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Dear Peter

Exposure Draft ED 5 – Insurance contracts

We appreciate the opportunity to respond to the International Accounting Standards Board's exposure draft of its proposed IFRS, ED 5 – *Insurance contracts*. This letter represents the views of KPMG International.

We support the IASB's effort in implementing a standard on insurance accounting. We acknowledge that the two phase approach is not ideal, but we accept that it is necessary given the difficulties in developing a comprehensive standard in time for those insurers applying IFRS for the first time in 2005. We therefore support the IASB's decision in issuing an exposure draft on Phase I but we see Phase I as no more than an important stepping stone towards a final standard. We encourage the Board to place the highest possible priority on completing a comprehensive, high quality Standard before 2007.

We agree with the approach taken in ED5 to define an insurance contract, to distinguish it from other contracts, particularly financial instruments, and to provide certain exemptions from standards, to avoid the possibility that insurers may need to reverse Phase I accounting changes once Phase II is implemented. In many cases we agree with the specific proposals, although in some areas we believe the proposals provide exemptions that are wider than is necessary to achieve the stated objective.

We believe the objective in paragraph 1(a) should specify that the intention is to avoid complex *systems* changes that may need to be reversed or amended in Phase II. We suggest the Standard should provide further guidance on how to determine whether or not a change should be made.

Our specific concerns, which are dealt with in more detail in the responses to specific questions raised, are:

- **Exemption from the hierarchy in (proposed) IAS 8**. While we support the proposed exemption from the IASB Framework as a whole, we do not support exempting insurance contract accounting from the qualitative criteria set out in the Framework. We believe that a requirement for information to be relevant and reliable is fundamental to any Standard and, without this requirement, we do not believe that ED5 can meet its improvement objective. We believe that Phase I should at least provide this limited degree of discipline as a step towards Phase II.

- **Definition of insurance contract**. We support the proposal that an insurance contract should contain significant insurance risk. However, we believe the guidance provided will result in the definition being applied too broadly. It may therefore inappropriately provide 'shelter' for contracts that have too little insurance risk. In particular, we believe the combination of one 'plausible' event and, in that event, a loss that is 'more than trivial', creates a rather broad notion of significant insurance risk. We would support guidance that requires a reasonable possibility of a loss that is significant, compared to the cash flows that would take place in the absence of an insured event. We suggest the Standard should include illustrative examples of contracts that would and would not contain significant insurance risk. We also believe the significance of insurance risk should be assessed only once, at the inception of a contract.

- **Loss recognition test.** The proposals on unbundling and separating embedded derivatives from insurance contracts are necessarily limited in their impact. We generally support those proposals as a practical compromise for Phase I. However, to compensate for the lack of component accounting in Phase I, we believe the Board should consider strengthening the minimum requirements for the loss recognition test , regardless of any existing test that may be in place, in particular by clarifying which minimum cash flows should be included in the test. We believe it is essential for the Standard to be clear on what is, and is not required under the test. We also believe strongly that the Standard should require disclosure of the nature of the loss recognition tests applied to each type of contract.

- **Reinsurance**. We understand that reinsurance in practice takes many forms that are more complex than the simple 'quota share' examples used in the proposals. We therefore believe that principles will need to be developed in Phase II on when, and to what extent, reinsurance might give rise to gains and losses. We are concerned that some of the proposals seek to establish such principles now, without taking into account the complexity of the reinsurance marketplace.

- **Sunset clause**. Although we strongly agree that every effort should be made to complete Phase II before 2007, we do not believe the sunset clause is an appropriate way to reinforce that message. Indeed we believe it may be counter-productive in that it provides an 'open door' to simply extending the sunset clause in the future.

- **Fair value disclosure**. Although we agree that information on fair values (or on the inputs to fair value measurement) is important, we do not agree that the Standard should set a date for full fair value disclosures. Rather, the disclosure requirement should be introduced once guidance on the measurement of fair value has been developed and subjected to due process, and after providing an appropriate period of time for systems to be developed.

