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THE INSTITUTE OF
Chartered Accountants
IN IRELAND

28th October 2003

Peter Clark,

Senior Project Manager,

International Accounting Standards Board,

30 Cannon Street,

London,

EC4M 6XH.

Dear Mr. Clark

ED 5: Insurance Contracts

The following are the comments of the Accounting Committee (AC) of the Institute of Chartered Accountants in Ireland on the proposed interim standard on insurance contracts.

A. Overall Comments

AC welcomes the publication of the above exposure draft and the opportunity to respond to it. AC supports the view that this Phase I guidance is required for European insurers in advance of applying IFRS for the first time in 2005. AC would welcome progress to Phase II on a timely basis so that more complete guidance is available to insurers as soon as possible.

In summary AC is in agreement with the general thrust of ED 5, but has a number of specific areas where we have concerns, including:

1 The need for greater clarity when applying the definition of an insurance contract, including the sequencing of unbundling and stripping out embedded derivatives in the application of the insurance contract definition (Q2)

2 The level of insurance risk needed in order for a contract to qualify as an insurance contract as it is somewhat unclear as to how to interpret the wording in the ED as currently presented (Q2)

3 The level of change being sought at this point in relation to reinsurance accounting given the wide variation in reinsurance products that exist in the marketplace (Q7)

4 The inclusion of a specific deadline mandating compliance with the IAS 8 hierarchy (Q4)

5 The inclusion at this interim stage of the fair value disclosure requirements that will be needed in 2006, i.e. in advance of having a clear picture of what fair value means (Q10)

6 And finally, how the transitional rules on first time application will apply in light of the tentative IASB decision to allow IAS 39 to apply to 2005 without comparatives (Q13).

B. Responses to specific questions

Question 1: Scope

(a) AC supports, in the interest of comparability of financial statements, the proposal to apply the ED to <u>all</u> insurance contracts (including reinsurance contracts) whether issued by what might be viewed a 'traditional' insurance entity or another entity that enters into contracts meeting the definition in the ED.

AC also supports the IASB's proposal that assets held by entities to back insurance contracts should be accounted for in accordance with the relevant IFRS, e.g. IAS 39 in most cases. AC is therefore not in favour of establishing a new class of assets that would then be held to settle liabilities to policy holders. The reasons for this are as follows:

1 If the timing and amount of the liability to policy holders is predictable, it should be feasible for the entity to use the Held-to-Maturity category in IAS 39.

2 If, as is more likely in practice, the amount and timing of these liabilities cannot be predicted that accurately, thereby requiring assets to be sold on the open market at various times to meet these liabilities, the entity is exposed to the fair value of these assets and therefore the financial statements should reflect this.

AC supports the decision of the IASB to apply the ED only to the insurance contracts of insurers, i.e. thereby requiring insurers to apply other IFRS's (including IAS 39) to other financial instruments.

(b) AC supports the IASB's decision to include weather derivatives within the scope of IAS 39 (unless such contracts actually meet the definition of insurance contracts).

Question 2: Definition of insurance contract

In principle, AC is in agreement with the proposed definition used in Appendix A. AC considers that for insurers there is a level of subjectivity involved in applying the definition, the consequences of which will really only become apparent in Phase II when the accounting for insurance liabilities is finalised. There may be economic consequences arising from these Phase II requirements that will cause insurers to either tailor their product offerings or re-visit subjective decisions made by them in Phase I and there may be a case for permitting this. AC considers clarification on its application in a number of areas is required as set out below.

Embedded derivatives and unbundling of deposit components

AC considers that the timing of when the insurance definition is applied is critical, i.e. before or after unbundling deposits and embedded derivatives. AC would welcome clarification that the definition of an insurance contract should be applied <u>after</u> the removal of these items. Clarification on this point is critical because if one applies the definition of an insurance contract to a <u>total</u> contract (before stripping out embeddeds and deposit elements) an entity may get an entirely different answer to the question of the significance of insurance risk than if one applies the definition to the pure insurance component.

