RESPONSE OF THE ASSOCIATION OF BRITISH INSURERS TO ED5 INSURANCE CONTRACTS

1 INTRODUCTION

We broadly welcome ED5 as it goes some considerable way to providing a pragmatic solution for the interim period until IASB has finalised its proposals under Phase 2. Inevitably however we have some concerns. The more important of these are listed below. We give our views on the specific questions raised by the IASB in the final part of this response.

2 EXECUTIVE SUMMARY

Application of IAS 39

We strongly believe that it is unrealistic to expect IAS 39 to be applied to some contracts issued by insurers in the absence of further guidance from the IASB on how this should be done. In the absence of such guidance, it is likely that some inconsistencies will be introduced into the way in which different insurers apply IAS 39. This could undermine the credibility of insurers' financial reporting. More time may also be required to resolve the large number of outstanding issues if each company has to develop its own solutions. We believe these problems should be addressed by extending phase I to all contracts issued by insurers that transfer insurance risk and subsequently converging the application of IAS 39 to any contracts issued by insurers with the publication of the phase 2 standard. This will avoid the possibility of the eventual phase 2 requirements requiring changes to what companies might have done previously to implement IAS 39.

This approach will result in all companies simultaneously moving to a consistent methodology for all contracts with an element of insurance risk in Phase 2. Furthermore, we believe it will be welcomed by investment analysts and other users of the financial statement as it will ensure consistency in the principles applicable to these contracts and facilitate comparability of results.

There are also some serious conceptual and practical concerns which must call into question whether it would be appropriate and feasible to apply IAS 39 to some contracts issued by insurance undertakings (in particular unit-linked contracts) from 1 January 2005.

For some contracts issued by insurers to which IAS 39 will apply, it will be more appropriate to measure the associated insurance liabilities at fair value as opposed to amortised cost. The Board's current stipulation however that the fair value of liabilities for those contracts with a demand feature should not be less than the "deposit floor" (i.e. the amount that the policyholder can require to be paid on demand) is inconsistent with the going concern assumption and requires the use of excessive prudence. We do not believe that the application of the deposit floor will lead to a sensible estimate of fair value or reflect the economic reality of the contracts in question. Therefore, even if the IASB rejects the proposal to widen the application of phase I as outlined above, we strongly believe that this requirement should be removed from the final text of the revised IAS 39.

The prevailing uncertainty has been compounded by the fact that IAS 39 will not be issued in its final form until 2004, and is likely to contain a number of changes from the exposure draft. This raises serious concerns over whether, given the limited amount of time available, EU insurers will be able to implement IAS 39 by 1 January 2005, in view of the major systems changes that this will require. In particular there is now very little time to complete field-testing before then. This consideration alone would be sufficient justification for IASB to allow a transitional period after 1 January 2005 for the implementation of IAS 39 by insurers with compliance only being mandatory at the end of that period. The tentative proposal not to require IAS 39 comparatives in the 2005 financial statements does not go far enough in this direction because accounts users will require them even if IASB does not.

<u>Fair Value Disclosure</u>

We are strongly opposed to any unqualified requirement for note disclosure of the fair value of insurance assets and liabilities from 2006. This is not because we disagree with the concept of fair value. Indeed, we believe that phase 2 should adopt an appropriate fair value methodology. The concern is that compliance with any requirement to disclose fair value will be difficult unless the IASB provides some guidance on how this should be done. We do not believe it is appropriate to mandate a requirement to apply irrespective of whether or not the principles to support it have been put in place. While IASB has undertaken to reach tentative conclusions by 2006, there is no certainty given the complexity of the issues that this will be possible, or that if any tentative conclusions are reached, they will eventually be incorporated in the phase 2 standard. Moreover, it is probable that any fair value figures disclosed will need to be accompanied by additional explanation of what they represent for the benefit of accounts users and to aid comparability between companies. Some consensus on the nature of this additional explanation would need to be agreed.

<u>Other Disclosures</u>

We are concerned about the substantial disclosures proposed in ED 5 in the draft IFRS itself, but more particularly in the implementation guidance. Some of these do not have sufficient regard to commercial sensitivity while others may have little or no relevance to the needs of accounts users. In many cases, and certainly in the UK, a large amount of the required information is already included in regulatory returns that are on the public record. We believe preparers should be able to apply the principles of disclosure in the manner that is most appropriate to their business. We think there should also be a clearer statement that the implementation guidance is advisory and not mandatory.

