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

22 October 2003

Dear Sir David

The forum of European Insurers (the "Forum") welcomes this opportunity to comment on the IASB (the "Board") proposals for accounting for insurance business set out in Exposure Draft 5, Insurance Contracts ("ED5").

The Forum is fully supportive of the development of a single international accounting standard for insurance business as this accords with the Forum's aim of providing its stakeholders with relevant and reliable financial reporting. The Forum also acknowledges those positive moves that the Board has taken in trying to make the transition to IFRS a practical possibility. However, the Forum believes that there are significant issues within ED5 which must be addressed to ensure that phase I will not result in financial statements that are less relevant or reliable than those currently prepared under local accounting practices. We have identified our three key issues below and provide further analysis of these and other issues in our detailed response to the questions you have raised.

Assets held to back insurance contracts

We believe that the Board must address the potential for misrepresentation, in many jurisdictions, of reported equity caused by assets measured in accordance with IAS 39 and liabilities for insurance contracts and investment contracts with discretionary features measured effectively on an amortised cost basis. The Forum believes that if assets are economically matched to their liabilities through the use of techniques such as asset/liability matching, then it is imperative that the financial statements faithfully represent this position in both the income statement and reported equity.

The Forum has investigated the misrepresentation on insurers' reported equity if fixed maturity assets backing (non-linked) insurance contracts and investment contracts with discretionary features were classified as available for sale and liabilities continued to be reported in accordance with existing accounting policies. The potential impact on the insurer's reported equity if interest rates moved up or down by 1% is of the order of 10% to 20%. This is a very significant amount that would undoubtedly misrepresent the insurer's position. We therefore strongly disagree with the view expressed in BC111 that the potential mismatch on the insurer's reported equity does not outweigh the reasons provided in BC110.

We have investigated the various options to address this issue and as described in our detailed response, our view is that the most appropriate option is to permit, for the interim period that phase I is effective, a separate class for fixed maturity assets backing liabilities for insurance contracts and investment contracts with discretionary features. These would be valued at amortised cost consistent with the measurement of the related liabilities. The other requirements of IAS 39 would continue to apply to the remaining assets. The Forum believes that if such an exemption were permitted, then the potential misrepresentation in the reported equity would be substantially mitigated. The Forum offers to collaborate with the Board on defining the criteria by which fixed maturity assets backing liabilities for insurance contracts and investment contracts with discretionary features would fall into this separate asset class.

The application of IAS 39 to investment contracts

IAS 39, based as it was on several standards in US GAAP regarding primarily financial assets such as FAS115 and FAS133, was not designed with the measurement of financial liabilities, particularly long-term liabilities, being its primary purpose. The Board acknowledges this in paragraph BC116 where it discusses those features of investment contracts written by insurance entities that are rare amongst other financial instruments.

The Forum believes that the ‘demand deposit floor’ as stated in BC117(e) should not be applied to the measurement of a financial liability with a demand feature under the fair value model. The application of this restriction applied to investment contracts is wholly inappropriate for precisely the reasons noted in paragraph BC116, namely that the contracts have long maturities, recurring premiums and may involve high initial transaction costs. In consequence, the introduction of a demand deposit floor into the measurement criteria would result in excessive prudence that would contravene the *IAS Framework* and will markedly misrepresent the financial position of financial institutions offering long-term investment contracts.

The Forum requests that when the Board finalises the amendments to IAS 39 and ED5, paragraph BC117(e) in ED5 should be deleted and the paragraph should not be included in the final standards or implementation guidance.

Disclosures

The Forum acknowledges the importance of disclosure in providing the users of financial reports with a fuller understanding of the income statement and balance sheet and would support the objective of phase I to enhance the information disclosed. The Forum agrees with the principles expressed in paragraphs 26 and 28 of ED5.