A further general concern is that the conclusions reached in the Implementation Guidance are not always apparent from reading the Exposure Draft and its appendices. In many cases we believe the Implementation Guidance is essential to understanding the Board's intentions. Therefore we believe the guidance should include frequent cross-references to the guidance. We are also concerned that the proposals do not distinguish between life and non-life, or short-term and long-term business, where the risks are fundamentally different. We suggest that the distinction should be recognised in the language used throughout the document.

We assume, consistent with the Board's tentative decisions on IAS 32 and IAS 39, that the transition to a Standard based on ED5, for a first-time adopter in 2005, would be at 1 January 2005 with no restatement of comparatives, and that early adoption would be permitted. This may help to deal with concerns about the time available to implement the Standard. We assume that this would be dealt with through consequential amendments to IFRS 1.

Question 1 – Scope

We support the proposal in the ED to apply the IFRS to all insurance contracts including reinsurance contracts. We believe the Standard should emphasise that Phase I on insurance contracts applies not only to insurance companies, but to all entities issuing contracts falling under this standard. We also believe that paragraph 3 should state explicitly, for the avoidance of any doubt, that an insurer should apply all the requirements of all other IFRSs to its transactions that do not fall within the scope of this Standard.

We agree with the proposal that, in Phase I, no separate category should be introduced for financial assets held to back insurance liabilities. We also agree that no further exemptions should be provided to the held-to-maturity category in IAS 39. To the extent that an insurer wishes to make use of the held-to-maturity category, it will need to be satisfied that, except in extremely rare circumstances that could not be anticipated at the outset, it will not be required to dispose of those assets before maturity.

When such uncertainties require an insurer to measure its financial assets at fair value, the result will clearly be volatility, either in income or in equity, when an insurer either cannot or chooses not to measure its insurance and deposit liabilities at fair value. We believe the Board should consider providing additional guidance in the Basis for Conclusions to explain that an insurer may mitigate that volatility for life assurance and participating investment contracts by adjusting its accounting policies for the related liabilities.

We believe the Standard should address so-called 'shadow accounting'. We understand shadow accounting to mean that changes in the carrying amount of a liability are recognised in equity to offset corresponding changes in the value of related assets. We assume that ED5 would permit such accounting to continue, or may be introduced, in Phase I for a contract that qualifies as an insurance contract. However, we note that such accounting is inconsistent with the Framework and IAS 1 and would therefore not be permitted for a discretionary feature in a contract that does not contain significant insurance risk. We suggest that guidance on whether the Board believes 'shadow accounting' is appropriate in these circumstances should be provided in the Standard.

We note that there may be circumstances when the Board's decision on demand deposits in IAS 39 would prevent an insurer from reducing its liability under an investment contract below its demand or surrender value to offset losses on the related assets. The problem would arise, for example, when an increase in interest rates gives rise to fair value losses on fixed-rate assets that cannot be offset by equivalent fair value gains on related deposits.

In circumstances when an investor could surrender or redeem an instrument at its face value, regardless of any accumulated fair value losses on related assets, it is difficult to argue that those losses should not be borne by the insurer. We note, however, that a third-party willing to accept such a portfolio of liabilities would price a transaction taking into account behavioural considerations. We suggest the Board give further consideration to whether there are circumstances in which the fair value of demand deposits might be less than the surrender value.

We agree that weather derivatives should be included in the scope of IAS 39 unless such contracts meet the definition of an insurance contract. We note that warranties provided by a manufacturer are excluded from the scope of the proposed Standard and we support that approach for Phase I. However, we suggest that the Board clarify in the Basis for Conclusions whether the intention for Phase II is that all such warranties would be accounted for as insurance contracts.

Question 2 - Definition of insurance contract

Generally we agree with the definition of an insurance contract in Appendix A. However, we are concerned that some of the guidance in Appendix B would apply the definition too broadly in the areas set out below.

Significant insurance risk

We do not agree with the guidance on significant insurance risk in paragraphs B21 and B22. The combined effect of an event needing to be merely "plausible" and a resulting loss being "more than trivial" will result in almost any contract with any insurance risk being treated as an insurance contract under existing GAAP during Phase I. We have heard it suggested that a savings contract with a death benefit 1% higher that the accumulated fund balance would be considered to meet the proposed requirements, and we do not believe that would be appropriate. We believe that the current definition might encourage contracts with very little real insurance risk to be engineered to meet the definition.

