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Sir David Tweedie
The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

29 October 2003

Dear Sir David

We have reviewed the IASB's proposed standard and have also made a significant contribution to the responses of the CFO forum and Association of British Insurers. Whilst we concur with the responses of these organisations we would like to take this opportunity to make representations on areas of particular interest to Prudential.

In summary, although we are supportive of the need for an interim standard we feel that significant improvements need still to be made in our areas: the application of IAS39 to contracts that have insignificant insurance risk, unallocated surplus, reinsurance and disclosures.

We would also comment that if the Board were minded to include significantly different proposals in the final Phase 1 IFRS in a way that would be more onerous for insurers' IAS transition timetable we would question how this could be accomplished within the bounds of adequate due process. An example of such a circumstance might be the basis of measurement of significant insurance risk in determining which contracts qualify as insurance contracts rather than requiring re-measurement as financial instruments under IAS 39. We would also be concerned if there were changes to the guidance to have the effect of implying a significantly different approach even if the text in the IFRS on the particular issue is either unchanged or only marginally altered.

Our detailed response is attached. We would be very willing to discuss our comments with Board representatives or your staff.

Yours sincerely

Philip Broadley

ED5 — IASB Proposals on Insurance Contracts

Detailed response of Prudential plc

1. Definition of insurance contract

We note that the guidance included in paragraphs 21 to 23 of Appendix B is apparently contradictory. We are also aware from comments made by a member of the IASB staff at a recent seminar that the interpretation of the “net” test under paragraph 21 was intended by the Board to be based on a comparison of gross benefits under different scenarios rather than profit.

On common sense grounds we consider it invidious that amounts at risk should not be considered by reference to the overall impact of a contract on a company’s results. In essence a company writes an insurance contract and incurs expense in the process. Its net reward is dependent on whether or not insured events take place. In any common sense assessment of whether or not insurance risk is significant in the context of that particular contract, on which the company would not have incurred expense had it not written the contract, must be by reference to the impact on overall profit. We would therefore contest the Board’s apparent view that comparison of gross policyholder benefits is the appropriate measure.

2. Application of IAS39 to contracts that do not contain significant insurance risk

We are conversant with the arguments of consistency with other industries that are portrayed by some observers as being a persuasive reason for the inclusion of certain types of contract within the measurement principles of IAS 39. A particular cause for concern though is the application of IAS 39 to unit linked contracts.

Our understanding is that for such contracts that have insignificant attaching insurance risk, the Board is determined that they must be accounted for as financial instruments without recognition of the particular features of these contracts. The logic for this view, we assume, is that these contracts are little different from contracts of a similar nature issued by other financial service companies. We note further that such contracts are referred to in paragraph 1.9 of Example 1 of the implementation guidance of ED5 as “creating an embedded derivative that typically requires separation”.

In our opinion such an analysis of the accounting features of such contracts is misguided. In an ideal world the Board would amend the requirements of ED5 and IAS39 so as to consider properly the particular attributes of these types of contract. In the absence of a fundamental reassessment by the Board, for which there is now insufficient time for adequate due process, such contracts should be permitted to be accounted for under local GAAP as if they were insurance contracts that contain significant insurance risk.

To explain our rationale we note that under IAS39 the liabilities under such contracts would be required to be accounted for in one of two ways, namely amortised cost or fair value.

Our understanding is that under the amortised cost approach the measurement process would be in two stages. First, an underlying debt host contract would be established which would, after allowance for transaction costs, be re-measured to reflect accrued interest. Secondly, an embedded derivative would be identified so as to reflect the policyholders interests in the investment returns, net of tax allowance for disposals of the underlying securities in the unit linked fund, and after taking into consideration the insurance component of the contract.