However, as noted in our previous letters to the Board, the Forum believes that the suggested disclosures within the implementation guidance are excessive and would result in undue cost and effort as well as significantly increasing the audit requirements. For example, disclosure of claims sensitivity tables within the audited financial statements is costly and impractical and would go beyond that required under most local reporting frameworks. It is more appropriate that an insurance entity should comply with the principles outlined in paragraphs 26 and 28 by providing the user with relevant, material and succinct information that will aid understanding and not obfuscate through excessive detail. We request that the Board confirms that the status of the Implementation Guidance is not part of the final IFRS and consequently not mandatory.

The Forum does not agree with principle 30 as it regards as premature the proposal that the fair value of insurance contracts should be disclosed in 2006. The Board has not yet provided draft guidance on the measurement of the fair value of such contracts and to set a date for disclosure before a basis is decided upon is illogical. We are very concerned about the negative impact of publishing information that is not well understood by market participants. The proposal should be dropped and replaced by the voluntary disclosure of value-based information in phase I where relevant.

In addition, the Forum does not believe that it is appropriate to require the fair value disclosure of financial instruments with discretionary participating features in 2005 as the treatment of such discretionary features is unclear under IAS 39 as described in BC104.

Concluding Remarks

Whilst we acknowledge that ED5 is an interim standard, it is important that the application of ED5 does not result in misleading financial statements. We will continue to work with the Board to identify practical solutions to the concerns raised on ED5 and to maintain a constructive dialogue on the development of phase II.

Yours sincerely

J Streppel *on behalf of the Forum comprising the companies listed:*

- AEGON N.V.
- Allianz AG
- Assicurazioni Generali S.P.A.
- Axa SA

- Aviva plc
- Fortis B.V.
- Försäkrings AB Skandia
- Hannover Rueckversicherungs-AG
- ING Groep N.V.
- Münchener Rückversicherungs-Gesellschaft
- Old Mutual plc
- Prudential Assurance Company plc
- The Standard Life Assurance Company
- Swiss Reinsurance Company
- Swiss Life Group
- Winterthur Group

ANNEX 1

CFO Response to ED5

Question 1 – Scope

(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting 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) The exclusion of accounting by policyholders means that there is no clear accounting standard that would apply to insurance contracts in policyholders' accounts. Such policies can be significant within the accounts of corporate policyholders and the lack of a standard could lead to diversity and to policyholders developing their own versions of fair values of liabilities. The treatment of captive insurers is undefined by ED5. For the avoidance of doubt, it would be useful for ED5 to clarify that captive insurers fall within its scope. The fact that direct insurers are regulated as policyholders with respect to reinsurance, but non-insurers are not regulated in ED5 will be contrary to the Board's intention not to produce entity-specific standards.

Misrepresentation of reported equity

As stated in the covering letter, we do not believe that it is appropriate that the exposure draft has not considered the accounting for fixed maturity assets backing insurance liabilities.

The proposals in ED5 mean that most entities will continue with their current local accounting policies for contracts classified as insurance and those contracts with discretionary participation features. Many local accounting policies result in these liabilities being valued on a basis conceptually similar to an amortised cost basis. However, the application of IAS 39 means that the assets held to back these liabilities will, in most cases, be accounted for in the balance sheet at market value, as either: (i) the criteria within IAS 39 to classify these assets as held-to-maturity are unlikely to apply due to the possibility that these assets will need to be sold early (if more policyholders than expected lapse their contracts early or due to a changing economic, demographic or regulatory environment) or (ii) the assets do not have fixed payment and maturity and are not eligible for the held-to-maturity category.

This will lead to a less relevant and reliable form of reporting as it could result in a material misstatement of the reported equity in the balance sheet, unless adjustments are made, for example through "shadow accounting", as described below. This will not be a fair representation of the insurer's position, particularly in cases where there is an effective economic match between assets and liabilities through the use of techniques such as asset/liability matching.

We understand that the Board has considered this problem and concluded that the issue in BC110 and BC111 is not significant enough to warrant temporary arrangements. We disagree with this stance. We have investigated the impact on the insurer's reported equity if fixed maturity assets backing insurance contracts and investment contracts with discretionary features were classified on an available for sale basis and liabilities continued to be accounted in accordance with existing accounting policies. The results of our investigation were that the potential misrepresentation of the insurer's reported equity if interest rates moved up or down by 1% was of the order of 10% to 20%.

