technical release

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

TECH 34/03

ED5: INSURANCE CONTRACTS

Memorandum of comment submitted by the Institute of Chartered Accountants in England and Wales to the International Accounting Standards Board ('the Board') in response to its Exposure Draft ED5: Insurance Contracts.

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INTRODUCTION

1 The Institute of Chartered Accountants in England & Wales welcomes the opportunity to respond to the International Accounting Standards Board ('the Board') regarding the proposals in Exposure Draft 5: 'Insurance Contracts' ('ED5'), published by the Board for comment in July 2003.

2 We have reviewed the exposure draft and set out below a number of comments and suggestions. We deal first with the major points before answering the questions specifically raised by the Board.

MAJOR POINTS

ED5 as an Interim Solution

3 We support the Board in its aim of developing a model for accounting for insurance contracts, and the decision to split this project into two phases, with Phase I in place for the adoption of IFRS by all EU listed insurers by 2005. We agree that it is sensible to defer major changes in the measurement of insurance assets and liabilities until Phase II allowing further time for full development, discussion and testing of a fair value model for insurance contracts.

4 Subject to the comments in this response, ED5 presents an acceptable solution as an interim measure towards assisting insurers in adopting IFRS for 2005. However, we would have concerns were ED5 to be extended significantly beyond 2007 as a result of delays in the introduction of the Phase II standard. Given the importance of ensuring that the Phase II standard is of a high quality and the pressure to have Phase II in place by 2007, we consider it important that substantial resources are devoted by the Board to the project. The 'sunset clause' in the temporary exemption to IAS 8 creates uncertainty as to what will happen in 2007 if Phase II is not in place. We strongly recommend that the sunset clause is removed from the Phase I standard and replaced with a strong commitment to developing Phase II as soon as is practicable. *See Question 4.*

Fair Value Disclosures in 2006

5 We support the disclosure of fair value information as soon as a suitable fair value model has been developed which can be applied to insurance contracts. However, we question whether this will be achieved by 2006. We recommend against introducing a mandatory fair value disclosure requirement before the such an agreed model is in place. We would also recommend that the Board undertakes a project to set out high level principles behind fair value accounting to ensure that it can be applied consistently. *See Question 10 and Appendix II.*

Importance of Field Testing

6 The demanding timetable for introducing the Phase II standard by 2007 might lead to restricted development of the model. Proper field testing is a fundamental component in the development of any new accounting model. We would be interested in participating in any field testing of the Phase II model. *See Question 13.*

Prior Year Comparatives for Year of Implementation

7 We would recommend that the Phase I standard is applied prospectively, with no requirement to restate prior year comparatives in the year of implementation. Given the close link between ED5 and aspects of IAS 39, we consider it important that a similar exemption is included in ED5 as is in IAS 39. *See Question 13.*

Interpretative Panel

8 We recommend setting up an interpretative panel, under the auspices of IFRIC, but with specialist insurance expertise, to deal with interpretative issues on a referral basis. *See Question 13.*

Inconsistent Definition of Insurance Contract

9 We note some inconsistencies in the definition of an insurance contract. We agree that it is appropriate to define insurance contracts around the transfer of significant risk. However, the drafting in ED5 is imprecise and inconsistent. *See Question 1.*

Mismatch and Loss Recognition Test

10 We note that ED5 permits mismatch between the measurement of assets and liabilities. This reflects the difficulties in dealing with insurance labilities in an interim solution, rather than problems on the asset side. We have concerns over one potential mismatch issue arising as a result of the use of locked in interest rates in measuring insurance liabilities. We would recommend the unlocking of interest rates, either directly or through the loss recognition test. We would further recommend that the definition of a loss recognition test is made more robust. We consider both of these changes to be sufficiently significant to warrant a limited re-exposure of ED5. *See Questions 1 and 4(b).*

Volume of Disclosures

11 We are concerned that the disclosures suggested in the implementation include overly complicated and, in places, unnecessary disclosures. The status of the implementation guidance may also be unclear. *See Question 13 and Appendix III.*

Unit-Linked Contracts and Embedded Derivatives

12 We set out in Appendix I a summary of the particular issues surrounding unit-linked contracts. We would favour allowing the recognition of deferred acquisition costs for unit-linked contracts, given that insurers are willing to incur significant expenses to generate unit-linked contracts. We do not consider that unit-linked contracts include embedded derivatives as the linkage to a specified index forms a fundamental and integral component in that contract. *See Question 3*.