Furthermore, the guidance in Appendix B is not clear on what basis should significance be judged. For example, should significance be judged in comparison to premiums received or compared to the cash flows under the contract as a whole? We believe it should be primarily the latter, although we would support an additional high-level requirement that the premium related to insurance risk must be substantive compared to the total payments received from the policyholder.

We suggest that guidance on significant insurance risk should be based on the present value of the probability weighted contingent (insurance) 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. We would not introduce a quantitative requirement into the Standard. We believe the test should be based on whether insurance risk is substantive, and that the best way to achieve this is to support the guidance by illustrative examples, perhaps along the lines set out below.

<u>Example 1</u>

An insurer offers a product under which the investor pays fixed annual premiums of 1000 for 10 years. Funds are invested in a basket of equity shares equivalent to the local market index and the increase or decrease in the index is adjusted against the fund balance. The insurer charges the fund at a rate of 5 per annum to cover the death benefit and 10 per annum for investment management services. At the end of 10 years, the investor receives cash equivalent to the value of the fund. If the investor dies during the life of the contract, a death benefit is paid of 105% of the fund value. The mortality risk over the term of the contract is assessed at 3%.

The insurance risk, a 3% risk of a loss at 5% compared to the cash flows that would take place if the insured event does not take place, is not considered significant in relation to the contract as a whole. The contract is accounted for as a financial liability under IAS 39.

Example 2

The fact pattern is similar to that described in Example 1, except that the death benefit premium is 40 per annum, the death benefit is 120% of fund value and the mortality risk is assessed at 5%.

In this case the insurance risk, being a 5% risk of a 20% loss, compared to the cash flows that would otherwise arise under the contract, is considered significant. The entire contract is accounted for as an insurance contract.

If the Board decides to retain the concept of a plausible event, we would suggest adding guidance on circumstances when an event would not be plausible. One example would be that the insured events are unlikely to occur even in a relatively large portfolio of contracts that share a similar risk profile, or that the event has never before been seen in practice.

Paragraph B25 appears to require continuous monitoring of contracts not qualifying as insurance contracts at inception to determine if they subsequently qualify. We do not believe such a requirement is necessary for Phase I.

Uncertain event

We agree with the definition of an insurance contract in Appendix A that requires the existence of an uncertain future event that adversely affects the policyholder or other beneficiary. We agree that either whether or when an insured event will take place (or will be reported to the insurer) create the necessary uncertainty. However, we do not agree that uncertainty over the amount that will be paid, on its own, as implied in B4(c), is an uncertain event as described in Appendix A.

We are concerned by the example used in paragraph B6. This suggests that 'insurance' of the amount that may be required to be paid by the direct insurer, under claims already received, would meet the definition of an insurance contract. Since there is no uncertain future event in this case, simply a liability of uncertain future amount, we believe such contracts would not meet the definition in Appendix A and would fall to be accounted for under IAS 37.

However, we agree that it would be inappropriate, in Phase I, to require retroactive reinsurance contracts to be accounted for under IAS 37. In our view, the appropriate solution is for the Standard to recognise that such contracts do not meet the definition, but to include a requirement that such contracts should be accounted for as if they were insurance contracts, and to provide a specific scope exclusion from IAS 37.

We suggest that the Board give further consideration to the issue of reinsurance for the uncertain amount to be paid under claims already received by an insurer, which we understand is a common practice in the industry. If the Board agrees that such contracts should not be accounted for under IAS 37 during Phase I, then we believe the appropriate solution is to provide a specific scope exemption in IAS 37 rather than including such contracts in the definition of an insurance contract.

Group contracts and groups of contracts

We believe the Standard should address how to account for group contracts taken out by an employer and covering, for example, a group of employees against health or car accidents. Such contracts are usually agreed on company level by the employer. However, a number of different single risks are covered under such contracts. We believe the standard should clarify when such contracts constitute a number of individual contracts and when they comprise one contract covering all risks. We believe it its important to clarify this matter, as the definition might have impact on the qualification of the contract as insurance. Some of the single risks might qualify separately for insurance accounting but on an overall basis insurance risk might not be sufficient.