In paragraph BC111, the Board notes that the possible mismatch has existed for some years in US GAAP. However, it is important to note that there was considerable opposition within the insurance industry at the time SFAS 115 became effective in 1993. FASB has mitigated part of this issue through the introduction of "shadow accounting" as described in EITF D41. Moreover, since that date, interest rates have reduced relatively steadily. The effect of the mismatch has therefore been to increase insurer's reported equity, which has inevitably attracted less comment than if the equity had been eroded.

The situation in Europe will be compounded as phase I will apply to a more diverse range of insurance contract types than those found in the US, and the range of local accounting policies used to value insurance liabilities will also be diverse, many without the use of a mechanism such as shadow accounting.

In BC110, the Board suggests that an insurer may argue that part of the fixed maturity assets could be classified as held-to-maturity. This will only have a limited impact as existing experience suggests that insurers would only be able to classify a much smaller proportion of their assets than the 80% cited in BC110 as held-to-maturity. This is due to the need to retain the ability to sell the assets prior to maturity if the demographic, policyholders' behaviour or economic environment changed.

We acknowledge that the problem of inconsistency is temporary in light of the Board's proposals for phase II. However, until phase II is complete, we propose that temporary arrangements are made to resolve this problem. We do not believe the option to categorise financial assets as held for trading is a practical solution as long as there is not yet a fair value standard for long-term insurance contracts.

We have investigated the various options available to enable insurance entities to continue to apply their consistent accounting models on both sides of the balance sheet.

We believe that the most practical manner to address the misrepresentation is to permit a separate asset class of “fixed maturity assets backing liabilities for insurance contracts and investment contracts with discretionary features”. These would then continue to be valued at amortised cost consistent with the liability valuations for the interim period in which phase I is effective. Each entity would need to identify individual fixed maturity assets that are held to meet their rights and obligations under the insurance contracts or investment contracts with discretionary features before such a categorisation would be permitted.

We believe that this is a more effective method than adjusting the basis of measurement of insurance contracts liabilities to mitigate the mismatch. We note that one option may be to adjust the discount rate used in the valuation. However, such an adjustment would not be in line with many of the current local accounting policies that would continue to be applied for the insurance contracts liabilities and there is no current guidance on how such an adjusted discount rate should be determined. It would also imply the reflection of future investment margins in the measurement of insurance liabilities, which would contravene paragraph 16(c). Further, such an adjustment would have limited impact on contracts with discretionary features where part of the discretionary element has not been reflected in the measurement of the liabilities. Moreover, adjustments to liabilities through the discount rate would cause serious system issues.

We therefore believe that addressing the potential misrepresentation of the reported equity through our proposal above represents the only credible way to ensure that the financial statements remain both relevant and reliable in phase I.

Owner occupied property accounting

We believe that the Board should address the anomaly in accounting for owner occupied properties that are held to back insurance liabilities. As described in BC114, under IAS 16, these assets can be held at fair value but the fair value adjustments are taken into revaluation surplus. We disagree with the stance taken in BC114 and believe that the Board should introduce the appropriate changes into IAS 40.

Treatment of investment contracts

We expect that a number of long-term contracts currently issued by insurers will not qualify as insurance contracts under the definition in ED5, and therefore will need to be accounted for as financial instruments under IAS 39. The scope of ED5 does not include extensive and tested guidance on the valuation of long-term investment contracts. We believe that adequate and tested guidance should be provided.

A number of insurers are expected to take the option included in the June 2002 Exposure Draft to account for these contracts at fair value. Even for those that do not adopt fair value, disclosure requirements dictate the development of fair value amounts. We have two principal concerns with regards to the fair value of investment contracts:

- the introduction of a demand feature "floor" in paragraph BC117(e)
- the treatment of transaction costs.

The application of a demand feature floor to the measurement of investment contracts under the fair value model could result in an excessively prudent basis that would be misleading to users. We believe that the deposit floor goes beyond the principles of impairment testing used in other standards.