There are several defects to this approach

(a) The assertion that such bifurcation of contracts in to these separate elements is fundamentally misguided. It is clearly does not reflect the commercial nature of the transaction viewed from either the company or the policyholder perspective.
(b) The choice of debt host is arbitrary. For a unit-linked fund that is invested in a basket of equities, bonds, properties or combinations thereof, there is no underlying debt host to identify. For the IASB to infer that there is such a debt host overlooks that there is, in most circumstances, no underlying agreement to repay a particular amount by reference to a particular interest rate. Furthermore, to assert that a host contract can be constructed ignores the commercial reality of the contracts.
(c) The assertion that other, non-insurance, companies write similar products, which are being accounted for in this manner, is also, in our view, based on an incorrect assessment of the facts. We would ask the IASB to examine the specific contracts they have in mind and discuss them with insurers so that a clear understanding of the comparability issue is obtained.
(d) Despite all best efforts to establish this artificial construction, for example by using a variable rather than fixed rate debt host contract, there is a risk that second order effects in the calculations will lead to a lack of symmetry between the measurement of linked asset and liabilities on an IASB basis. This is contrary to the commercial nature of the arrangement from the perspective of the investor and policyholder.
(e) Preparation of records on this basis would be required by cohort of policy issue. This would be exceptionally onerous.
(f) Under IAS39 the value of the embedded derivative would require disclosure. Since the debt host choice is arbitrary any disclosed amount is also arbitrary. There is no justification in IASB literature for this highly questionable basis of financial reporting.

In practice, for most unit-linked contracts, there is a direct relationship between asset values and liabilities, through unit values to policyholders. The only exceptions to this rule might be in certain extreme scenarios, where the asset of the funds are both not legally insulated and the company is in distress. In other words, in all, going concern scenarios the assets and liabilities are essentially matched.

Recognising these features we suggest that the IASB proposals should be amended so that the amortised cost approach can be applied by approximate methods by:

(i) Excluding the need for bifurcation of debt host and embedded derivative elements.

(ii) Amortisation of transaction (i.e. acquisition) costs over a period that is no longer than a prudent estimate of the average duration of the contracts concerned and subject to recoverability testing by reference to investment management and other related charges. Logically such amortisation should be by reference to the expected emergence of margins.

The alternative approach permitted under IAS39 is to apply a fair value approach. We, along with other companies, are unclear as to what this means when applied to unit linked contracts. There are three components in particular for which the accounting is shrouded in mystery.

(a) Unit Liability

In common sense terms it may be viewed that the current basis of determining unit values is adequate for the purposes of IAS basis reporting. We are aware though, that some commentators have reached different conclusions.

(b) Deferred Acquisition Costs

Our understanding is that an explicitly recognised asset for deferred acquisition costs is not permitted, though even on this fundamental point there appears to be disagreement between commentators with some suggesting that it is permissible in relation to the service arrangements for not dissimilar example of mutual funds and unit trust contracts.

If not permitted then, absent relief by allowing the recognition of expected future management charges, the impact of the deposit floor proposal will be to radically skew the profit profile of unit linked contracts for no apparently justifiable purpose.

(c) Insurance Liability

In the absence of phase 2 guidance on fair value of liabilities for such contracts it is difficult to know how companies can be expected to proceed.

We would encourage the IASB to articulate explicitly that if the fair value option is applied it may, at least for phase 1, be on the following basis:

(i) Bifurcation of the unit linked and insurance element of the contracts is acceptable.

(ii) The measurement of the pure insurance element in accordance with local GAAP is acceptable. This is logical as the risk is likely to be significant in the context of the insurance element of the contract.

(iii) The capitalisation of acquisition costs is acceptable providing they relate in aggregate, without the need for bifurcation, to costs that are recoverable in the context of the expected margins to emerge from the service (e.g. fund management) element of the contractual arrangements or as being related to the insurance element of the contract.

(vi) In normal circumstances the actuarially determined unit linked liability can be taken as the fair value.

In summary, the proposals outlined above would be sufficient to ensure that under the amortised cost and fair value basis a sensible accounting answer for phase 1 whilst still being within the technical auspices of IAS39

Whilst we acknowledge that these proposals for amendment of the application of the amortised cost and fair value methodologies represent a relaxation of the rules applying under IAS39 it more faithfully reflects the nature of the contracts. If the Board have concerns with this relaxation, it would seem reasonable, as a quid pro quo, that companies should be required to provide full details of the nature of the funds, degree of legal insulation and other relevant features, to provide readers of financial statements with adequate explanations of why the applied basis of accounting is appropriate.

3. Unallocated Surplus

We note that although ED5 is not prescriptive as to how companies should classify unallocated surplus between liability and equity there is a potential difficulty when ED5 is considered alongside the usual, not unreasonable, requirement in the IASB framework that liability treatment reflects the existence of a constructive obligation.