An appropriate way to distinguish between group contracts that comprise a single contract and those that comprise individual contracts for each employee may be to consider whether the contract is priced by considering risks specific to each employee or whether it is priced by considering the average risk applying to all employees or categories of employees.

Question 3 - Embedded derivatives

We support the proposal to separate embedded derivatives from host insurance contracts in the same way as is required under IAS 39 for other types of host contract . However, we believe the Board should give further thought to situations when an insurance derivative embedded in a non-insurance host contract might be separated.

For example, consider a traditional retirement benefit contract (deferred annuity), in which contributions and assets returns, less management charges, are accumulated in a fund over the investor's working life. On retirement, the investor either must or may use the balance in the fund to purchase a life-contingent annuity. The insurer has guaranteed an annuity rate at the inception of the contract.

If the Board believes that the savings and insurance components of such a simple deferred annuity product will be accounted for separately under Phase II, then we believe such a requirement should be introduced now. Any Phase I requirement to separate contracts into their insurance and non-insurance component should, we believe, be based on the Board's current thinking as regards Phase II and the objectives of Phase I, specifically the need to improve the accounting for insurance contracts without introducing systems changes that may need to be reversed later.

If the Board decides to retain its proposed approach for Phase I, then we believe it is important that both the guidance on significant insurance risk is strengthened, and that the nature of the loss recognition test is fully disclosed, including the approach applied, if any, to ensuring that the reported liability captures the investment components that would otherwise be accounted for under IAS 39.

We support the Board's decision to give insurers the exemption not to separate options to surrender an insurance contract for a fixed amount in order to avoid significant system changes in Phase I. We agree with the proposals to require the separation of put options or cash surrender options based on equity or commodity prices.

We agree it is appropriate, for Phase I, to exempt from fair value measurement life-contingent annuity options and guaranteed minimum death benefits.

The Exposure Draft suggests that interest rate guarantees embedded in a host contract that are out of the money at inception should not be separated from the host insurance contract because they are considered to be closely related. Although it is the case, for a long-term (life) contract, that the host contract is priced to contain significant interest rate risk, we believe that argument should be made explicit in the guidance. For short duration (non-life) contracts, we believe an interest-related guarantee is less likely to be closely related to the host contract.

Question 4 - Temporary exclusion from criteria in IAS 8

We understand and agree with the proposal to exempt insurance contracts from the requirement to apply paragraph 6 in (proposed) IAS 8. In particular, we agree it would be impractical to require an insurer to apply IAS 37, even by analogy, to its insurance liabilities in Phase I and then to require a further change, possibly to fair value, in Phase II.

However, we are not convinced of the need to exempt an entity from applying paragraph 5 of (proposed) IAS 8. We believe an entity should, in developing and applying an accounting policy for insurance contracts in Phase I, consider the qualitative criteria set out in the IASB Framework, as reproduced in paragraph 5. We assume it is extremely unlikely that a Phase II standard on insurance contracts would not require information that is relevant and reliable, and therefore we do not believe there is a significant risk of an insurer being forced, by paragraph 5, to amend a policy for Phase I where the amendment would need to be reversed in Phase II. We find it difficult to imagine that requiring the qualitative criteria to be met would require the introduction of costly systems changes.

The only issue of significance would seem to be prudence. Applying paragraph 5 would simply require the policy chosen to ensure that the financial statements, in this respect, "are prudent". The loss recognition test in paragraph 11 appears to require this in any case. Therefore the only reason not to apply paragraph 5 would be in circumstances when an entity wished to apply excessive prudence. Referring back to the Framework, paragraph 37, the language that would prohibit excessive prudence states:

"However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions… or the deliberate overstatement of liabilities…"

What is considered "excessive" in this context remains open to judgement. Therefore it would seem unlikely the proposals would require policies to be changed except to eliminate practices that are clearly inappropriate. Again, we believe it is unlikely that the Board, in approving a Phase II standard, would allow "excessive" provisions. We believe that excessive prudence is one of the main concerns of investors and policyholders who find it difficult to interpret the level of prudence used in the financial statements of insurers and the effect on reported results.