We note that there was a lack of consultation in advance of the adoption of the demand deposit floor into ED5 and the absence of any opportunity to comment on the proposal. The Forum believes that if the impact of the change had been fully appreciated by the Board then a more appropriate solution would have been achievable.

As the Board is aware, insurance contracts often incur significant costs at point of sale. We are concerned that the current proposals restricting the deferral of these costs will result in a method of reporting that obscures the financial reality of the business, particularly in the situation where the first premium or consideration received is lower than the amount of transaction costs incurred. Paragraph BC117(e) indicates that future margins under the contract are unlikely to qualify for recognition as an intangible asset under IAS 38. We believe that under the fair value model, certain aspects of a customer relationship should be recognised and as such, an intangible asset for the customer relationship should be permitted.

We note that other industries establish assets for costs already incurred, subject to normal impairment testing, using IAS 11 *Construction Contracts* and IAS 18 *Revenue.*

Paragraph 21 of IAS 18 states that the requirements of IAS 11 *Construction Contracts* are also generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services. IAS 11 requires contract revenue and contract costs to be recognised as revenue and expenses by reference to the stage of completion of the contract.

Paragraph 21 of IAS 11 requires costs that relate directly to a contract and which are incurred in securing the contract to be included as part of the contract costs. We believe that this could be applied to investment contracts as well.

Paragraph 27 of IAS 11 permits costs incurred that relate to future contract activity to be recognised as an asset. We believe that this would allow costs incurred in securing an investment contract (i.e. transaction costs) to be deferred and spread over the estimated life of the contract.

(b) We believe it is appropriate that weather derivatives be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract.

Question 2 – Definition of an Insurance Contract

The draft IFRS defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder 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?

We support the definition of an insurance contract set out in ED5.

We believe that the words in paragraphs B21 to B24 should be internally consistent. We note that in B22, the significance of the insurance risk is tested against a change in the present value of the contractual cash flows. Further in B23, the significance of the risk is tested against the amount of the excess death benefit. On the face of it, these two tests could lead to contradictory judgments of significance. We propose that paragraphs B22, B23 and B24 should be altered as follows to be consistent with paragraph B21:

Paragraph B22
"Insurance risk is not significant if the occurrence of the insured event would cause a trivial change in the present value of the insurer's net cash flows arising from the contract in all plausible scenarios."

Paragraph B23
"It follows that if a contract pays a death benefit exceeding the amount payable on surrender or maturity, the contract is an insurance contract unless the additional death benefit is insignificant (i.e. trivial, judged by reference to the insurer's net cash flows arising from the contract rather than to an entire book of contracts).

Paragraph B24
"Paragraph B21 refers to the present value of cash flows. The significance of insurance risk can be considered in the context of whether or not the insured event takes place and, where the occurrence of the insured event is certain but the timing is unknown, when the insured event takes place.

In the context of timing of insured events that are certain, if the timing is earlier than expected, the insurer may suffer a greater loss than would otherwise arise. An example is whole life insurance…(paragraph continues as currently drafted)…"

Question 3 – Embedded derivatives

(a) IAS 39 Financial Instruments: Recognition and Measurement requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:
(i) meets the definition of an insurance contract within the scope of the draft IFRS; or
(ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).
However, an insurer would still be required to separate, and measure at fair value:
(i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and
(ii) an option to surrender a financial instrument that is not an insurance contract.
(paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)
Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). Is it appropriate to exempt these embedded derivatives from fair value measurement in phase I of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase I?

(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs IG54-IG58 of the draft Implementation Guidance). Are these proposed disclosures adequate? If not, what changes would you suggest, and why?

(d) Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?

We recognise the Board's desire to have all guarantees and derivative features within insurance contracts reported at fair value. However, the need to identify and separate embedded derivatives may only be a temporary requirement in the light of the phase II proposals that may require the whole contract to be at fair value. Significant time and effort will be involved in identifying, bifurcating and valuing embedded derivatives that could otherwise have been used to focus on implementing the phase II proposals. In addition, as IAS 39 only captures a portion of financial options and guarantees of many insurance contracts, such an extensive effort would only be partially effective. Consequently we would propose that the Board consider an exemption for insurance contracts and investment contracts with discretionary features relying on the loss recognition test in paragraphs 11 to 13 to ensure that the level of provisions is adequate in phase I.