Sunset Clause

We firmly believe that the proposed sunset clause should be removed. Instead Phase 1 should apply until the Phase 2 IFRS is in place. While we fully support IASB's intention to complete the phase 2 standard by 2006, there is no certainty that this will be possible. Moreover, the IASB Insurance Advisory Committee has indicated that a 2–3 year transitional period is likely to be needed for the implementation of Phase 2. This makes the 2006 deadline even less realistic. The removal of the exemption from the hierarchy within Phase 1 would result in the unacceptable position of the insurance industry potentially incurring the cost of three accounting systems changes in under a decade.

3 ANSWERS TO THE QUESTIONS RAISED IN ED5

Q1 **(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 by 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?

A (a) We agree that the IFRS should apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds. We also agree that the draft IFRS should not apply to accounting by policyholders.

We accept that assets held to back insurance contracts are more appropriately covered under existing IFRS dealing specifically with certain types of asset (e.g. IAS39 and IAS 40).

We strongly disagree however with the proposition set out in clause (a)(ii) that financial instruments that are not insurance contracts [according to the IASB definition] but are issued by an entity that also issues insurance contracts should not be covered by the IFRS. Given the outstanding technical and practical issues, and the need for consistent financial reporting, we believe that phase I should be extended to all contracts issued by insurers that transfer insurance risk and that subsequently the application of IAS 39 to any contracts issued by insurers should be converged with the publication of the phase 2 standard.

Our principal concerns with IAS39 can be summarised as follows:

- It was not designed originally to apply to insurance contracts. As a result, some of its requirements will be new to insurers and do not fit easily into an insurance context.

- Partly as a result of this, some aspects of IAS 39 allow certain options or may, in the absence of any further IASB implementation guidance, be subject to differing interpretations leading to inconsistencies in accounting practice.

- In particular, there is an absence of clear guidance on how liabilities relating to contracts issued by insurers should be measured under IAS39 at either fair value or amortised cost. We would be happy to provide examples of those areas where guidance is considered necessary in the specific context of insurance products issued in the United Kingdom.

- This leads to the additional concern that any guidance that IASB might subsequently issue on fair valuing liabilities either in relation to IAS39 or under Phase 2 of the insurance project, could invalidate the practice adopted by insurers from 1 January 2005 and as a result require further accounting changes.

- We are pleased to note that at the July Board meeting IASB agreed that acquisition costs could include internal as well as external costs. The Board also clarified however that transaction costs are included in the measurement of items *other than those measured at fair value with changes recognised in the profit and loss account.* While we understand that deferred acquisition costs may be recognised implicitly where liabilities are measured at amortised cost, the ability to achieve the equivalent of such deferral where fair value is adopted by recognising future management charges in the cash flows used to determine fair value will be constrained by the IASB requirement for a deposit floor approach (ie the fair value of the liability cannot be less than surrender value).

- This restriction, which will particularly impact on unit-linked life insurance where valuation of liabilities at fair value is the more appropriate method, could create or increase losses at inception thereby pushing profit recognition back to the later stages of the contract. This in turn could lead to an increase in the cost of capital and in extreme cases might make it no longer commercially viable to write some kinds of business.

- Some concerns have been raised because the requirement to measure assets at fair value under IAS39 when many insurers will continue to measure liabilities at amortised cost under Phase 1, may give rise to an unacceptable degree of volatility. While we understand that this is an issue for some insurers, we would not want it to be resolved in a way that precluded the adoption of fair value measurement for such assets, by, for example, creating an additional class of assets backing insurance liabilities to be measured at amortised cost, without any options to use fair value.

- Given the major systems changes that IAS39 will require for contracts written by insurers that fall within its scope, and the fact that the revised version of IAS39 may not be issued in 2004, insurers will find it hard to comply with the new standard by 1 January 2005. At the very least this suggests the need for a transitional period with adoption of the new standard being mandatory only from the end of that period.

(b) We agree that weather derivatives should fall within the scope of IAS39 unless they meet the IASB definition of an insurance contract.

Q2 **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 or 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 Guidance).**

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?

A While we believe that the definition and supporting guidance probably goes as far as possible without being over-prescriptive, we believe that this is one of the areas that is likely to result in the greatest inconsistency in interpretation. The key question is *what is meant by trivial?* We appreciate however that the alternative of a quantitative definition could facilitate avoidance or accounting arbitrage. Some work is already being carried out on this within the industry as a result of which we hope an industry consensus will emerge.