Definition of significant insurance risk

However, AC has some concerns that the definition of 'significant insurance risk' is unclear as there may be some inconsistency in the explanations in Appendix B, paragraphs B21 and B22 on this point, as set out below:

> Paragraph B21 says that insurance risk is significant only if it is 'plausible that an insured event will cause a <u>significant adverse change</u> in the present value of the insurer's net cash flows arising from that contract.'
>
> Paragraph B22 states that 'insurance risk is not significant if the occurrence of the insured event would cause a <u>trivial change</u> in the present value of the insurer's contractual cash flows in all plausible scenarios.'

In summary, B21 requires 'a significant adverse change' in cash flows in order for a contract to qualify as an insurance contract, while B22 implies that everything causing greater than a 'trivial' impact on cash flows qualifies as an insurance contract.

Furthermore, AC would welcome clarification on the following:

1. How is 'significant insurance risk' to be defined and calculated? For example it might be useful to include the wording in the IASB Draft Statement of Principles (DSOP) proposal which stated that significant insurance risk is defined based on the present value of the range of probability weighted contingent cash flows being a significant proportion of the expected present value of the contractual cash flows that will occur if the insured event does not take place, and also assuming no surrenders. Related to this, the first sentence of B21 above refers to the use of '<u>net</u> cash flows arising from the contract' in determining significance; it is unclear if this means the net profit on the contract after costs. Note that B22 does not include a reference to 'net'.
2. As noted earlier, clarification is required as to whether the impact of insurance risk should be assessed by reference to the <u>pure insurance aspect</u> of a particular contract, i.e. <u>after</u> stripping out any investment contracts and relevant embedded derivatives, for example.

Group contractual arrangements

AC would welcome the inclusion of additional guidance in relation to group contracts taken out, for example, by employers covering employee health or car insurance for example. Specifically, the issue arises as to whether such arrangements can be considered as a single contract taken out by the employer at the company level (which would be more practical) rather than a series of individual contracts undertaken on behalf of each employee as an individual.

Question 3: Embedded derivatives

(a) AC supports the proposal in the ED to require embedded derivatives to be separated out from host insurance contracts, measured at fair value and the changes in their fair values included in the income statement except for the two circumstances noted in the ED, namely where the embedded (i) itself meets the definition of an insurance contract within the scope of the ED or (ii) is an option to surrender an insurance contract for a fixed sum.

(b) AC supports the exemption from the requirement to separate out guaranteed life-contingent annuity options and guaranteed minimum death benefits in the circumstance described, i.e. only when the insurance risk meets the definition of significant and where it is not capable of being separated from the non-insurance component derivative because the cash flows are inter-dependent.

(c) AC supports the proposed disclosure requirements relating to the embeddeds that are not being separated out as described in (b) above.

(d) AC does not see a case to exempt further embeddeds from the separation requirement.

Question 4: Temporary exclusion from criteria in Proposed IAS 8

(a) Being most familiar with the financial reporting regimes in place in Ireland and the UK, AC is disappointed that achieving compliance with paragraph 5 (excluding paragraph 5b (iv) on prudence) is not possible in Phase I. If, however, IASB considers that this is the case, AC supports the proposal to exempt insurers from applying the hierarchy set out in paragraphs 5 and 6 of Proposed IAS 8 relating to the criteria an entity uses in developing an accounting policy if no IFRS applies specifically to that item. AC sees practical difficulties in defining at this stage what is meant by 'excessive prudence' (versus the Framework's requirement for 'prudence') and therefore, regrettably, the ability to meet this qualitative factor in paragraph 5 is difficult.