(b) We believe that it is appropriate to exclude embedded derivatives that transfer significant insurance risk from the scope of IAS 39 in phase I.

(c) We consider the proposed disclosures for the derivatives in 3(b) to be adequate.

(d) We have not identified any other embedded derivatives that we believe should be exempted from the requirements of IAS 39 in phase I.

Question 4 – Temporary exclusion from criteria in IAS 8

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for:

(i) insurance contracts (including reinsurance contracts) that it issues; and

(ii) reinsurance contracts that it holds.

(paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions).

Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?

(b) Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:

(i) eliminate catastrophe and equalisation provisions.

(ii) require a loss recognition test if no such test exists under 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) We note that the temporary exclusion relates only to accounting periods beginning before 1 January 2007. The Forum recognises the purpose of such a date but believes that the primary responsibility for completing phase II in time for the withdrawal of the exemption rests with the Board. If the Board does not deliver phase II within the required timetable after a full and extensive due process, it seems counter-intuitive to disrupt the working of the existing phase I reporting. The Forum suggests that the date for the withdrawal of the exemption is removed and the Board undertakes to commit sufficient suitable resources to the phase II project to ensure that the project is completed in a timely fashion.

(b)(ii) We believe that the Board should provide further clarity on the application of paragraphs 11 to 13 of ED5 which require an entity to carry out a loss recognition test using current estimates of future cash flows for its insurance contracts. Paragraph 12(b) states that where a loss recognition test is triggered an entity should compare its liability for insurance contracts with the measurement under IAS 37. Where an insurer's existing accounting policies do include a loss recognition test, we request that the Board confirms this test would need to comply with IAS 37 only if it is the case that the existing accounting policies do not meet the minimum requirements expressed in paragraph 11.

Question 5 – Changes in accounting policies

The draft IFRS:
(a) proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).
(b) proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss (paragraph 35 of the draft IFRS).
Are these proposals appropriate? If not, what changes would you propose and why?

We believe that the proposals in (a) and (b) are appropriate.

Question 6 – Unbundling

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) We do not believe that the unbundling of insurance contracts is appropriate particularly in the absence of a performance reporting standard (as revenue recognition may be considerably different between similar contracts, one of which is unbundled and the other is not) and in light of the imminent move to phase II. Some insurance contracts are sold as a package comprising insurance and deposit elements, and separation could be unduly complicated and artificial, particularly if the deposit element cannot be readily identified. We do not believe that unbundling provides any additional information to users. Following the implementation of phase II, we expect that the measurement basis for insurance liabilities will eliminate the Board's concerns in respect of certain rights and obligations not being recognised, and so urge the Board to reconsider its approach for the intervening period.

If unbundling is required, then in some cases this will mean that insurers need to make system changes during phase I that will not be necessary in phase II. This is contrary to one of the Board's objectives for phase I.

(b) Refer to our response to Question 6(a).

(c) If unbundling is deemed necessary, we believe that the criteria for unbundling should consider when the cash flow of the insurance component and the investment component do not interact at all rather than the one-sided test of whether the cash flows from the insurance component do not affect the cash flows from the deposit component.

Question 7 – Reinsurance

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?

The proposals in ED5 prevent an entity from setting up an asset in respect of rights under a reinsurance contract that is greater than the premium paid for the contract. The Board acknowledges that the proposals are conceptually imperfect and we are concerned that the inconsistent measurement bases for insurance and reinsurance will cause significant problems for the industry. Further, the application of IAS 36 in paragraph 19 of ED5 effectively pushes all reinsurance assets towards a fair value approach in phase I although the Board has not decided upon the fair value measurement of insurance obligations. At a minimum, paragraph 19 should refer to the impairment test under IAS 39 as the rights resulting from a reinsurance contract meet the definition of financial assets under IAS 32.