As it stands, the definition is helpful in appearing to confirm that:

- A contract can meet the definition where the transfer of insurance risk is not trivial but is less than the transfer of non-insurance risk; and

- A contract issued by a non-insurer that does not initially transfer any insurance risk cannot be transformed into an insurance contract by the addition of a trivial amount of insurance risk transfer.

Nonetheless there are a number of contradictions contained within the definition of insurance. We have highlighted some of the key areas below. We believe deferral until Phase 2 will provide additional time for the IASB, the industry and its professional advisors to address these matters.

Paragraph B21 of the supplementary guidance refers to insurance risk being significant if, and only if, it is plausible that an insured event will cause a significant change in the present value of the insurer's net cash flows arising from that contract. "Net" for this purpose should not be restricted to premiums and claims based cash flows but should also encompass expenses and any other ancillary cash flows that result from the contract being written.

Paragraph B22 is more restrictive however in its reference to contractual cash flows which we interpret as being linked to cash flows between the insurer and policyholder only. We consider that the reference to "contractual cash flows" in paragraph B22 should be changed to "net cash flows" consistent with paragraph B21 and similarly the words "judged by reference to the contract" in paragraph B23 should be changed to "judged by reference to the insurer's net cash flows".

Paragraph B24 is somewhat ambiguously worded in that it might be interpreted as suggesting paragraph B21 applies only to contracts where the amount of the loss and the resulting payment by the insurer are known and only the timing is uncertain. Paragraph B21 seems wider than this however and in particular also covers the significance of insurance risk in the context of whether or not the insured event takes place.

We believe that pure endowment contracts (IG 1.4) should also be classified as insurance contracts. The risk to the insurer's cash flows lies in the possibility of underestimating the number of policyholders who will survive to the stipulated age. Moreover, there is an adverse event similar to that described in paragraph B17 (d) in relation to life-contingent annuities. A more complete solution however would be to amend the definition of insurance contract to permit contracts that are contingent on human life (ie the lifespan of the policyholder, or the policyholder's survival to an age or date specified in the contract) to meet the definition of insurance contract. This will avoid the wholly unnecessary precondition in these circumstances for the policy benefits to be triggered by an adverse event to the policyholder. IASB already acknowledge this point to some extent in ED5 by referring to some policies that are "life-contingent" (for example IG 1.3, 1.5, 1.6).

Q3 **(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 1 of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in Phase 1?

(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 IAS39? If so, which ones and why?

A (a) We agree that as an interim measure pending Phase 2 of the insurance project, embedded derivatives that meet the definition of insurance contract should not be subject to the requirement for separate accounting at fair value in accordance with IAS 39.

Paragraph A5 of the IAS39 Application Guidance proposes that paragraph 23 (separate accounting of a derivative embedded in a host contract) would apply where the host contract is a debt investment and the derivative is a puttable investment that gives the holder the right to put the investment back to the issuer in exchange for an amount of cash that varies with an equity or commodity index. This is because the embedded derivative and the host contract are not deemed to be closely related. This could theoretically apply to unit-linked life insurance contracts, but is at variance with the way in which they are currently managed and treated for accounting purposes. If required, it would impose significant additional costs on insurers without any commensurate benefits to accounts users.

We note that the proposed replacement paragraph A7(b) included in Appendix C of ED5 is illogical and should be amended. To do otherwise will lead potentially to grossly different results being reported by different companies depending upon small differences in terms at issue of their contracts. To illustrate, this paragraph states that an embedded floor is closely related to the host debt instrument provided the floor is at or below the market rate of interest when the instrument is issued.

First, the reference to "host debt instrument" should be to the "host debt instrument or insurance contract".

Secondly, the distinction between "in the money" and "out of the money" contracts at issue is an inappropriate basis for deciding whether an embedded floor needs to be valued within a company's accounts. In an ideal world all such arrangements should be accounted for consistently and this needs to be addressed as part of the Phase 2 proposals. However, in the meantime the use of an artificial dividing line will lead to distorted comparisons. Indeed it is quite possible that companies with a more exposed commercial position on embedded floors, but not with "out of the money" contracts at issue, will report better results than a company that issued such contracts at some point in the past. This is illogical and therefore for Phase 1 all embedded floors on the interest rate on an insurance contract should be deemed closely related.

This will be addressed under phase 2 and therefore does not need to be dealt with now.

