense' view of an insurance contract.

If it is the IASB's intention that the contracts described above should be regarded as insurance, it would be helpful if this was clarified in the examples in the implementation guidance. If, alternatively, the IASB had not intended this interpretation, as would seem more likely, again **implementation guidance to this effect would be helpful and paragraphs B21 to B23 need to be rewritten.**

4. *The consistent measurement of matching assets and liabilities (Question 1)*

The need for consistent measurement of the liabilities arising from insurance contracts and the assets held to back those assets has been much discussed. As noted in the introduction to this commentary, the European actuarial profession believes the consistent measurement of assets and liabilities to be a fundamental principle underpinning the accounting discussion. Consequently we support the discussion in EFRAG's response. We would however reach a slightly different solution. As we have discussed, ED5 is at best a pragmatic solution which will need to be replaced by a comprehensive, integrated standard in as short a timeframe as possible. In the context of such a pragmatic solution, we believe it should be acceptable to specify certain government and corporate bonds as being part of a matching portfolio for designated bodies of policies without going through the extensive and expensive documentation associated with hedging procedures. **The matching portfolio would then be accounted for on a held to maturity basis through the short period through which Phase I is effective**.

5. *Disclosure of the amount and uncertainty of cash-flows (Question 11)*

   The Groupe understands and supports the desire of IASB for investors to appreciate the risks and uncertainties to which the financial performance of insurers are subject. However, the manner in which the IASB proposes in its implementation guidelines to disclose these risks and uncertainties will result in very extensive reporting in which key information could well be submerged under the volume of data.

   Given the very limited timeframe for the introduction of Phase I **we recommend that the disclosure requirements relating to future cash-flows are dropped in Phase I** and, as part of the development of Phase II, IASB institutes a detailed field testing exercise to assess how best these disclosure requirements can be achieved so that the investor receives concise and relevant information.

6. *The disclosure of fair values in 2005 for investment contracts and in 2006 for insurance contracts (Question 10)*

   We agree with EFRAG when it expresses concern that the IASB proposes to mandate the disclosure of fair values in the immediate future when the concept of fair value remains undefined. **We believe this concern should be expressed in stronger terms**.

7. *Timetable (Question 13)*

   The publication of the IFRS based on ED5 is currently expected in March 2004 to be effective from 1 January 2005. While understanding the background to these dates, the Groupe is concerned that this timetable leaves no time for an orderly introduction of the standard. While actuaries are currently working to implement the proposals in ED5, this work is necessarily constrained by the number of areas where clarification and amendment are essential. In order for the transition to IFRS to be achieved, ED5 should only include the smallest possible number of changes in current accounting practices.

   The Groupe asks EFRAG to comment to the IASB that **any reduction in the requirements placed on preparers by ED5 would be welcome**. This is particularly true of the disclosures required which are potentially very extensive.

8. *Sunset Clause (Question 4)*

   We agree with EFRAG that there is little use in setting a date when the interim exemption from elements of IAS8 will cease and we suggest that EFRAG's comment is clarified to **recommend unambiguously the removal of the time limit from ED5**.

9. *Embedded derivatives (Question 3)*

   We do not regard all options in contracts as derivatives, and would like to endorse the IAA comments on this subject. The requirement for separate measurement of embedded derivatives may require major changes in valuation systems and may impose costs that exceed the benefits. The requirement would be not only to separately value the embedded derivative, but also to value the host contract by current accounting policies. The valuation of the host contract under current accounting policies is likely to present many conceptual difficulties and to require extensive systems changes.

Notwithstanding our view that fair-value treatment for embedded derivatives in insurance contracts should not be required, we do not agree that, if fair-value treatment of embedded derivatives is required, there should be an exception for those that have insurance features. Making an exception for these derivatives would result in companies giving fair-value treatment to some embedded derivatives, but not to others that, in the current environment, may be the most material to the balance sheet.

We recommend that paragraphs 5 and 6 be entirely deleted, and that, for the interim period, the standard should allow use of current accounting policies with a robust loss recognition test and adequate disclosures.

In summary, we would urge EFRAG only to support endorsement of ED5 under the following conditions:

- retention of equalisation reserves during Phase I (see topic 1.b. above)
- removal of the deposit floor from the fair value measurement for long term investment contracts (see topic 2 above)
- accounting of the matching portfolio on a held-to-maturity basis through Phase I (see topic 4 above)

We are grateful to EFRAG for this opportunity to comment and recognise the effort that EFRAG has put in this far to achieve a workable insurance accounting standard. We will be happy to discuss these issues with you further at any time.

Yours sincerely

Bart De Smet
Chairman, Insurance Committee