As regards the inclusion of a specific end date for the above exemptions in paragraph 9 of the ED, (i.e. periods beginning on or after 1 January 2007), we understand the IASB's view that it is important to limit the use of the exemption from the hierarchy to as short a time as is reasonable. However AC does not see that imposing such a date at this point will necessarily assist in the process of achieving a workable, more complete solution under Phase II of the insurance project. The inclusion of the deadline may divert insurers' efforts into making contingency plans for an interim solution in compliance with the hierarchy, which AC considers would not be desirable. AC's view is that mandating compliance with paragraphs 5 and 6 at a point prior to the finalisation of Phase II is not appropriate and could lead to inconsistent accounting practices across the industry. Therefore, AC recommends that it should instead refer to the date on which Phase II is implemented.

(b) Nonetheless, AC supports the proposals in paragraphs 10-13 of the ED to (i) eliminate catastrophe and equalisation provisions, (ii) require a loss recognition test to policyholder liabilities, and finally (iii) to include requirements restricting the derecognition and offsetting of insurance liabilities.

Question 5: changes in accounting policies

(a) AC regards the proposal to allow the continued use of the specific list of practices in paragraphs 14-17 as extrtremely pragmatic given that IASB proposes that entities cannot switch to such practices. However, AC supports the proposal that insurers can only change their accounting policies for insurance contracts if the change makes the financial statements more relevant to the decision-making needs of users and are more reliable, judged by the criteria in Proposed IAS 8.

AC is not supportive of the proposal in paragraph 16(e) to allow insurers, to continue to use non-uniform accounting policies for insurance contracts across their subsidiaries.

(b) AC supports allowing insurers to change the accounting for certain financial assets to a fair value basis through income when making insurance contract policy changes in the situation described in (a) above.

Question 6: Unbundling

(a) AC agrees with the proposal that an insurer should unbundle deposit components of some insurance contracts, to avoid the omission of certain assets and liabilities from its balance sheet. However we would welcome the inclusion of further practical guidance particularly those that arise for primary insurers, rather than focusing on reinsurance only.

(b) AC believes it would be useful to clarify that unbundling applies where investment contracts (as opposed to purely deposit arrangements) are a part of the overall insurance arrangement.

(c) As noted in Question 2 above, AC would welcome further practical guidance both as to when precisely to unbundle and how to calculate the separate amounts.

Question 7: Reinsurance

AC has concerns that making changes to the accounting for reinsurance which may then be reversed in Phase II would be undesirable.

The ED refers to payments from a reinsurer to the cedant insurer as being 'gains at inception'. AC is of the view that this is not necessarily the case as in some situations the reinsurer's share of losses is often a reduction in the insurer's losses rather than gains. Therefore there may be situations when such 'gains' at inception of a reinsurance contract should be recognised to offset losses recognised on the related direct insurance contract recognised in either the same or indeed an earlier accounting period. In addition, it is possible that the proposal to spread such a 'gain' forward 'over the period of the underlying risk exposure' may be reversed in Phase II. This view is borne out by paragraph BC92 which says: 'The Board acknowledges that the requirements … are conceptually imperfect. They are needed in Phase I only because of imperfections in existing measurement models. They will not be needed in Phase II.' Therefore AC is of the view that it would be more appropriate not to seek changes in the accounting requirements for reinsurance at this point.

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

AC support the IASB's decision to require the fair value rules in IAS 22 (Business Combinations) to be applied and to permit the expanded presentation format in Phase I. However AC has concerns that, given that there is no guidance on how to measure fair value for insurance liabilities, there may well be a wide variety of approaches taken by different entities. Therefore further guidance on how to compute fair value for this particular purpose is needed in the ED.