We should make clear that we are not proposing that unallocated surplus should be categorised as something other than equity or liability. Indeed the current MSB treatment of the fund for future appropriations for with-profit funds is technically as a liability. We wish this treatment to continue to be possible, irrespective of the constructive obligation criteria.

The reasons for our preference are as follows:

(a) From 2005 IASB basis results will be our principal method of reporting for our financial statements. The treatment of unallocated surplus in these statements conveys a significant message to investors, shareholders and policyholders. Any change from the current liability treatment, unless as part of a court approved reorganisation of the funds, would send a misleading impression.

(b) The unallocated surplus of UK 90/10 with-profit funds, can be broadly distinguished as to three components:

   (i) The excess of policyholders’ asset share over explicit liability.

   (ii) The related shareholders interest in the cost of bonus attaching to amounts recognised under (i) above.

   (iii) Any residual excess that is unlikely to be distributed to current policyholders (other than through second order bonus smoothing effects) or, through the constraints of the distribution mechanism, to the shareholders’ funds of companies with ring fenced with-profit funds.

   Arguably, assuming the very considerable resources that would be required could be made available, item (i) can be identified for regular financial reporting purposes. However, given that asset shares alter from period to period for investment performance and there is no obligation to pay the amount it is questionable whether it is appropriate, at least for phase 1, to book such amounts as liabilities if not required to do so by local regulators.

(c) The balance (item(iii)) is genuinely the “orphan” amount in which shareholders and the current generation of policyholders do not have a direct interest.

   Under both US GAAP and the achieved profits methodology, the unallocated surplus is assumed to be attributable to policyholders and shareholders over time applying the 90/10 basis of distribution. Under achieved profits it is assumed that surpluses will be allocated to policyholders by enhanced terminal bonus for existing contracts. Under US GAAP the treatment is a consequence of the specific accounting treatments under FASB standards and other US accounting pronouncements. Neither of these two approaches fits with the IASB framework and it is questionable as to whether or not the “orphan” unallocated surplus can be allocated applying the 90/10 relationship.

(d) If classification of unallocated surplus as liability is not possible within the confines of the IASB framework then, by default, it would be accounted for as equity. If one defines equity as merely the difference between assets and liabilities then in a technical sense this is the correct treatment. However, it is grossly misleading, and fundamentally untrue, to suggest that the surplus is attributable to ordinary shareholders. Until such time as the surplus is allocated under a court approved arrangement the surplus is definitely not attributable to ordinary shareholders except to say that as and when it is capable of distribution 10 per cent would be allocated to shareholders.

(e) In a technical sense the surplus, if deemed not to be a liability, is rather a second category of equity that has yet to be allocated between ordinary shareholders and policyholders. If one follows this treatment to its logical conclusion it would be necessary to present a performance reporting statement that distinguished between amounts attributable to ordinary shareholders and those attributable to the equity arising from unallocated surplus of with-profit funds.

This would necessitate the use of a two column profit and loss account, with allocation of investment returns, taxation changes, and other items between the two types of equity. It would also necessitate the development of alternative earnings per share so as to provide investors with appropriate information for the two classes of equity. All of this would be very difficult to achieve but even if it could it would be contrary to the apparent direction in which the IASB performance reporting profit is heading.

If one was to superimpose the IASB's own tentative version of a two column P&L, for historic cost and re-measurement on to one for with-profits offices, with a two column approach for ordinary shareholders and equity arising from unallocated surplus, the resulting performance statement would be extremely complex.

Taking all of these factors into consideration we suggest that, until phase 2 has been successfully completed and the performance reporting project explicitly considered for with-profit offices, it would be in everybody's interest for the current liability treatment of unallocated surplus to be permitted. This should be permissible irrespective of the normal 'constructive obligation' criteria. This could be achieved by a simple embellishment of the relevant paragraphs in ED5 in respect of temporary exclusion from IAS8.

4. Reinsurance

We find the requirements of paragraphs18 and 19 and BC 89 to 92 confusing, and in particular are concerned that in many circumstances the application of IAS36 may lead to a position whereby the measured IAS reinsurance asset may not match insurance liabilities. This would appear to be the case even where the liability is wholly reassured and the insurer, except for counterparty risk, is unexposed. It would be helpful if the IASB could alter the proposals make clear that for reinsurance contracts that transfer significant insurance risk (i.e. not financial reinsurance or similar arrangements) the local GAAP approach, as for the liabilities, may continue to be permitted during phase 1.