Finally, we do not believe that an IFRS, as proposed in paragraph 16, should specify that "an insurer may continue using existing accounting practices that involve… measuring insurance liabilities with excessive prudence".

Sunset clause

We understand the Board's desire, in including a "sunset clause" within the draft, to send a strong signal that the hierarchy exemption in Phase I is expected to be temporary. However, we do not believe this the appropriate way to convey such a message, for several reasons. First, it would be entirely inappropriate, in our view, to allow the sunset clause to be triggered, because the guidance then in place (through the hierarchy) in IAS 37 and the Framework would clearly be inadequate for use on its own.

Secondly, since IAS 37 excludes from its scope provisions arising from insurance contracts, it would be unclear whether IAS 37 should, indeed, apply. The same issue arises currently under IAS 22 with respect to common control transactions. Some believe that IAS 22 should apply by analogy to such transactions (via the hierarchy); others believe a specific scope exemption should override the use of the hierarchy. Thirdly we believe the inclusion of a sunset clause implicitly creates an expectation that the date might be extended.

Catastrophe and equalisation reserves

We agree with the proposal to eliminate catastrophe and equalisation provisions. We believe the Standard should clarify what is meant in paragraph 10(a) by the words 'under future insurance contracts'. We assume the intention is that renewals of existing short-duration contracts should also not be assumed in this context.

Loss recognition test

We support the requirement for introducing a loss recognition test. However, we believe the test should be specified in more detail. In particular, the language in paragraph 11 should be amended to clarify what cash flows the Board intends should be included in the test. We support the proposal at the beginning of paragraph 11 that the test should be based on current estimates of future cash flows under an entity's insurance contracts, and we believe this is the principle that should underpin the loss recognition test. The last sentence in paragraph 11, however, creates confusion by stating that the proposals do not specify which cash flows should be included. We believe that guidance should encourage an insurer to develop a test that captures both insurance cash flows and the cash flows arising under the investment component of its contracts, including any embedded derivatives (annuity options, surrender values, interest guarantees, etc) that are, for practical reasons, not separated in Phase I.

Guidance should also specify that the test should be applied to insurance liabilities after deducting related deferred acquisition costs and separately presented 'PVIF' assets.

BC 67(b) notes that the draft IFRS does not specify whether the loss recognition test should be carried out for a book of insurance contracts or contract-by-contract. We believe the loss recognition test should be carried out on the basis of portfolios of similar contracts incorporating similar risk profiles that are managed together for internal reporting purposes.

We note that most jurisdictions (including EU Member States, for example) will have enshrined in the law or in regulatory requirements a test that provisions should be 'measured on a prudent basis'. We believe it is arguable whether this might be sufficient to qualify as an existing test under paragraph 11, and that this should be clarified. Consistent with our comments above, we believe it should not.

We agree with the Board's proposals on derecognition and offsetting of insurance assets and liabilities. With regard to the offsetting of income and expense in the income statement, we believe the Standard should clarify whether it is intended that reinsurance costs may be deducted from direct insurance as long as each is separately disclosed on the face of the income statement, whether reinsurance costs should be presented as expenses in the income statement, or whether 'grossing-up' the net amount in the notes to the financial statements would be considered sufficient. We believe note disclosure would be sufficient.

Finally, we note that the Standard will deal with derecognition but not with the timing of *recognition* of insurance contracts. We assume that is because there may be divergent practices that the Board does not wish to address in Phase I and we believe that should at least be clarified in the Basis for Conclusions.

Question 5 - Changes in accounting policies

We agree with the Board's decision to allow insurers to change their accounting policies for insurance contracts if the requirements of paragraph 14-17 of the Exposure Draft have been met. We believe the proposed changes in accounting policies are appropriate for the interim period of Phase I.

We also believe that the option to reclassify assets into the category of financial assets that are measured at fair value with changes in fair value recognised in income is appropriate for Phase I. It will assist insurers to reducing the volatility and potential mismatches that might otherwise arise.