Many entities measure their liabilities under insurance contracts using a prudent basis. When reinsurance is ceded for an insurance contract, the uncertainty around the future obligations under the insurance contract is reduced or in some instances eliminated. By restricting the reinsurance asset to the level of the reinsurance premium, entities will be unable to release some of their prudence in the liability leading to their financial strength being misrepresented in financial statements. This will be particularly exaggerated for blocks of business where a large proportion of the liability is reassured.

The requirements under paragraph 18 will require significant system changes for many entities, which would need to be reversed in phase II, contrary to the Board's aims for phase I.

We therefore believe that it is appropriate to remove paragraphs 18 and 19 from ED5 and consider reinsurance contract accounting in phase II along with the accounting for directly written insurance contracts.

<u>Question 8 – Insurance contracts acquired in a business combination</u>

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?

We regard these proposals as appropriate.

Question 9 – Discretionary participation features

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.
Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?
In principle, we support the proposals for accounting for discretionary participation features in phase I. We agree with the Board's opinion expressed in paragraphs BC102 to 108 indicating that the Board wishes to avoid any changes during phase I for unallocated surplus because it may have a different treatment under phase II.

We note that paragraph 24(b) of the draft IFRS does not specify how the issuer determines whether unallocated surplus is a liability or equity. It should be noted that the term "unallocated surplus" has different meanings in different countries. For example, in Germany, "unallocated surplus" consists of a special provision for future profits to policyholders (the so called RfB). The entire RfB is designated as allocated to policyholders, so that it has to be considered as liability. The timing of the allocation depends on the conditions and terms of the contract. In this case, we would recommend the classification of unallocated surplus as a liability.

Paragraph BC105 refers to the Framework derivation of equity as a balance sheet item that does not meet the definition of, and recognition criteria for, assets and liabilities. It is not transparent in stating that the usual requirement for liabilities to be no more than that required to meet constructive obligations is overridden in the circumstances of discretionary participating features.

In general terms we would not be in favour of amounts being recognised as liabilities that fail to meet the constructive obligation criteria. However, in the case of unallocated surplus, there are, in some circumstances, for example for with-profits funds in the UK, amounts that are unlikely to be attributable to either policyholders or, under the current basis of distribution, to equity shareholders. In such circumstances the only possible classifications are as a liability or as a second class of equity that has yet to be allocated between policyholders or shareholders. In the absence of any performance reporting proposals for a "two types of equity" scenario, we would propose that, at least for phase I, classification as a liability without capping by the constructive obligation criteria should be permitted. It would be helpful if the Board could confirm that this is the intention.

Further, we request that the Board clarifies whether investment contracts containing discretionary participation features are exempted from IAS 39 other than the requirements that are stated in paragraph 25 of ED5 and clarify in particular that the issuer of such a contract should continue its existing accounting policies to recognise revenue for such contracts. In particular, we believe that it is inappropriate to require the fair value disclosure of financial instruments with discretionary participating features as the treatment of such discretionary features is unclear under IAS 39 as described in BC104 and the fair value requirements for long-term investment contracts remain ill-defined.

Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).
Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?

As noted in the covering letter to this response, we regard the requirement for the disclosure of the fair value of insurance contracts in 2006 as premature and illogical. If a date is to be set for disclosure, it should be described in terms of a set period of time, say two years, from the date at which the measurement of the fair value of insurance contracts is substantially finalised.

In addition, although the Board does not intend fair value comparatives to be disclosed for 2005, it will be necessary to determine fair values for insurance liabilities by the end of 2005 (and possibly 2004) for internal quality control purposes. A fair value system change is clearly not feasible by that date.

In consequence, and if it is concluded that phase II should be based on fair value reporting, we believe that the fair value disclosure should be considered as part of the transitional arrangements for phase II. In this way, there is a direct link between the timing of the phase II requirements and the need to disclose fair value of insurance liabilities and assets.