As an aside we note that the UK Government has permitted unlisted companies the choice of preparing the statutory accounts on either IAS or UK GAAP principles. Whilst the rules applying to intra-group and external reinsurance are shrouded in mystery, and there is a high likelihood of a measurement mismatch of reinsurance assets and insurance liabilities, UK insurers will, justifiably, shy away from adopting IAS as their reporting basis. They will also lobby the UK Accounting Standard Board to delay migration of UK accounting requirements towards those of the IASB.

5. Disclosure of fair value of liabilities

We concur with the universal discontent of commentators at the proposal to disclose fair values of liabilities of insurance at 31 December 2006. Furthermore we would be averse to a watered down proposal of value based information (rather than results on a particular basis) being required to be disclosed. Such a watered down approach will inevitably lead to confusion for investors as to comparability between companies and give audit firms difficulties as to the basis of their review.

6. Disclosure of fair value of liabilities for contracts with discretionary participating features

Out understanding is that those contracts with discretionary participating features, with insignificant risk transfer will be accounted for under a mixture of the rules of IAS39 and paragraph 25 of ED5. Accordingly, subject to the fixed element hurdle being satisfied, the liability shall continue to be accounted for under its existing accounting policies. However, the contract itself would continue to fall under the disclosure requirements of IAS32 and IAS39. A consequence would be the requirement to disclose the fair value of the liabilities of these contracts.

Until phase 2 has been successfully delivered insurers will have no agreed basis on which to determine such fair value. We therefore ask the IASB to amend the proposals to remove this requirement.

7. Other disclosures

We are supportive of the proposed non-prescriptive nature of the implementation guidance attaching to the disclosure requirements of paragraphs 27 to 29. We would though request that the IASB articulate more explicitly that the guidance need only be followed “in spirit” and may be ignored where the requirements are clearly not relevant, of no use to readers of the company’s accounts, or not quantifiable without undue cost.

As regards comments on specific paragraphs we confine our observations to the following instances where the current draft of ED5 is clearly inappropriate.

Paragraph 27(d) - ***Effect of changes in assumptions***

In many instances it will not be possible to determine the effect of changes in assumptions without very onerous systems developments. This is likely to be also true for changes of basis of estimation, for example if a company alters its valuation basis from a net premium basis to a gross premium basis of reserving. We would encourage the IASB to permit some flexibility in how articulation of the effect of changed assumptions may be disclosed.

Paragraph 27(e)/IG27 - Material changes in insurance assets and liabilities

We consider the categories of movements in liabilities referred in IG27 are inappropriate for long-term business. Again some flexibility from the IASB would be welcome.

Paragraphs IG39 (a) to (c)* - *Aged analysis of liabilities and related requirements

These requirements are completely inappropriate for long-term business and need to be completely reconsidered.

Paragraph IG48* — *claims development

It would be helpful if the Board could clarify that this paragraph is not intended to apply to long-term insurance business

8. Application of IAS32, IAS39 and ED5 for comparatives results for periods prior to 2005.

Our understanding is that, following a recent decision by the Board, companies will be permitted but not required to apply IAS39 and the disclosure requirements of IAS32 for comparative results for periods prior to 2005. However, the proposals under ED5, excluding those which relate to further amendments and the application of IAS39, will be applicable for comparative results. For companies such as Prudential, which have a US listing, this may necessitate publication of disclosure comparatives for insurance contracts for 2003 and 2004. Given that the successor IFRS to ED5 is unlikely to be completed before March 2004 we believe it would be reasonable to extend the proposed relaxation to IAS32 and 39 to disclosure requirements under ED5 for insurance contracts.

Notwithstanding these comments, we recognise that companies may wish to provide markets with comparative results on a full IAS basis as regards results in primary statements, but without the IAS32 and ED5 disclosures and without the need to provide details for 2003. It would be helpful to companies and investors if the IASB could adopt a flexible approach for these issues so as to permit partial application in results and disclosures for comparative periods.

Group Finance
Prudential plc
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