Link between Insurance and Reinsurance

13 The proposal to require an IAS 36 impairment test for reinsurance assets does not properly reflect the link between the value of reinsurance assets and the related insurance liabilities. The IAS 36 impairment test would require reinsurance to be measured at the lower of cost and recoverable amount. *See Question 7.*

ANSWERS TO IASB QUESTIONS

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?

14 We support the Board's approach of developing an accounting standard for insurance contracts rather than insurance entities. The major benefit of this approach is that non-insurance contract assets and liabilities are accounted for in a consistent way, regardless of the

entity. In particular, this approach will allow further harmonisation of accounting policies between banking and insurance groups, many of which are now engaged in both activities.

15 ED5 will permit mismatches between the measurement of assets (normally measured at fair value) and insurance liabilities (recognised on various different measurement bases depending on local GAAP). This reflects the inadequacies of ED5, as an interim solution, in addressing insurance liability measurement.

16 We have particular concerns regarding the permissible mismatches, where local GAAP allows insurance liabilities to be valued using locked in interest rates, but assets are measured at fair value. Where there is a significant fall in interest rates, the asset values will rise (particularly for bond portfolios), while liabilities would be undervalued if the old interest rates continue to be used. A rigorous loss recognition test would pick up this understatement, although this would be a one-way test. We are concerned that local GAAP loss recognition tests may not be sufficiently robust to require unlocking of interest rates.

17 While it would be inappropriate to measure insurance liabilities at fair value under Phase I, we recommend that where locked in interest rates are used to measure insurance liabilities, those interest rates should be unlocked, either on the balance sheet or through the loss recognition test. We further recommend that the definition of the expected loss recognition test is made more robust and that the Phase I standard makes it clear that a local GAAP test may not meet this definition.

18 Introducing the requirement to unlock interest rates and making the definition of a loss recognition test more robust would be significant changes to ED5 representing improvements in accounting for insurance contracts. These changes would require proper due process by the Board. If the Board were to introduce these changes, we recommend a limited re-exposure of ED5, similar to limited revisions to IAS 39 exposure of the fair value hedge accounting proposals.

(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?

19 We agree that weather derivatives are brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract.

<u>Question 2 – Definition of an Insurance Contract</u>

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?

20 The definition of an insurance contract is fundamental to accounting for insurance contracts. There can be a fine line between the features of an investment contract and an insurance contract. While we fully support adopting a principles based approach to setting criteria, it is important that there is a clear definition of an insurance contract in the Phase I standard, capable of consistent interpretation. Without such a definition, there would be uncertainty as to which contracts would qualify as insurance contracts and financial statements would lack consistency.

21 We are concerned that the current drafting of the definition of an insurance contract does not achieve this aim and appears internally inconsistent. The dividing line between insurance and investment contracts is defined in terms of significant insurance risk in B21, whilst B23 introduces the concept of risk being non-trivial. B25 introduces a further term "plausible". Significance is a well understood accounting term, while triviality and plausibility are not well defined or understood in this context. We recommend that references to triviality and plausibility are removed from ED5 and that insurance risk is defined in terms of significance.

22 As a further inconsistency, B21 measures the significance of risk based upon the present value of future cash flows (i.e. a net basis) while B23 measures it in terms of a comparison of death and maturity or surrender benefits (i.e. a gross basis). The consequence of introducing a net cash flow measure for insurance contracts is that many more types of product will fall under the definition of an insurance contract than on a gross basis, as risk could be considered significant in comparison to profitability on contracts rather than in light of the insured event. We recommend that the Board clarifies whether this is its intention.

23 There is a third potential problem with the definition of insurance risk. Under B21, it would seem necessary for any change in net (or gross) cash flow arising from an insured event to be significantly different from the cash flow arising from voluntary discontinuance at that date. If this was not the case, all investment contracts might qualify as insurance simply because, on death, there would be a loss of future management charges. This problem might be addressed if B21 referred back to B15, which requires that insurance risk is significantly different to lapse or persistency risk.

24 Many concerns over the definition of insurance contracts surround the potential treatment of unit-linked contracts. *See Appendix I.*

25 Subject to the above comments, we generally support the definition of insurance contracts around significance of risk, although we consider that the final definition should be revisited as part of the Phase II 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?***

26 We are concerned that Board's proposals for embedded derivatives may create significant implementation problems. ED5 is an interim solution and will not provide consistency of measurement between companies because of its dependency on local GAAP. Implementation of such a transitional regime should be as straightforward as possible.

27 The proposals in ED5 appear to be highly complex for many investment contracts. This can be demonstrated by looking at unit-linked contracts. Payments to policyholders will vary in line with an index of products. This linkage appears to meet the ED5 definition of an embedded derivative under ED5. As this linkage is not in itself an insurance contract, it would therefore need to be separated and measured under IAS 39. However, the value of the liabilities of unit-linked contracts tend to be strongly linked to the value of the assets backing such liabilities and are therefore well hedged. This appears to be a highly complex solution for a relatively straightforward problem, particularly given that Phase I will be an interim standard.