Many companies throughout the world already use value-based reporting measures such as embedded value to manage their business and communicate with analysts. For 2006, we consider that companies should be able to elect to disclose an appropriate form of value-based reporting. This information should be part of the Operating and Financial Review (OFR) for the reason described below. This has the advantage of being consistent with the Board's aim not to require companies to implement methodologies or system changes that need to be reversed for phase II.

Question 11 –Other disclosures

(a) The Exposure Draft proposes requirements for disclosures about the amounts in the insurer's financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of the draft Implementation Guidance).
Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.
To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.

(b) The proposed disclosures are framed as high level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements.
Is this approach appropriate? If not, what changes would you suggest, and why?

(c) As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS (paragraphs 34, BC134 and BC135).

Should any changes be made to this transitional relief? If so, what changes and why?

(a) We generally support the principles in paragraphs 26 and 28 of ED5, provided that the information is relevant, and that quantification is only necessary where it is practical to provide it. However, we have serious reservations as to the level of detail that is implied by the 55 paragraphs of guidance on disclosure set out in paragraphs IG7 to IG61. As paragraph IG34 quotes:

> "It is necessary to strike a balance between over burdening financial statements with excessive detail that may not assist users of financial statements and obscuring significant information as a result of too much aggregation."

There is no doubt that the disclosure as discussed in the guidance would represent "excessive detail". If the Board wished to gain a sense of the volume of disclosure required, it is suggested that it examines the scale of the Returns provided to prudential regulators. These Returns often run to hundreds of pages and even then do not cover some of the elements of disclosure suggested in ED5 such as cash flows separated by estimated periods of inflow or outflow, risk management policies and sensitivity analyses.

We are particularly concerned about the audit implications of the disclosure requirements for which neither the auditing profession nor the industry is prepared and which would require a substantial investment of time and resources. In particular, we believe that disclosure of the following would require undue time or effort within the audited financial statements:

- Claims development tables as required under paragraph 29(c) (iii) and IG48 and IG49. There may be considerable issues in obtaining historical data that reaches auditable standard and, further, it may not be possible for an auditor to audit information over a period of the past ten years (or five years in the transitional arrangements described in paragraph 34) particularly where there has been a major corporate transaction or a change of auditor.

- Information about interest risk and credit risk that IAS 32 "would require **if** insurance contracts were within the scope of IAS 32" under paragraph 29(d) and IG50 to IG53. This requirement is inappropriate prior to the introduction of phase II for insurance contracts as the information will be dependent on the existing accounting policies for insurance contracts and it will create work that may need to be reversed in phase II.

- Detailed information as implied by paragraphs IG27, IG29 and IG39. This appears to be a checklist of movement accounts that could be very onerous to produce.

Instead, we believe that entities should be allowed to disclose information, where relevant, within the Operating and Financial Review (OFR) or other supplementary information provided with the financial statements. This approach would be the most practical to apply and provide consistency with many local reporting frameworks, including SEC reporting. Disclosure within the OFR would also allow entities to ensure that the discussion on risk will cover aspects of all contracts whilst ensuring that those items that need to be disclosed in the financial statements are appropriately cross-referenced. This will provide users with an overview of risk exposures whilst ensuring that the requirements under existing IFRS are met. We recommend that the risk-related disclosure proposals are considered together with the Board's project on Financial Risk Disclosures.

As noted in our covering letter, we believe that it is more appropriate to develop effective disclosure regimes within the principles outlined in paragraphs 26 and 28 which provide the user with relevant, material and succinct information that will aid understanding and not obfuscate through excessive detail.

(b) We request that the Board clarifies that the Implementation Guidance is not part of the final IFRS and therefore is not mandatory. For example, we would recommend that it should be acceptable for an insurer to adopt an approach that is in the spirit of the principles set out in ED5, but contrary to some of the detail in the Implementation Guidance. This would allow insurers to develop effective and appropriate disclosures that are concise and relevant.

(c) We do not believe that any further changes should be made to the transitional relief but as described above, we do not consider the disclosure of a claims development table within the audited financial statements to be appropriate.

Question 12 – Financial Guarantees

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?

We agree that the Board's proposals are appropriate.

<u>Question 13 – Other comments</u>

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

We have no further comments.