(b) We agree that guaranteed annuity options and guaranteed minimum death benefits should be exempted from fair value measurement in Phase 1 of the project. While some commentators might regard these as predominantly financial, we believe this treatment is justified because these options and guarantees are life contingent. As an additional safeguard, note disclosure will be required of their existence and potential impact on the insurer's financial position. In due course, and when systems constraints permit, it will be appropriate to disclose the fair value of these but without any requirement for separate accounting. This should be postponed however until rules for doing so have been worked out under Phase 2.

(c) We do not consider it appropriate to require note disclosure of the fair value of certain embedded derivatives when such disclosure is not required by ED5, given the practical problems of doing this at the present time, and in the absence of clearer guidance from the IASB on how fair value should be determined. This is an issue that should be left until Phase 2.

(d) We are not aware of any other embedded derivatives that should be exempted from the requirements of IAS 39.

Q4 **(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 an 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?

A (a) The proposed exemption is inevitable given the need for an interim standard in Europe from 2005 and the fact that the Board does not expect to completed its Phase 2 work on the definitive IFRS on insurance contracts before then. In particular, we support the Board's conclusion's in BC 81 to 84 that the IFRS should not preclude insurers from continuing to recognise embedded values in the balance sheet even if they include future investment margins.

We believe the proposed sunset clause to be inappropriate, although we understand there was pressure for this from some Board members who were unwilling to see the temporary exemption from the hierarchy continue *sine die.* Our concern is over what will happen if at the end of 2006 the Phase 2 IFRS is not in place. The observance in these circumstances of paragraphs 5 and 6 of IAS 8 could lead to a wide number of different interpretations. Some of these could have an adverse effect for example if IAS37 applied to insurers' technical provisions although not designed with this in mind, or a deferred acquisition cost asset could not be recognised because it failed to satisfy the definition of an asset in the IASB Framework.

We support IASB's commitment to producing the phase 2 standard for 2007. There is no certainty however that this will be possible. In order therefore to avoid any possibility of insurers suffering a third accounting system change in less than a decade, the Phase 1 proposals should remain in place until Phase 2 is issued.

(b) We believe the circumstances where the temporary exemption should not apply are appropriate. In the interim period, we do not consider it appropriate to undertake a loss recognition test under IAS 37 for purposes of comparison where such a test is already carried out under local GAAP and meets the requirements of paragraph 11 of the draft IFRS.

Q5 **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?

A (a) We support the basic premise of paragraph 14 that changes in accounting policies for insurance contracts should only be permitted if they result in more relevant and reliable financial statements. We have two particular concerns however over the proposals in paragraph 16.

Firstly, ED5 does not appear to permit incremental improvements to accounting policies. For example, whereas it would be permissible to change from an accounting basis that measures insurance liabilities with excessive prudence to one that does not, it would not be permitted to move from a basis that measured these labilities with excessive prudence to one where the level of prudence was less excessive.

Secondly, the proposal that greater relevance and reliability cannot be achieved by moving to an accounting methodology that reflects future investment margins or future investment management fees in the measurement of insurance liabilities appears to prejudge the outcome in Phase 2 on an issue where the debate is far from concluded. Furthermore, in countries such as the UK, embedded value methodology is far more relevant to a fair value model than the currently required MSSB accounting. It seems inappropriate not to allow insurers to move to such a model in Phase 1, especially as all will need to be mindful of the final requirements under Phase 2.

We would also like clarification from the Board that a change in accounting policy that is not in respect of accounting for insurance contracts (for example a change in consolidation presentation as required by IAS 27) is outwith the scope of the conditions provided for in ED5 BC76-BC88.

(b) We are happy with the proposal in paragraph 35 provided any move to fair values remains optional.

Q6 **The draft IFRS proposes that an insurer should unbundle (ie 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?

A (a) We broadly welcome what is being proposed in relation to unbundling. Where, as in most cases, contracts are written as an indivisible whole and priced on that basis, unbundling will be difficult from the company systems point of view and any artificiality which may of necessity have to be introduced into the unbundling process may compromise the IASB's requirement for relevance and reliability. Unbundling should therefore be limited to extreme cases where any deposit element of the contract can be readily identified and quantified and, as IASB proposes, where accounting for the contract solely as insurance would result in the non-recognition of a material obligation (e.g. liabilities to repay amounts received under the contract).

(b) We are not aware of any other circumstances where unbundling should be required.

(c) We believe that it may be difficult to draw the line between when unbundling should be required and when it is unnecessary. This is because many types of insurance contract include some kind of deposit element but as we suggest above unbundling should only be required in extreme cases.

Q7 **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?

A These proposals represent a departure from IASB's general approach in ED5 of permitting insurance accounting to continue broadly speaking in its existing form until Phase 2. In this regard reinsurance is just a subset of insurance.