28 In our opinion, unit-linked contracts do not contain embedded derivatives. There is an assumption that derivatives involve a low premium for the risk involved. The premiums on unit-linked products are invested to cover the liabilities and the linkage forms a fundamental part of the underlying product. We do not consider that separating out different components of unit-linked contracts as embedded derivatives would provide a sensible answer. We recommend that ED5 is amended to make clear that the linkage between liabilities and a specified index on index-linked contracts does not meet the definition of an embedded derivative. Appendix I sets out in more detail the difficulties in respect of unit-linked contracts.

<u>Question 4 – Temporary exclusion from criteria in IAS 8</u>

(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?

29 We believe that it is appropriate to grant insurers an exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8 during Phase I of the insurance standard. Given that the IASB has decided to address accounting for insurance contracts in two phases, such an exemption is essential to avoid substantial accounting policy changes twice in a relatively short time span.

30 If no such exemption was granted companies issuing insurance contracts would be forced to interpret, in an insurance context, accounting standards that were not developed to address the particular features of insurance policies. Local GAAP measurement bases would not be available and it would require substantial time and effort for insurers to apply this complex solution.

31 We recommend that Phase I allows further exemptions from the constructive obligations requirements of IAS 37 in respect of unallocated balances of discretionary funds with participating features as described in our response to question 9, and from IAS 36 for reinsurance balances. *See Question 7*.

32 The 'sunset clause' of 1 January 2007 for these exemptions should be excluded from the final standard. If the exemptions expire without a suitably developed Phase II solution in place, insurers would be faced with problems of fitting general accounting solutions around their complex products. The Board has acknowledged, by prioritising its project on insurance, that general accounting solutions are inappropriate for insurance contracts. Furthermore, it would be undesirable if insurers were faced with three significant accounting system changes in a short period of time, firstly from the need to implement Phase I, secondly to interpret and adopt IAS 37 in an insurance context and finally to implement the Phase II standard when it is eventually issued. Not only would this require significant time and effort on the part of preparers of financial statements and auditors, it would be unlikely to increase the understanding of users during the interim period.

33 The sunset clause imposes unnecessary pressure on the development of the Phase II standard. The Phase I standard would become the only accounting standard issued with a time limit. We consider this an unwelcome precedent that might undermine confidence in the Phase I standard.

34 We support a rapid move towards a well developed, discussed and field tested Phase II standard. If this can not be achieved by 2007, the Phase I requirements should be extended. We would not wish to see a reduction in the development and consultation of Phase II as a result of the need to meet any artificial deadline. We consider the Board should replace the sunset clause with a strong commitment to implementing Phase II without undue delay, including an outline of how it intends to achieve this.

(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?

35 We agree that it is reasonable to eliminate catastrophe and equalisation provisions. While there may be merit in insurers managing their business to ensure they have sufficient resources in the event of significant future losses, this should be addressed through capital requirements rather than liabilities.

36 The requirements of a loss recognition test are not well defined, as noted above in our comments to question 1. We recommend that the required loss recognition under ED5 is made more robust and that Phase I sets minimum requirements for all loss recognition tests irrespective of local GAAP requirements, rather than only requiring one where no such test exists under an insurers existing accounting policies. This would be a significant change to ED5 which would require a limited re-exposure prior to the implementation of Phase I.

<u>Question 5 – Changes in accounting policies</u>

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?

37 We consider the proposals in (a) and (b) appropriate in general. However, we note that a strict interpretation of the wording in paragraph 16 of the draft standard would prevent an

insurer, when making any change to its accounting policies for insurance contracts, from continuing with other aspects of their existing policies involving the matters listed in paragraph 16. This is inconsistent with BC77, which would prohibit the adoption of accounting policies that would diminish the relevance and reliability of financial statements, although it would permit insurers to continue such policies. We would recommend that the wording of paragraph 16 is amended to be consistent with the wording of BC77.

<u>Question 6 – Unbundling</u>

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?

38 The proposals on unbundling appear reasonable as part of an interim solution.

<u>Question 7 – Reinsurance</u>

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?

39 We agree that insurance liabilities and related reinsurance assets should be reported separately without offsetting.

40 We consider that a more appropriate measurement basis for reinsurance would be to allow insurers to continue with local GAAP accounting for reinsurance contracts under Phase I, which typically match assets and liabilities. We agree that it is necessary to deal with the particular issue of retroactive reinsurance but suggest that that any solution should be limited to

that type of contract. Reinsurance contracts without significant risk transfer would be excluded from the definition of an insurance contract and dealt with in that way.

41 Payments under reinsurance contracts are linked to the claims paid under the underlying insurance policies. Paragraph 19 of the draft statement and the proposed change in C10 to the scope of IAS 36 would require an insurer to apply an IAS 36 impairment test to its rights and obligations under a reinsurance contract. This would require an insurer to value such balances at the lower of cost and recoverable amount. We do not consider that this would appropriately reflect the link between the value of reinsurance assets and the underlying insurance liabilities. For example, reinsurance may be bought for £100 guaranteeing to pay 90% of each and every claim. Claims relating to the underlying insurance policy might total £1,000. £900 of these claims may be recoverable from the reinsurer but the IAS 36 impairment test would limit the value of the reinsurance asset to £100. We recommend allowing the retention of local GAAP impairment tests.

42 We note that the definition of significance may differ for reinsurance from direct insurance, as a reinsurance contract may bundle together a portfolio of insurance contracts, thereby potentially reducing risk compared to the exposure on the underlying contracts. It might still be generally appropriate to treat such contracts as reinsurance.

Question 8 – Insurance contracts acquired in a business combination

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?

43 We agree that it is appropriate to measure at fair value insurance assets and liabilities acquired as part of a business combination. We also welcome the Board's recognition that a significant change to the accounting applied to such acquisitions of insurance assets/liabilities would not be practical as part of Phase I. However the proposals made with respect to business combinations lack clarity. For example BC93 refers to PVIF and VOBA, but it is unclear how such amounts should be measured. Furthermore this is only relevant in a life insurance context. There is no guidance provided for general insurance contracts acquired.

44 The standard is also unclear as to what will happen to the accounting for historic acquisitions upon adoption of the Phase II accounting standard. We believe that an insurance entity should be allowed to recalculate the fair value of assets and liabilities acquired to be consistent with the final definition of fair value and hence restate goodwill. If such a restatement is not permitted then insurers will be left with the unacceptable position of having two calculations of fair value, one for purchase accounting and the other for historic accounting. We do not believe that this will result in relevant and reliable accounting.

45 The weakness of having an interim standard means that it is difficult to resolve the issues outlined above. Given that the Board will not to provide definitive guidance on the definition of fair value until Phase II we strongly recommend that an additional clause is added to paragraph 20 which says:

'Until the Phase II insurance standard is issued, companies will need to use existing accounting policies to calculate the intangible asset referred to above. Any changes to these policies should meet the general requirements within paragraphs 14-17 on changes to accounting policies. Upon adoption of Phase II, companies will be permitted to revisit acquisition accounting to bring the fair values of insurance assets and liabilities acquired into line with the requirements of the Phase II standard, with a corresponding adjustment to goodwill.'

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?

46 We consider that the proposals for accounting for discretionary participating features under ED5 could be improved for Phase I by a tightening of the definition of what can be recognised as equity. We do not believe that unallocated funds under contracts with discretionary participating features should be included as equity when there may be a constructive liability to policyholders established by past behaviour. In this context, we believe that constructive obligations should be defined in broad terms. We recommend that surpluses on such contracts should only be treated as equity to the extent that there is evidence to support shareholders' rights to that surplus.

47 The rebuttable presumption should be that unallocated surpluses are split between liabilities and equity. In the event of doubt over the allocations between liabilities and equity, we would favour recognition under liabilities. This approach would include permitting 100% to be recognised as a liability. Although this approach might be considered to be excessively prudent, a worse result would be to allocate more to equity than shareholders have a legitimate right to expect. We also recommend that insurers should disclose, at a high level, the method used to allocate surpluses between liabilities and equity.

48 Investment contracts with discretionary participation features are exempted from the measurement requirements of IAS 39, but not from the disclosure requirements of IAS 32. This is inconsistent with other aspects of ED5. It will require insurers to incur the system costs of measuring the fair value of such contracts without clear guidance on how to do so. The Board have recognised, in allowing the exemption, that it would be difficult to apply IAS 39 without first addressing a number of issues. We recommend that the exemption from IAS 39 for participating business is extended to also apply to IAS 32.

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?

49 The proposed disclosures from 31 December 2006 are likely to be in advance of the Board defining fair values for insurance contracts. Particular issues in applying the fair value model to insurance contracts are explained in more detail in Appendix II.

50 We strongly recommend that any requirement to disclose the fair values of insurance liabilities is deferred until the Board has defined what fair value means in the context of insurance contracts. We support fair value disclosures for insurance liabilities once the Board has reached an agreed definition of what fair value means. Any fair value disclosure requirement without a proper definition, however, would involve experimentation in the financial statements, which is undesirable.

51 We expect most listed insurers to develop supplementary information containing value based measures. This might be along the lines of an enhanced version of Achieved Profits. We believe that, until the Board is able to satisfactorily explain how to apply the fair value model to insurance contracts, it would be more appropriate to disclose value based information as supplementary information rather than in the financial statements. Such disclosures should not be restricted by future Phase II proposals while they remain uncertain.

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?

52 We have general concerns over the volume and extent of some of the disclosures proposed by ED5 and, more particularly, that suggested in the implementation guidance. We support the approach of producing high level principles to determine the required level of disclosures. We are concerned, however, at the level of detail contained in the implementation guidance. Users might welcome clarification from the Board over the status of this guidance and whether it is expected that the implementation guidance should be adopted as best practice, or whether it is intended as an example of what may be considered suitable disclosures.

53 Our concerns over the potential volume of required disclosures are set out in more detail in Appendix III. Many of our concerns might be addressed by allowing a reasonable level of aggregation and disaggregation in the disclosures. We also have some concerns that some of the suggested disclosures are not relevant for all types of insurance contracts.

<u>Question 12 – Financial Guarantees</u>

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?

54 We do not consider this to be a significant issue. In principle, if there was such a contract, we consider it would be appropriate for it to be accounted for in the same way as for other financial guarantees.

<u>Question 13 – Other comments</u>

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

<u>Importance of Field Testing</u>

55 As discussed above, the timetable for producing a Phase II standard for 2007 appears ambitious as there are a number of areas requiring further development. Although we would have concerns were Phase I to be extended beyond the short term, we consider it more important that the Phase II standard is of a high standard than that any strict timetable is met.

The development, discussion and testing of the Phase II standard should not compromised in order to meet any pre-determined timetable. We would like to stress the importance of proper field testing as part of the further development of the Phase II model. We do not consider field visits to represent field testing. We would welcome a commitment from the Board to include field testing as part of the development of the Phase II model. We would be interested in assisting in the field testing process and might be able to provide volunteers from both the insurance industry and accountancy practices.

Interpretative Panel

56 As discussed above, given the current diversity of insurance accounting and local insurance products, it might be useful to have an interpretative panel set up after the implementation of Phase I to deal with issues arising in relation to accounting for insurance contracts. This would allow consistent interpretation of issues arising. The interpretative panel should include specialise insurance knowledge. It might be appropriate for the panel to be under the auspices of IFRIC, possibly as a sub-group, and deal with issues on a referral basis.

Performance Reporting

57 We consider that performance reporting may be the best way to address the concerns over the potential for asset and liability mismatches and volatility. We consider that this is a Phase I issue and that the Board should concentrate resources on solving the performance reporting issues. Looking ahead to the future performance reporting model, we would encourage the Board to permit a flexible approach to performance reporting under Phase I, as this will allow insurers to accommodate many of the potential issues of volatility and distortion under the interim standard. A tight definition of performance reporting requirements might prevent this.

Prior Year Comparatives for Year of Implementation

58 As discussed above, ED5 would require 2004 comparatives for the 2005 year end. This could be problematic for insurers given that IAS 39 will be applied prospectively for the first time application of IAS. ED5 requires liabilities that are not within the scope of ED5 to be accounted for under IAS 39. This might require insurers to apply IAS 39 to 2004 comparatives when other companies are allowed to apply it prospectively and for accounting periods ending before IAS 39 has been adopted. We would therefore recommend that the Phase I standard is applied prospectively, similar to IAS 39.

Status of Implementation Guidance

59 It is unclear whether the implementation guidance is expected to be followed or whether it is provided as an aid to interpreting the draft standard. This uncertainty is not helped by the fact that, we understand, the implementation guidance will be provided in English Language only,

while the standard will be translated into several languages. We recommend that the status of the guidance is made clearer and that it is provided in the same languages as the final Phase I standard.

APPENDIX I: UNIT-LINKED CONTRACTS

UNIT-LINKED CONTRACTS

i) Many unit-linked contracts may not meet the definition of an insurance contract under a gross cash flow test. This would force insurers to account for unit-linked contracts under IAS 39, allowing the options of accounting for liabilities under amortised cost or fair value. Given that assets and liabilities are closely matched in unit-linked contracts, the amortised cost route is not a good solution in addition to being hugely complex. Insurers are willing to incur significant costs to generate long term business as the policies can last for terms of over 25 years. The fair value route would therefore be problematic as insurers would have to write off acquisition costs on inception, thereby creating initial losses for insurers on contracts they expect to be profitable. This would have significant impacts upon shareholders funds.

ii) We would recommend that unit-linked contracts not meeting the definition of insurance contracts are given a temporary exemption from IAS 39 in a similar manner to investment contracts with participation features. This would allow insurers to recognise deferred acquisition costs until the particular issues of unit-linked products are dealt with as part of the Phase II project. Deferred acquisition costs do not represent the expected value of the relationship with policyholders. They do, however, reflect the actual expenses insurers are willing to incur in order to secure future cash flows.

iii) We do not consider that this will create inconsistency with the accounting for similar products by companies other than insurers, as we are not aware of similar products offered by other companies. Unit-linked contracts differ from unit trusts in that unit trusts are a separate legal entity and their assets and liabilities are not included on the balance sheets of the investment manager. A further difference is that unit trusts do not have the same long-term relationship with unitholders that an insurance company has with unit-linked policyholders. Unit trust managers typically cover the costs of acquiring new unit holders by the spread between the cancellation and creation prices. Management companies do not invest to the same extent in acquiring relationships with individual unitholders. Insurance companies, on the other hand, are willing to invest significant amounts of up-front expense in acquiring individual unit-linked contracts. We would suggest allowing a further exemption from IAS 39 under Phase I for unit-linked contracts, similar to the exemption provided for investment contracts with participating features.

iv) An alternative approach to deal with the issue of unit-linked contracts would be allow companies writing unit-linked products to split acquisition costs between investment and service elements, where it could be demonstrated that there is a service element to the product. This would allow insurers to account for the service element of acquisition costs under IAS 18 and write it off against future management charges.

APPENDIX II – FAIR VALUE MODEL

DEVELOPMENT OF FAIR VALUE MODEL FOR PHASE II STANDARD

i) Fair value, as defined in Appendix A of ED5 and IAS 39, represents a market based measurement. It is an approximation of the price that would be exchanged between a willing buyer and seller in an arm's length transaction. Fair values are most easily observable where there is an efficient, liquid market. While we support the fair value approach in principle for insurance contracts, there are difficulties in practice of applying the general model to insurance contracts. We discuss these difficulties below.

A Policyholder Perspective

ii) Policyholders do not typically hold portfolios of insurance contracts. It is not easy for them to diversify their general insurance risk in the same way that they might diversify investment risk, for example. For this reason, insurance contracts provide protection to policyholders from both the general market risk and their individual risk and policyholders are prepared to pay a risk premium to cover both the market and individual risks of that contract.

iii) Policyholders receive both tangible and intangible benefits from taking out insurance contracts. The tangible benefits arise from indemnification from liabilities. The intangible benefits include the "peace of mind" of having insurance in place. In addition, insurance can be a legal requirement, such as motor insurance. Policyholders are willing to pay for both the tangible and intangible elements.

An Insurance Company Perspective

iv) In contrast to policyholders, insurance companies are able to diversify risk. Insurers' internal risk management procedures measure insurance liabilities on a portfolio basis. Insurers have more information about expected claims rates than policyholders and they generally set prices based upon a number of factors, including expected claims patterns and prices set by their competitors. Insurers also have access to the reinsurance market, where both buyers and sellers have similar information, both benefit from diversification and transactions are at arms length.

v) As a result of the above factors, the prices on reinsurance markets are generally lower than the prices set by insurance companies and charged to policyholders. On certain types of insurance product, there is strong competition and the prices set by insurers may be close to the present value of the expected future cash flows of the liabilities under that contract, with a small profit margin added. A typical example would be motor insurance. For other types of product where there is less competition, more information asymmetry and the products may be less transparent, there can be significant differences between the premiums paid by policyholders and the cost of reinsurance. An example would be product warranty policies, where the premium paid by policyholders might be 100, while expected claims payments might be 50.

Reinsurance Market as a Measure of Fair Value

vi) Insurance is a regulated market. The law prevents insurers from disposing of insurance risk. The reinsurance market is a way of managing exposure to risk, but does not extinguish such risk. Claims are still paid by the direct insurer and then recovered from the reinsurer. For this reason insurers are still required to maintain regulatory capital in respect of insurance liabilities when reinsurance is in place and it is proper that insurance liabilities and reinsurance liabilities should not be netted off. These legal and regulatory restrictions prevent a true secondary market for insurance liabilities from existing.

vii) A further reason for pricing differentials between insurance and reinsurance premiums is the timing of cash flows. Reinsurance cash flows are often paid on an aggregate basis and at specified times. There are therefore potential timing differences between payment of claims to policyholders and recovery of those amounts from the reinsurance market.

viii) For these reasons, the risk transfer bought and sold in the reinsurance market is not an exact match to the products sold in the direct insurance market. However, in general we would suggest that pricing in the reinsurance market is based more closely on the best estimate of the present value of future cash flows than the premiums paid by policyholders.