We believe the Standard should provide further guidance on which changes in accounting policies are considered as 'improving' relevance and reliability during Phase I. We are concerned that the current guidance will lead to inappropriate judgement and entity specific interpretations. One approach is to specify that improved relevance and reliability should mean moving in the direction of decisions made by the Board in developing proposals for Phase II.

On balance, we support the proposal not to require insurers to apply uniform accounting policies during Phase I, since achieving consistency in accounting for insurance contracts between existing national requirements may be almost as onerous, from a systems perspective, as applying the full Phase II solution. Requiring consistent policies might also encourage a 'lowest common denominator' approach which would be undesirable. However, we note that this is another exemption that does nothing to assist in the understanding and comparability of IFRS financial statements. The existence of this exemption should be considered a further reason to move Phase II forward as quickly as possible. To the extent that uniform policies are not applied, disclosure should be required of the policies that are applied to each significant part of the business.

Question 6 - Unbundling

We agree with the proposal to require unbundling of deposit components embedded in insurance contracts. However, neither the guidance nor the Basis for Conclusions is clear on the principle that underlies the requirement. Why, for example, is a deposit component to be separated but not any other investment-type feature?

The criterion in paragraph 7 for unbundling a deposit component from an insurance contract is that the cash flows from the insurance component do not affect the cash flows of the deposit component. If applied as a principle, this would require full component accounting; that is, all 'independent' deposit, investment features and embedded derivatives would be separated before applying the definition of an insurance contract to each component. But that does not seem to be the Board's intention, based on the examples in the Implementation Guidance.

Except for the financial reinsurance example on reinsurance stated in the Implementation Guidance, no further guidance is available. We believe additional guidance should be provided in the form of examples of contracts to which the requirements would apply. On the other hand, if the intention is not to establish a principle, but only to require separation of the deposit component in a financial reinsurance contract, then the Standard should be clear in this respect.

BC 33 refers to the 1999 Issues Paper which proposed that a deposit component should be unbundled if it is either disclosed explicitly to the policyholder or clearly identifiable from the terms of the contract. We wonder whether this approach might usefully be incorporated into the Standard?

Many reinsurance contracts also contain a deposit feature that is more akin to a current or 'clearing' account. The main purpose of such balances is to simplify cash flows between the parties involved, in order to clear balances regularly instead of transferring funds for every individual claim that is made. We believe that such balances should be accounted for under IAS 39. This should be clarified in the guidance.

We note that, if the Board were to strengthen both the loss recognition test and the guidance on significant insurance risk, the need for requirements on unbundling may be reduced or even eliminated.

Question 7 - Reinsurance

On balance we do not believe that the Phase I standard should introduce principles for gain or loss recognition on reinsurance when no principles are established for direct insurance contracts. We believe both should be deferred as Phase II issues, and that Phase I should seek only to eliminate specific practices that are clearly unacceptable, that will not survive Phase II and that therefore should be dealt with in order to meet ED5's objectives.

The proposals are based on a limited number of examples of reinsurance contracts that do not reflect the complexity and variety of reinsurance contracts found in the market. In practice, the simple, proportional quota-share contract is the simplest of a vast array of products that include both proportional and non-proportional loss-sharing applied to various combinations of portfolios of contracts of different types, and stop-loss contracts.

We would limit Phase I to prohibiting recognition of gains on reinsurance that arise from inconsistencies in <u>accounting</u> between direct insurance and reinsurance contracts. For this reason, we support the proposal in paragraph 18(a), but we believe the proposed requirements in paragraph 18 (b) to (d) should be deferred and considered further in the development of Phase II.

To prevent one unacceptable practice that the Board appears keen to tackle in Phase I, we suggest including a principle that there should be no gain on initial recognition of a reinsurance contract except when that contract legally (or in substance) extinguishes an insurance liability. Another approach, by analogy to the Board's recent discussions on derivatives and other products where the entity has ready access to more than one market, might be that no gain or loss should be recognised on taking reinsurance unless it can be demonstrated that the risk (or a measurable portion of risk) has been fully and irrevocably transferred and that the premium received related to that risk can be reliably measured by reference to similar market transactions.