Question 9: Discretionary participation features

AC notes that the ED does not specify how an issuer determines whether the unallocated surplus arising from a discretionary participation feature should be presented as equity or a liability. However, AC notes that IAS 32 defines liabilities in terms of what the issuer has contracted, i.e. this reads as though one should not include items in liabilities where the issuer has a choice as to whether or not it will pay out. Therefore this would appear to require the exclusion of discretionary payments from the amounts presented as policyholder liabilities. We recommend the inclusion of a definition of 'discretionary' in the context of this part of the ED that links to the material in IAS 32 to ensure the consistent interpretation of the requirements across entities. Related points on which AC would welcome clarification:

1 Whether additional (but not contracted) payouts arising under a constructive obligation to policyholders can be included as part of the liability amount

2 Whether a particular item with discretionary features, classified as equity (as opposed to a liability) under IAS 32, should be accounted for as an equity item under the proposals

3 AC is unclear as to why, in paragraph 25, financial instruments (not meeting the definition of insurance contracts) that have discretionary features can continue to be accounted for under their current accounting policy rather than dealing with the discretionary features in accordance with the requirements of IAS 32. AC's view is that such instruments should not be given an exemption from IAS 32.

Finally, AC is supportive of the IASB's decision not to permit the presentation of the unallocated surplus as an intermediate category that is neither a liability nor an equity item.

Question 10: Disclosures of the fair value of insurance assets and insurance liabilities

AC does not support the inclusion of the 2006 requirement to give fair value disclosures. AC believes that it is not appropriate to deal with this until the Phase II decision is reached as to how fair value should be determined. Without this agreed interpretation, there is the risk of significant divergence in the approach taken by companies in presenting this information. AC's preference would therefore be to wait until the definitions of fair value are developed at which point the guidance on the required disclosures can be issued pending completion of Phase II.

Question 11: Other disclosures

AC supports the other disclosure proposals in the standard. As regards the (practical) transitional relief for insurers to disclose only information about claims development for the last five years AC supports the requirement for the table to be accompanied by appropriate narrative disclosures in the circumstances where this information does not give the full picture of the underlying trends. This is likely to apply where there are classes of business that run-off over a long period of time. Furthermore, clarification as to whether the table should be presented on the basis of the underwriting year or accident (or equivalent) year would be helpful, after consultation with those in the insurance industry

Question 12: Financial guarantees

AC is of the view that it is unclear whether the proposals as described in BC46 will result in consistent treatment of similar financial guarantees across entities. This is because BC46 (a) notes that for financial guarantees, regardless of their legal form, (e.g. financial guarantee, letter of credit or insurance contract):

1 If they <u>initially</u> arose from the transfer of financial or non-financial assets or liabilities they must (as at present) be initially measured under IAS 39; it is only on the finalisation of the improvements to IAS39 that the IASB will review the <u>subsequent</u> measurement of such guarantees. (Currently the subsequent measurement is made using IAS 37).

2 On the other hand, all other financial guarantees, requiring the holder to be exposed to a loss on the failure of a debtor to pay, will meet the definition of an insurance contract and are therefore within the scope of the ED. As noted in BC46(c) this means that they are subject to the existing accounting policies of the issuers of those guarantees, with the only requirement being to carry out the loss recognition test per paragraphs 11-13 of the ED.

AC questions the rationale for measuring possibly very similar guarantees (that happen to have arisen under different circumstances as in 1 and 2 above) in a potentially very different manner.

Question 13: Other comments

1. AC notes that the IASB has tentatively agreed that for entities applying IFRS for the first time in 2005, IAS 39 need only be applied for the 2005 year-end, i.e. there is no requirement to restate the comparatives. In light of this, consideration needs to be given to taking a similar approach to the insurance ED as AC considers it would not be appropriate to apply it in any meaningful way to the 2004 numbers without also applying IAS 39 to that year's numbers.
2. AC requests clarification of the status of the very detailed Implementation Guidance (IG). AC notes the statement at the beginning of that section which says that the IG 'accompanies, but is not part of, the [draft] IFRS'.

<u>C. Conclusion</u>

Subject to the specific issues raised, AC supports the exposure draft published by the IASB as representing an interim solution in advance of first time application of IFRS around Europe in 2005.

If you require any clarification or further details on any of the points raised in the response please contact the Secretary to the Committee, Simon Magennis on +353 1 6377316 or at simon.magennis@icai.ie .

Yours sincerely

Simon Magennis

Secretary

Accounting Committee

Institute of Chartered Accountants in Ireland