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Sir David Tweedie
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Zurich, 30 October 2003

Comments on Exposure Draft 5 "Insurance Contracts"

Dear Sir David

We welcome the opportunity to comment on the Exposure Draft 5 “Insurance Contracts”. We would take the opportunity to point out some material issues, which should be particularly addressed by the Board such as Asset Liability Management and fair value valuation of insurance contracts. We have addressed such issues in our attached answers.

Yours sincerely,

Swiss Institute of Certified Accountants and Tax Consultants

Urs Moser Martin Frei

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 for 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?

Answer
(a) (i)
We agree that it is appropriate to develop an accounting standard for insurance contracts rather than for insurance undertakings. We are not fully convinced that this exemption is consistent, because a lot of policyholders who reports under IFRS have complex insurance products.

We are concerned that the proposed valuation of the insurance liabilities in accordance with the existing local GAAP, and financial assets recognised in accordance with IAS 39 could give rise to high volatility in entities' equity and profit and loss accounts.
We suggest that the Board should readdress this issue. A possible solution could be to allow an additional category of financial assets held to back insurance liabilities, or not to prohibit unlocking of interest rates in measuring insurance liabilities.
We believe that to not prohibit entities to unlock interest rates should be the preferred solution but we understand that ED 5 is only an interim solution and therefore Phase II Standard should also cover the insurance contracts held by the policyholder.

(a) (ii)
We agree with the proposal.

(b)
We agree that weather derivatives should be accounted for under IAS 39 unless they meet the definition of an insurance contract.

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 of 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 Guide).

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?

Answer
We agree with the concept of the definition in ED 5. We think that the examples in the implementation guidance are helpful and we suggest that additional examples should be added, in particular examples for non life insurance contracts and additional examples of contract that are critical.

The term "significant" is fundamental for the identification of an insurance contract. The comments to the examples and the additional guidelines in B21 to B24 should be more clear and consistent in this regard. In B21-B24 the usage of the terms "non-trivial", "trivial" and "plausible" seems to be inconsistent.

The measurement of the significance of the insurance risk appears to be an other inconsistency in B21-B24. The significant insurance risk measurement in B21 is based on the present value of the future cash flows (net basis). In B23 it is based on a comparison of the death, surrender or maturity benefits (gross basis). The two methods can lead to different conclusions in regards to significant insurance risk.

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?

Answer
We agree with 3 (a), 3 (b) and 3 (c).

We would welcome the additional guidelines in regards to the details / aggregation of the requested disclosure. In addition we would appreciate more guidance in regards to the disclosure of those embedded derivatives that are insurance contracts themselves and therefore do not follow the IAS 39 rules.

We agree with 3 (d) that no other derivatives should be exempted from the requirement for separate accounting.

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 and 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?

Answer
(a)
We think that it is appropriate to exempts an insurer from applying the criteria of paragraph 5 and 6 of ED IAS 8 to its existing accounting policies for insurance contacts and reinsurance contracts that it holds but we believe that it is not appropriate to introduce a sunset clause.

We understand that Phase 2 is expected to be mandatory in 2007. If this target cannot be achieved an amendment has to be introduced at late stage to defer or remove the sunset clause.

(b) (i)
We agree with the decision to eliminate catastrophe and equalisation reserves. Companies can use different names for those reserves. Sometimes those reserves are not segregated but integrated in other insurance reserves. The wording of paragraph 10 (a) could suggest that only separate provisions that are called "catastrophe reserves" or "equalisation reserves" are not allowed. For this reason we suggest to change the wording of this paragraph in order to clarify that all catastrophe, equalisation and other similar provisions for future claims under future insurance contracts are not allowed.

(b) (ii)
We agree with the requirement of a loss recognition test if no such test exists under an insurer's existing accounting policy.

We think that more guidance in regards to the identification of the cash flows and in regards to the allowed level of aggregation would be useful. The level of aggregation is a very important feature. Additional guidelines would increase the comparability of different companies. We are concerned that the loss recognition tests of the companies will not be in line with the requirements of ED 5.

(b) (iii)
ED 5 concept is the interim solution and therefore insurance liabilities can be prudent in accordance with local GAAP's. Nevertheless ED 5 should not allow excessive prudence.

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?

Answer
We agree, but we also believe there should be more guidance on what constitutes “more relevant and reliable” (paragraph 14).

We also believe that it is not clear whether a change of an accounting policy is allowed if all requirements of paragraph 16 are met or if only one requirement of paragraph 16 is met. On the same time it is not clear if a change of an accounting policy needs to be made in all subsidiaries or only in certain subsidiaries. For this reason we suggest to change the wording of paragraph 16.

We think that it is appropriate to allow changes of an accounting policy if at least one requirement of paragraph 16 is met and to allow changes only in certain subsidiaries.

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?

Answer
We agree and believe more examples would be helpful.

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?

Answer
We consider all assets established for reinsurance contracts should be measured in accordance with local GAAP whilst the corresponding liabilities are measured on that basis. We believe that this guidance should be delayed until further guidance is available under Phase II. That will achieve a degree of consistency of measurement that the proposals in paragraph 18 would undo. If an appropriate definition of insurance contract is established, financing reinsurance will automatically be dealt by the other paragraphs of ED 5 and measured in accordance with IAS 39.

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

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?

Answer
We agree.

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?

Answer
We believe that the proposal is appropriate.

In regards to recognition and measurement we would appreciate additional guidance. It should be clarified that entities should follow local GAAP and not IAS 39 for recognition, and it is not clear if the minimum fixed element is measured at amortized cost basis or at fair value basis. Furthermore we believe the ED 5 should define more clearly what is equity and what is a liability, referring to IAS 32.

Insurance companies that are already reporting in accordance with IAS generally apply US-GAAP for the measurement of its insurance liabilities. In accordance with US-GAAP they make shadow adjustments for the discretionary participation features of the non-realised gain and losses on available for sales financial instruments recognised directly in equity. We understand that ED 5 will not prohibit this shadow adjustment if current local GAAP allowed it. This means that if current local GAAP does not allow such shadow adjustment, the whole amount of the liability for the discretionary participation feature must be recognised in the P&L.

If this is the intention of the Board this should be clarified in ED 5.

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?

Answer
We do not think that it is appropriate to disclose a fair value of insurance assets and liabilities before significant issues about fair value measurement have been resolved and before a detailed guideline has been developed.

We are concerned about the audit ability of the fair values disclosed by the companies if no methodology and no guideline is available. For this reason we think that it is more appropriate to resolve all issues in regards of fair value measurement and to prepare a guideline before to such disclosure is requested in financial statements.

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?

Answer
We agree with the principles.

In regards to paragraph 29 we are concerned about the fact that the disclosure about the claims developments shall go back several years (not more than ten years). This is unusual for a financial statement and we have concerns in regards to the audit ability of those figures. We think that it is more appropriate to disclose this information in the MD&A.

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 of 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?

Answer
We agree.

Question 13 – Other comments

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

Answer
None

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