With respect to the credit risk arising on reinsurance assets, it would seem more appropriate to apply the impairment requirements in IAS 39 than those in IAS 36 to these assets.

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

We support the Board's decision to require insurers to measure identifiable assets and liabilities in a business combination according to IAS 22 Business Combinations at fair value, and the proposal to permit an insurer, during Phase I, to use an expanded presentation as described. However, we believe that paragraph 20(b) should require that the carrying amount of the separated asset should not exceed the present value of the future profits that the entity expects to generate from contracts in force at the date of acquisition. It should not include the value of expected renewals or new business. Paragraph 20(b), as drafted, would appear to permit either.

We also believe that the Standard should state explicitly that the requirements of and the guidance in [ED 3] should be applied in determining the fair value of the insurance assets and liabilities acquired in a business combination. This is implicit in the first sentence of paragraph 20, but the 'does not exclude' language obscures this important message. We are anxious that ED5, in discussing the uncertainty about how to measure the fair value of an insurance contract, should not create an impression that the principles in IAS 22/ED3 need not be applied to insurance rights and obligations acquired in a business combination.

We agree that, because this is essentially a question of presentation, the separated 'PVIF' asset should be excluded from the requirements of IAS 38 and IAS 36. However, it is clearly important that these amounts are deducted from the liability before applying the loss recognition test. We note that this is required under paragraph 12 if an insurer's existing accounting policies do not require a loss recognition test. However, it does not seem to be required if an insurer is using an existing test under paragraph 11. Consistent with our earlier comments, we believe certain minimum requirements of an IFRS loss recognition test should apply regardless of whether such a test already exists.

Question 9 - Discretionary participation features

In finalising this requirement, we believe it is important to define the term "discretionary" more clearly.

The concept of discretion is an integral part of the distinction between equity and liabilities in IAS 32, and we believe the requirements of IAS 32 should be used to determine whether a feature is truly 'discretionary'. In that regard, IAS 32 would classify a feature as discretionary only when the entity may choose to avoid payment. The ability to defer payment generally would not be seen as discretionary unless payment could be deferred indefinitely, even until the liquidation of the entity. Where only the allocation of payments between reporting periods or between classes of investor is at the discretion of the insurer, we believe the amount should be classified as a liability.

IAS 32 also clarifies that an amount that must be paid 'subject to sufficient distributable profits being available' or subject to regulatory requirements being met, is a liability – i.e. the regulatory contingency is not sufficient to create 'discretion'. All these concepts should, we believe, be incorporated into the Standard by reference to IAS 32. We would not object to a truly discretionary amount being classified as liability for Phase I. However, we do not believe it is appropriate that an amount that would be classified as a liability under IAS 32 should be classified as equity for Phase I.

In some countries policyholders are legally eligible to participate in the insurer's profit. Under IAS 32, such a right would be accounted for as a liability. It is important that this is clarified in the Standard.

Paragraph 25 states that the proposals on discretionary participation features apply also to a financial instrument that contains a discretionary participation feature. We see no reason for ED5 to provide exemptions from the requirements in IAS 32 and IAS 39 for a financial instrument that contains little or no insurance risk. As noted above, IAS 32 contains sufficient guidance on the classification of a discretionary feature in a non-insurance contract. We do not believe that the 'deposit floor' feature in paragraph 25 is an adequate (or necessary) alternative to applying IAS 39 to such contracts. Consequently, we believe that paragraph 25 should be deleted.

We assume that transaction costs on such instruments would be allocated to the liability and (any) equity component following the guidance in SIC-18. Perhaps this should be clarified. We also believe the term 'fixed element' might be misleading, and suggest instead the term 'liability component' be used to include all non-discretionary contractual obligations that meet the definition of liabilities under IAS 32.

We support the Board's decision not to introduce or permit continued use of an intermediate category between liabilities and equity for the unallocated surplus.

We note that IAS 39 does not deal adequately with items such as acquisition costs and investment management fees that are found within investment products, and we suggest that limited guidance be introduced in these areas.