Entry Value vs Exit Values

ix) The current direction of the Board appears to be towards measuring the fair value of insurance liabilities based upon the prices paid by policyholders, in the absence of market evidence. It is unclear as to what would constitute market evidence. For example, it is unclear whether the prices on the reinsurance market would be considered as market evidence.

x) We have a more fundamental concern over describing the prices paid by policyholders as the fair value of underlying liabilities. We consider that this is inconsistent with the way in which fair values are derived in other circumstances and that it might be better described as ‘entry value’ accounting. In order that fair value accounting is properly understood, the concept of fair value must be clearly defined and that definition applied consistently. Introducing a separate definition of fair value for insurance contracts is only likely to make the concept of fair value accounting less understandable.

APPENDIX II – FAIR VALUE MODEL

Profits on Inception

xi) The Board appear to seek to prevent recognition of profits on inception of insurance contracts. On a contract where it is possible to obtain 100% reinsurance at significantly lower prices than the related direct insurance premium, it appears reasonable to recognise profits when the assets and liabilities relating to that contract are measured on a fair value basis. A natural consequence of any true fair value system is that profits can be recognised on measuring the assets and liabilities on a fair value basis.

xii) We recommend that the Board addresses the issue of subsequent measurement of insurance liabilities before a requirement to disclose the fair value of insurance liabilities is introduced. An 'entry value' approach would result in the recognition of profits when insurance premiums are lowered and losses when premiums increase.

Project to Develop Framework of Fair Value Principles

xiii) We recommend that the Board undertakes a project to develop a set of consistent principles for fair value accounting that can be applied consistently across a range of accounting issues, including but not limited to insurance contracts. The fair value model is being applied to an increasing spectrum of accounting policies. There is a danger that, if it is not applied in a cohesive and consistent manner, it will not be well understood by users and will not improve the relevance and reliability of financial information.

xiv) The fair value model can not be easily extended to all areas of accounting. It works well where there is a liquid, observable secondary market. The Board should develop a framework of fair value principles to assist accounts preparers in developing financial models for approximating fair values in other circumstances and ensure the model is consistently used.

APPENDIX III – VOLUME OF DISCLOSURES

VOLUME OF DISCLOSURES

i) We acknowledge the need to introduce a level of disclosure at Phase I to improve the information available to users of the financial statements of insurers. The temporary relaxation of the requirements in paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 makes it more difficult to prescribe detailed disclosure requirements in those areas where accounting policies may be specific to entities operating in a local environment. The draft standard therefore prescribes high level principles for disclosure.

ii) As indicated in Question 11, the high level principles are supported by a larger volume of detailed guidance and it may not be clear how the guidance should be interpreted. The potential for confusion is heightened by use of different grammar within the guidance which appears to imply different degrees of guidance. By way of example, the guidance in paragraph IG37 uses the wording "An insurer discloses for example…" which suggests a greater degree of latitude than the wording of the following paragraph (IG38) "To achieve this, an insurer discloses…".

iii) We understand that the Board did consider whether some of the guidance should be included in the draft standard but concluded that it was difficult to include only part of the guidance in the standard. We suggest that the Board should review the wording in the guidance and where wording of a more mandatory nature is adopted, it should consider whether to soften the wording or include the requirement within the draft standard. Additionally where a detailed table or reconciliation is deemed necessary then this should be included in the standard rather than in the guidance (in line with the requirement to produce claims run-off tables in paragraph 29(c)(iii)).

iv) Turning to the detail contained in the implementation guidance, we have concerns regarding some of the detailed proposals. In a number of instances, the suggested disclosures are drawn from comparison of the requirements of existing IASs and modified to provide similar levels of disclosure in respect of insurance contracts. We acknowledge that this methodology provides a basis for generating possible disclosure items but we believe that additional work is required to ensure that the disclosure suggested is relevant and reliable in the context insurance contracts. We have set out below various examples where we consider that the disclosures suggested in the implementation guidance to ED5 may be excessive.