Apart from this, the proposal to adjust the reinsurance asset instead of creating an additional provision runs contrary to US GAAP and in relation to paragraph IG48 would create a difference on reconciliation between claims development tables reflecting the full amount of reinsurance recoveries and the corresponding amounts reported in the balance sheet.

The IASB proposals represent no more than an interim solution to an issue that can on be finally resolved under Phase 2. IASB acknowledges this and that its interim proposals are conceptually imperfect. In view of this we think that any change to the current basis of accounting by cedants for reinsurance should be deferred until a comprehensive and conceptually sound methodology has been developed under Phase 2.

We think that paragraph 19 requiring a cedant to apply IAS36 (Impairment of Assets) to its rights under a reinsurance contract is inappropriate and should be deleted. This is because under IAS36 the recoverable amount is the higher of an asset's net selling price or value in use. Value in use is determined by estimating the future cash inflows and outflows associated with the asset and applying an appropriate discount rate to them. In the context of reinsurance recoveries this would require discounting even when the associated reinsured claims are not discounted.

Q8 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?

A We believe that it is appropriate to measure at fair value insurance assets and liabilities acquired as part of a business combination and welcome the Board's recognition that a significant change to the accounting applied to such acquisitions would not be practical as part of Phase 1.

Q9 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 2 of this project.

Are these proposals appropriate? If not, what changes would you suggest for Phase 1 of this project and why?

A While we are content with the broad thrust of what is being proposed, we have concerns on some points of detail.

Paragraph 25 should be clarified to confirm that it does not require deposit accounting for contracts that are not insurance contracts but contain both a discretionary participation feature and a fixed element that requires non-discretionary payments.

We disagree with the proposed addition to IAS 32 outlined in paragraph C4. Financial instruments that are within the scope of the Phase I standard because they contain a discretionary participation feature should not be subject to any of the requirements of IAS 32. The appropriate disclosure for these contracts should be determined in phase 2 of the insurance project.

We agree with the proposal in paragraph 24(b) that the FRS should not indicate how an insurer should classify unallocated surplus arising from discretionary participating features as liability or equity. We also concur with the proposition in paragraph BC105 that an intermediate category that is neither liability or equity should not be permissible.

We are concerned however that the result of these propositions coupled with the constraint in the IASB framework that liabilities should be restricted to actual and constructive obligations will produce misleading results. This is illustrated by considering unallocated surplus held within with-profit funds of UK life insurers. Allocation of this surplus between policyholders and shareholders is constrained by regulatory requirements and the basis of distribution of the funds which itself is discretionary. It is therefore misleading to account for all or some of such amounts in IFRS basis financial statements as being attributable to equity shareholders.

If IASB intends to confirm that there is a constraint on the classification of unallocated surplus as liability by virtue of the constructive obligation criteria, or otherwise remain ambiguous on the issue, insurers affected will need to consider whether the appropriate treatment of unallocated surplus is as a second category of equity that is not attributable to shareholders. This will have significant implications for performance reporting with companies needing to develop reporting statements that distinguish between the two categories.

Given these considerations, the embryonic state of development of the IASB performance reporting initiative, and the fact that the IASB phase 1 approach to insurance accounting is a stepping stone to a comprehensive solution, we urge that for phase 1, the IASB should permit the classification of unallocated surplus as liability without the usual constraints of the IASB framework.

Q10 **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?

A We have serious concerns over the proposed requirement for note disclosure of the fair value of insurance assets and liabilities from 2006. We note that the start time for this has been put back because the Board hopes to have made progress by then in defining how fair value is to be determined for the purpose of Phase 2. While we support an appropriate fair value approach under phase 2, our concern is that this may not be possible. If it is not, it will be particularly difficult for insurers to determine fair value, and to do so on a consistent basis especially the fair value of insurance liabilities, in the absence of any guidance from the Board on how this should be done. Even if the Board has made progress by 2006 with a tentative methodology for determining fair values, there can be no certainty that this will be the methodology eventually incorporated in the Phase 2 IFRS. On balance therefore we believe that requirements for fair value disclosure should be postponed and dealt with instead under Phase 2.

Q11 **(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?

A (a) There are a number of areas where we believe the proposed disclosure requirements will require modification.

In some cases they will impose a considerably heavier workload. While we accept this if improved disclosures have the effect of providing useful additional information to users of the accounts, we are not convinced that this will be the position with all the proposed requirements. For example the requirements of paragraph 29(b) to disclose those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of future cash flows could require very extensive additional disclosures and potentially make it difficult for accounts users to identify the real drivers of risk and uncertainty. A more acceptable alternative would be to require disclosure of the principal contract terms and conditions bearing on the amount, timing and uncertainty of the cash flows in question.

With regard to paragraph 29 (c)(iii), it is unlikely that claims development in relation to life insurance claims settled after more than on year will be meaningful. We assume that the reference in this paragraph to claims "typically settled within one year" will remove this disclosure requirement for life business, even in those comparatively rare cases where claims are settled after one year.

Moreover, excessive disclosure requirements may overload accounts users with inessential detail and make it more difficult to separate important disclosures from the unimportant. It should not be a requirement to disclose everything but only what accounts users need to know for an adequate understanding of the insurer's financial position.

We urge IASB to have regard to these practical considerations when finalising the IFRS and in particular to reduce or rationalise some of the proposed disclosure requirements which, although costly for insurers to implement, add little value for accounts users.

Apart from this, it may be difficult to comply with some of the disclosure requirements and at the same time meet the Board's requirements for relevance and reliability. For example the disclosure of insurance liabilities and reinsurance assets required by IG39, being based on estimates of when the associated cash flows are likely to occur which for some non-life insurance business are especially difficult to predict with any accuracy, would not seem to meet these criteria. The reference to "broad classes" in the first sentence also requires clarification.

In some cases the proposed disclosures would require the insurer to make a prediction of future policyholder behaviour. This is unrealistic. An example of this is IG51 where it may be difficult for an insurer to predict whether and, if so to what extent, lapse behaviour is likely to be sensitive to interest rates.

The proposals on sensitivity in IG41-43 analysis, while broadly acceptable, will require some consensus to be reached on those variables to which sensitivity analysis should be applied and, in relation to those variables, the range within which sensitivity analysis should be provided. Without this consensus a range of differing practices may emerge.

Commercial sensitivity should also constitute a valid reason for not making certain disclosures. Examples of this are the proposed requirement to disclosure policies for accepting and managing risk (IG37) other than in the broadest terms while disclosure of the levels at which guarantees of market prices and interest rates are likely to alter insurers' cash flows significantly (IG38) could reveal the insurer's investment strategy and hedging position.

(b) We believe that high- level guidance is appropriate in the standard. This raises the question however of the status of the implementation guidance. The wording of the appears to betray some uncertainty over its true status switching between for example "An insurer discloses <u>for example</u>" in IG37 and "An insurer discloses" in IG38. IASB should make a clearer statement that this is only guidance and should not in any way be construed as a set or requirements having in effect the same status as the provisions of the IFRS itself.

(c) We believe the proposed transitional relief is appropriate.

Q12 **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 or 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?

A We are pleased to note that genuine credit insurance meets the IASB definition of insurance contract irrespective of the legal form of the contract.

Q13 Do you have any other Comments on the Exposure Draft and Implementation Guidance?

A For a significant proportion of life insurance business in the UK, the tax charge comprises both the tax due on the investment return attributable to policyholders and the tax on the shareholders profit. The presentation in the UK GAAP accounts seeks to show the profit before tax after deducting policyholder tax. This is incompatible with paragraph 58 of IAS 12 (Income Taxes) however which requires all current tax to be included in the profit before tax for the period. IAS 12 is intended to apply to the generality of companies and does not therefore deal with this issue because it is of specific relevance to UK life insurance business. Applying IAS12 in its current form would, under many situations, create a misleading and volatile measure of pre-tax profits though the requirement to include policyholders' tax in the pre-tax profit (although it is not determined by reference to that profit) and the tax charge. We would therefore like ED5 to permit UK life insurers to continue with their current accounting treatment for tax as described above.

ED 5 is silent on the presentation of unit-linked business. Within Europe there is provision to present, on the face of the balance sheet, technical provisions for linked liabilities together with the corresponding valuation of assets held to cover linked liabilities. This presentation is appropriate because in substance the liability to policyholders is directly related to the valuation of the corresponding assets. If these products were issued by a fund management organisation, the assets would be directly in the name of the policyholder rather than the entity, and both the assets and corresponding liabilities would be off balance sheet. ED 5 should permit this presentation format, together with the related measurement of assets and liabilities, to be retained in order to differentiate this business from other business written by the entity that has higher levels of associated financial and/ or insurance risk. We believe this would result in more relevant and useful information to users of the accounts than a presentation under IAS 39 that ignores this link.

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