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

The requirement to disclose fair value from 2006 presupposes that Phase II guidance on the definition of fair value will be available at that time. As the Board itself is not clear at the current stage whether or how fair value should be determined, our comment on this is similar to those on the sunset clause. We do not believe it is appropriate to set a deadline for such disclosure. Rather, once guidance on fair value has been developed and subjected to appropriate due process, the Standard should be amended to incorporate that guidance and to require fair value disclosure, pending completion of Phase II.

Question 11 - Other disclosures

We support the other disclosures proposed in the draft standard in general. However, we believe the standard should recognise that the level of disclosure on a contract-by-contract basis would be excessive and therefore that an appropriate level of aggregation by product type (assessed based on products with similar risks, and not based on product descriptions) would be appropriate. On the other hand we also believe that the some specific disclosures on insurance related liabilities should be required, as policyholders eligible to profit participation and shareholders should have the opportunity to judge on the level of prudence applied by the insurer.

In particular, we believe the Standard should require disclosure of the nature of the loss recognition test applied to each type of insurance contract, including whether, and how, the expected investment cash flows from the following items are captured by the test:

(a) deposit components that are not separated from the host insurance contract;

(b) embedded derivatives that are not separated from the host insurance contract, including annuity options, surrender rights and guaranteed interest, equity or commodity features.

In addition, we believe this disclosure should include whether and how the cash flows are discounted in performing the loss recognition test, and how future investment returns are incorporated in the test.

We generally support the disclosures suggested in the Implementation Guidance. Some of the guidance however, might lead insurers to change current reporting structures in a way that would provide less useful information to the user. For example, the suggested disclosure in IG Example 4 may be appropriate for some insurers. Others may have developed more sophisticated reporting structures and disclosures that may provide better information about estimates, uncertainties and especially run-off of insurance liabilities. The guidance should clarify that this is only one possible disclosure format, and that an entity should use all available information to provide the most appropriate disclosure in its own circumstances.

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

We agree that IAS 39 should apply to a guarantee given in connection with the transfer of non-financial assets and liabilities.

Question 13 – Other comments

Transition

We believe that paragraph 32 should specify that, except where paragraphs 33-35 state otherwise, the requirements in (proposed) IAS 8 should apply.

Insurance contract remains an insurance contract until all rights and obligations are extinguished or expire

We believe this proposal in B25 should be amended to read 'until all insurance-contingent rights and obligations are extinguished or expire'. The need for this change is illustrated in IG example 2.18, a dual-trigger contract in which only the first trigger is based on an insured event. Once that insured event has occurred, we believe the remaining contract is a derivative and should be accounted for under IAS 39.

Implementation Guidance

1.2 – we are concerned that this example is too widely drawn in that it may capture almost any contract that has a redemption penalty which is waived on death. This would affect many loans and mortgages that would otherwise be accounted for under IAS 39.

1.15 – We believe the contract is an insurance contract only if the potential impact of changes in fair value due to changes in the condition of the specific asset is significant compared to changes in its market value.

1.18 – The nature of the contract is not clear from the description given.

2.6(b) – The example assumes that a minimum annuity rate guarantee linked to interest rates (out of the money) is closely linked to the host insurance contract. We do not object to this conclusion, but the guidance should explain more clearly that an interest-related feature is considered closely related to an insurance contract (or perhaps only a life contract?) and why this is so.

2.16 – In the second column, the last sentence should state that fair value measurement is required. We assume this is a drafting error.

Unbundling a deposit component

We believe the accounting entries that follow from IG example 3 should be more clearly explained. From the cedant's perspective, we believe accounting in case 1 is to recognise a deposit asset (originated receivable under IAS 39) reflecting the amounts shown in the 'closing balance' column, with accretion of the interest income in column 3. The insurance premium of 3.3 in each period would be accounted for under the cedant's existing policy for reinsurance contracts. In case 2, we assume that the 'loan from reinsurer to cedant' recognised in year 1 would be netted against the deposit recognised previously under case 1. The example should clarify that the balances would be similarly adjusted depending on the level of claims made in the remaining periods.

Once again, we appreciate the opportunity to comment on the proposals. Please contact Terry Harding at 020 7694 8640 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG