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Dear Mr Clark

SUBMISSION ON ED 5 *INSURANCE CONTRACTS*

In response to the IASB's Invitation to Comment on ED 5, we are pleased to attach the New Zealand Securities Commission's submission on the Exposure Draft containing our comments.

We commend the IASB on its work in producing this proposed standard.

Yours faithfully

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<u>Responses of the New Zealand Securities Commission to the IASB's Invitation to Comment on Exposure Draft 5 *Insurance Contracts*</u>

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?

<u>Response:</u>

We agree that scope of the proposed standard is appropriate.

We support the 'insurance activity' approach applied in the proposed standard, with the effect that the standard will apply to the insurance contracts of all entities.

We think it appropriate that other aspects of accounting by insurance entities should be addressed by other relevant IFRSs.

(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?

<u>Response:</u>

We agree that weather derivatives that do not meet the proposed definition of an insurance contract should be accounted for as a derivative contract under IAS 39. As is noted in the Basis for Conclusions, these contracts may have the legal form of insurance contracts but do not transfer significant insurance risk to the issuer.

Question 2 – Definition of 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?

Response:

We agree with the definition and with the related guidance in Appendix B of the draft IFRS, and IG Example 1.

We note that according to paragraph BC41 the definition will catch certain financial guarantees provided by third parties (such as letters of credit provided by banks), and that an insurer may be required to recognize a liability for such guarantees applying the loss recognition test provided for in the proposed standard.

We also support the proposed amendment to IAS 37 arising from the proposed standard on insurance contracts. This reflects the fact that these financial guarantees now fall within the meaning of the term insurance contracts.

Under IAS 37 a liability would be recognized/provided for a financial guarantee if the probability existed that payments would be required under the guarantee in excess of any expected offsetting cash inflows under the guarantee, and if a reliable estimate of the loss can be made.

We have examined the conceptual correctness of this treatment with reference to the definition of a liability, the criteria for recognition of a liability, and the definition of an insurance contract. Under the definition of an insurance contract the payment to the counterparty under the guarantee is contingent on an uncertain future event (for example a default event) that would adversely affect the counterparty (non-recovery of outstanding amounts).

It would appear that, under the loss recognition test, it is intended the recognition of an insurance contract liability arising under a contract to provide a credit guarantee takes place either when the guarantee is provided (ie at inception) or subsequently whilst the guarantee remains in force, if the expected estimated future cash outflows under the guarantee exceed the expected estimated future cash inflows. That is to say an insurance liability relating to expected estimated cash outflows under such financial guarantees and the related loss are only recognized when they meet the same probability test for recognition of a liability and an expense as applies for the recognition of other liabilities and expenses.

We think that the treatment of these financial guarantees under the proposed standard is an important area of application of the standard, and that the treatment of guarantees under the standard should receive further clarification in the Implementation Guidance for the proposed Standard, and also in Phase II of the Board's Insurance Project.

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?

Response to Questions 3 (a) to (d):

We consider that given the exemption from separately accounting for embedded derivatives that are themselves insurance contracts is made only on the grounds of temporary exclusion until such time as Phase II is complete, it is acceptable in view of the overall purpose of the IASB to ensure that a Phase I Standard on Insurance Contracts is in place by 1 January 2005.

Other than for this we disagree on a conceptual basis that there should be exemptions in the IFRS for accounting treatments that are already addressed in an existing IFRS.

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?

Response:

We consider that given the exemption from separately accounting for embedded derivatives that are themselves insurance contracts is made only on the grounds of a temporary exclusion until such time as Phase II is complete, the exemption is acceptable in view of the overall purpose of the IASB to ensure that a Phase I Standard on Insurance Contracts is in place by 1 January 2005.

Other than for this we disagree on a conceptual basis that there should be exemptions in the IFRS for accounting treatments that are already addressed in an existing IFRS.

(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?

Response:

We support these proposals. FRS 34 and FRS 35 in New Zealand already address these issues along the similar lines as the proposals in ED 5.

Regarding the application of the loss recognition test to insurance contracts, taking a conceptual view of this issue, we consider that not only losses but also gains should be able to be recognized, to give an equal treatment to both possible outcomes for a contract at the point in time when the probable outcome of the test is determined. Conceptually there is no basis for giving any higher priority to the recognition of insurance contract losses than insurance contract gains.

We also think that while the IASB has acknowledged the difficulties with specifying a loss recognition mechanism for insurance contracts at this stage, we do think that it would be helpful to entities who are required to comply with this standard if the loss recognition test could be addressed in the Implementation Guidance for the proposed standard.

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?

Response:

We support these proposals and furthermore we consider that they should be incorporated as a consequential amendment to IFRS 1 *First Time Application of IFRSs*. This is to ensure that this issue comes to the attention of preparers of financial reports when they apply IFRS for the first time in their financial statements.

Our concern is that these proposals represent important quality safeguards to ensure a smooth transition to IFRS for entities who are issuers of insurance contracts. Taking a proactive perspective on enforcement of IFRSs it would we think be advisable to give these arrangements greater profile through incorporating them into IFRS 1.

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?

Response:

We think that it is entirely appropriate that deposit elements be unbundled from the insurance components of insurance contracts, and this has already been done in New Zealand under FRS-34 for some years. The experience here has demonstrated that the approach is feasible.

We accept that the requirements for unbundling in the proposed standard are as yet addressed mainly at those sorts of insurance contracts where it is "easiest to perform" and perhaps where the effect of unbundling is likely to be greatest. However, taking a conceptual perspective on the issue, we consider that it is appropriate that the unbundling requirement be applied uniformly across all insurance contracts, rather than selectively. We understand that the issues will also be addressed in Phase II and we would encourage the IASB to adopt that approach to the issue.

We think that the unbundling requirements contained in the proposed standard are sufficiently clear, taken together with the Implementation Guidance.

Question 7 – Reinsurance purchased

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?

Response:

We support these proposals. These proposals are already a feature of the accounting standards applied for insurance in New Zealand. The presentation of assets and liabilities, and income and expense for reinsurance contracts is conceptually appropriate. This accounting treatment is being implemented by insurance entities in New Zealand.

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

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?

<u>Response:</u>

We agree with the proposals in the context of business combinations or portfolio transfers. We note that it the accounting treatment of the intangible asset arising in such transactions is described in the Basis for Conclusions, but that the standard is silent on this matter.

Whilst we acknowledge that the Board is not at present able to say how fair value for insurance assets and liabilities should be determined, we think that it is important that the accounting treatment of the intangible asset be addressed in the interim period prior to completion of Phase II, to ensure a basic level of consistency of approach between various preparers in different jurisdictions. We think that the Board should consider including some standards to addressing the presentation of the intangible asset in the issuer's financial statements, and include guidance on the application of the loss recognition test to the asset in the Implementation Guidance.

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?

<u>Response:</u>

We agree with these proposals.

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?

<u>Response:</u>

We note that the Board acknowledges that at present it has not determined what basis should be used for establishing the fair value of insurance contract assets and liabilities. This is expected to be available from the IASB to enable preparers to determine fair values in time for the required disclosures to be made from 31 December 2006.

Whilst we agree in principle that it is desirable that entities be able to make fair value disclosures as early as possible, we also consider that viewed from a cost-benefit perspective, entities may encounter some difficulty to establish systems that measure the fair values of insurance assets and liabilities within the envisaged time frame, and in time to comply with the disclosure requirements of the proposed standard.

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?

Response to Question 11 (a) to (c)

We consider that the proposed disclosures about amounts included in the financial statements that arise from insurance contracts are appropriate. The disclosures will significantly enhance the usefulness of reported financial information concerning insurance contracts.

We support the application of the high-level principles to the disclosure requirements, and we think that the Implementation Guidance is helpful in illustrating how the requirements should be applied.

We do not think that changes should be made to the transitional relief in relation to historical disclosures about claims development.

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

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?

Response:

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

Question 13 – Other comments

Do you have any other comments on the draft IFRS and draft Implementation Guidance?

We commend the IASB on ED 5. We think that the proposed standard will bring valuable positive changes in financial reporting of insurance activities, particularly in jurisdictions which did not previously have any accounting standards for insurance activity or insurance contracts for domestic reporting.

We emphasize that there are certain outcomes associated with the implementation of the proposed standard to insurance contracts in New Zealand which would involve acceptance of cost-based accounting treatments for assets that either are not permitted, or would preferably not be permitted under New Zealand's financial reporting standards [such as is the case in accounting for Investment Properties under IAS 40 and investment contracts under IAS 39].

Whilst the Securities Commission's view is that these are tolerable effects in the near term, given the high importance we attach to the goal of convergence to one set of global accounting standards and the benefits forseen from that development, we strongly encourage the IASB to address these issues in its medium term agenda.

The adoption of fair value accounting for all insurance assets and liabilities and indeed also for other assets and liabilities, is the direction the IASB should be moving in to ensure that IFRS lead to high quality and highly comparable financial reporting across national borders, and do actually represent 'international best practice'.