Disclosure of Net Cash Inflows and Outflows under IG39

v) IG39 provides an example of a disclosure of insurance contract net cash inflows and outflows that has been modelled on the requirements of the proposed amendments to IAS 32. The disclosure in IAS 32 is intended to provide information on a entity's exposure to interest rate risk where changes of interest rates might either impact contractual cash flows or affect the fair value of a financial instrument due to an exposure to fixed interest rate under contractual arrangements. We are not convinced that the above criteria apply automatically to insurance contracts and feel that any similarity is not sufficient to justify the disclosure requirements in IG 39.

vi) The disclosure requirements of the proposed amendments to IAS 32 apply to the earlier of the maturity date and the repricing date of an instrument and not to the anticipated cash flows as proposed in IG39. We appreciate that some users may find such information useful in the context of certain insurance liabilities, for example outstanding claims in general insurance business. For other provisions, such as those arising under life contracts, the basis of valuation during Phase I may render the information of little value to users. The cash flows assumed at a contract level on life contracts may be complex (involving both inflows and outflows over the duration of the contract) and prudent (for example the basis of valuation may assume an unrealistic estimate of the lapse experience of the contracts). We are not convinced that users will find these disclosures useful. Additionally, the proposed guidance applies to all insurance liabilities. In the case of some classes of insurance (e.g. general insurance business) this would include provisions for unearned premiums and it is unclear how the proposed disclosure would be provided for this category of liability.

Disclosure Requirements under IG 39(b)

vii) We also have concerns about the other disclosure requirements in paragraph IG39. For example, IG39(b) suggests a disclosure of the impact of adverse policyholder behaviour in respect of lapses and surrender options. Using a general insurance example, this could require disclosure of the impact of lapse of all those contracts where no claim would arise under the policy and retention of those contracts where a claim does arise. This is impossible to predict with certainty as insurance claims are fortuitous, but could be estimated and comply with the wording of this paragraph. Taking another example of an insurer underwriting catastrophe risks, this answer would be different depending on whether or not a catastrophic event occurs during the period of risk. In view of the uncertainties surrounding all forms of insurance contracts we are unclear as to the form that a disclosure satisfying the requirements of IG39(b) could take.

Disclosure Requirements under IG39(f)

viii) We acknowledge that the existence of a guarantee protection scheme for policyholders is relevant in the context of a contingent liability on an entity underwriting insurance risks. We do not believe that it is relevant in the context of the accounting for insurers' own insurance contracts, as any such scheme is unlikely to afford any protection to the shareholders of the entity. We therefore believe that the guidance in paragraph IG39(f) is unnecessary in an IFRS on insurance contracts and is adequately covered by IAS 37.

APPENDIX III – VOLUME OF DISCLOSURES

Presentation of information under IG27

ix) Another example of unnecessary disclosures is the information provided in IG27. This disclosure also follows a model of disclosure required in IAS 37. For certain insurance liabilities, we consider that the relevant information may be presented in a better format. For example, the information in the run-off tables for outstanding claims provides more useful information than the information proposed in the reconciliation of opening and closing provisions. In addition, the list of proposed items to be included in the reconciliation appears to include duplication: for example, a change in an existing claims provision would seem to appear in items (b) and (e).

x) The level of aggregation expected in item (d), which states that surpluses released should not be offset against deficits in other provisions, is unclear. The Board should explain the level (e.g. policy, class of business, etc) at which the identification of surplus/deficit is made. It appears that the principles adopted from IAS 37 in proposing the disclosure are more relevant to its usual use in a small portfolio of large provisions than to insurance contracts (a large portfolio of small provisions). The analogy of following the disclosure requirements in IAS 37 is lost in IG28 when the guidance proposes that prior year information is given. This is explicitly not required by IAS 37 (paragraph 84).

xi) Finally, the Board expects this disclosure to be on an aggregate basis, whereas existing accounting policies may include assets and liabilities of very different nature (for example outstanding claims provision and provisions for unearned premiums). It is presumed that provisions arising from the deferral of income would be better disclosed in a format similar to that proposed for the deferral of acquisition costs.

Information about run off claims

xii) The draft standard requires information about the run off of claims provisions to be provided for a period of at least ten years but has qualified this by permitting a starting point of 5 years of information. We understand that some companies may have difficulty in providing this information on a retrospective basis and would urge the Board to investigate the practical problems that this may cause insurers. For companies already listed in the USA similar disclosure requirements are already in place in respect of general insurance contracts but further work may be required to produce the data in respect of other classes of business (e.g. life insurance contracts where claims remain outstanding for more than one year). Again we would urge the Board to consider the practical issues of providing this information at a level that may be considered reliable.

APPENDIX III – VOLUME OF DISCLOSURES

Statement on Key Performance Indicators under IG59

xiii) The implementation guidance includes a statement on key performance indicators in IG59. We can find no reference in the draft standard to KPI's. We do not believe that the contents of this guidance aids the understanding of the standard and should be omitted.

IDC 31 October 2003