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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

EXECUTIVE HEADQUARTERS

2301 McGee Street
Suite 800
Kansas City MO
64108-2662
Voice 816-842-3600
Fax 816-783-8175

FEDERAL AND INTERNATIONAL RELATIONS

Hall of the States
444 North Capitol St NW
Suite 701
Washington DC
20001-1509
Voice 202-624-7790
Fax 202-624-8579

SECURITIES VALUATION OFFICE

1411 Broadway
9TH Floor
New York NY
10018-3402
Voice 212-398-9000
Fax 212-382-4207

WORLD WIDE WEB

www.naic.org

October 30, 2003

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street, First Floor
London EC4M 6XH United Kingdom

Dear Sir David and Members of the Board:

Thank you for the opportunity to comment on ED 5 Insurance Contracts. On behalf of the International Accounting Standards Working Group (IASWG) of the National Association of Insurance Commissioners (NAIC), I am pleased to provide you comments on the exposure draft in response to your Invitation to Comment. This letter provides i) background information on the NAIC, ii) general comments of the IASWG, and iii) direct comments in response to the IASB Invitation to Comment.

Background and NAIC Process

Formed in 1871, the NAIC is a voluntary organization of the chief insurance regulatory officials of the 50 states of the United States of America, the District of Columbia, American Samoa, Guam, Puerto Rico and the Virgin Islands. The mission of the NAIC is to assist state insurance regulators, individually and collectively, in serving the public interest in a responsive, efficient and cost-effective manner, consistent with the objectives of its members.

In fulfilling this mission, the NAIC has developed significant experience and expertise in the development of meaningful accounting principles for use in the financial statements of insurance enterprises. The NAIC has the responsibility to establish and interpret statutory accounting principles. This set of principles is recognized as an other comprehensive basis of accounting.

The fundamental concepts upon which these principles were promulgated are conservatism, consistency and recognition. While these principles are not identical to the framework used by the IASB, which govern general-purpose financial statements, the NAIC has developed expertise with general-purpose financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). The NAIC reviews all U.S. GAAP pronouncements to determine their relevance for statutory accounting purposes.

The NAIC's interest in the IASB's Insurance Contracts Project is two-fold. First, the convergence initiative between the IASB and FASB increases the probability that international standards will affect U.S. standards and hence possible relevance for statutory accounting; secondly, to assist the IASB in developing high quality standards to be used uniformly across all countries.

These comments have been prepared by the IASWG of the NAIC. As part of the NAIC's due process procedures, these comments have also been shared with interested parties of the IASWG, all of whom were given an opportunity to contribute to the IASWG's deliberations of these issues. However, the IASWG does not wish to imply that these comments are shared by all of the IASWG interested parties.

General Comments

Phase I Versus Phase II

In May 2002, the Board agreed to split the insurance contracts project into two phases. As stated in the IASB project summary, phase I was to be an interim step to assist insurers adopting International Financial Reporting Standards (IFRS) in 2005. Furthermore, this phase was to be a 'stepping stone' to phase II and was not to be interpreted as representing a comprehensive insurance standard. After reviewing the exposure draft, it appears that the Board has significantly strayed from the initial declarations that phase I would primarily advocate local GAAP with limited improvements to accounting practices.

During the initial phase I discussions, the Board conveyed concern with requiring insurers to implement significant system changes for phase I, when additional system changes would be forthcoming upon adoption of phase II. Furthermore, the Board was adamant that measurement issues would not be addressed within phase I. (On several occasions, including the IASB Roundtable and the Standards Advisory Council (SAC) meetings, the Board has avoided acknowledging comments pertaining to the measurement of insurance contracts.) After studying the exposure draft, it appears that the Board has dissolved both the concern for significant system changes as well as the strict separation between phase I and phase II regarding measurement. Although we recognize that the Board will no longer finalize phase II within the initially proposed timeframe (six months after the completion of phase I), and attempts to 'squeeze' more components within phase I may be appealing, the IASB must acknowledge that phase I is not representative of the Board's initial declarations. Though the IASB has digressed from the initial phase I intentions, the IASWG is still very concerned with the extent of system changes phase I will require as well as the measurement inconsistencies/requirements that stem from the phase I guidance. The IASWG requests that the Board reaffirm the intent of phase I and remove those elements included within the exposure draft that do not coincide with that assessment.

International Financial Reporting Standards and the Use of Implementation Guidance

In accordance with the Board's meticulous usage of a 'principles-based' approach, the draft IFRS, as a stand-alone document, fails to properly provide the elements necessary for a preparer/user to understand the appropriate accounting for insurance contracts. Although the Draft Implementation Guidance specifically states that '*this guidance accompanies, but is not part of, the IFRS*' it is essentially impossible to develop the appropriate accounting for an insurer without relying on the implementation guidance. As further detailed in our responses to the invitation to comment, specific examples of this include the embedded derivative guidance as well as the disclosure requirements.

The proper usage of a principles-based approach requires the standard to be sufficiently detailed so that comparability is feasible among the constituents. As comparability could not currently be obtained without reliance on the implementation guidance, we would request that the Board modify the draft IFRS so that it includes the objective-based guidance on disclosures currently found in the implementation guidance. The addition of this guidance will not sacrifice the principles-based approach, rather it will enhance this approach as comparability will be obtained. (The non-binding portion of the implementation guidance would then be restricted to sample illustrations of applying the binding objective-based implementation guidance.)

Use of the Principles-Based Approach

As stated by the IASB, the IFRSs are drafted in accordance with what the IASB deems to be a principles-based approach. However, given the recent study conducted by the U.S. Securities Exchange Commission (SEC) (*SEC Study on Adoption by the U.S. Financial Reporting System of a Principles-Based Accounting System)* released on July 25, 2003, the SEC does not believe the IASB has met the goal of developing principle-based standards. The SEC indicates that after reviewing the IFRSs, many of the standards would be more accurately described as rule-based standards. Furthermore, the SEC notes that those IFRSs that could be deemed principle-based standards should actually be characterized as 'principle-only' standards as they are overly general to the extent of prohibiting comparability.

As the SEC will be working with the U.S. Financial Accounting Standards Board (FASB) to more accurately detail the components of a principle-based standard, and as the IASB and the FASB plan to converge their respective accounting standards (to the extent possible), we would encourage the Board to modify the approach for IFRSs to mirror the objectives-based approach detailed by the SEC. This approach should be adopted for all revised IFRSs including the insurance contracts standard.

Invitation to Comment

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?

Response:

The IASWG disagrees with the decision not to include specific guidance for assets backing insurance liabilities within the phase I exposure draft. Although the Board has indicated that measurement issues are outside the scope of phase I, without addressing the measurement volatility exacerbated by the phase I limited improvements, the Board is knowingly advocating an IFRS that is inherently flawed.

As noted by the Board in paragraph BC110 of the Basis for Conclusions, using a different measurement basis for insurance assets (IAS 39) and liabilities (Insurance Contract IFRS) will result in meaningless 'noise' and distortions in the insurer's reported equity. Even with this insight, the Board continued to conclude that the benefits of altering the current method of accounting for insurance assets during the short-term phase I project to eliminate the effects of a possible mismatch in the financial statements would not be justified. The IASWG disagrees with this assessment as the mismatch in the financial statements will cause significant disparities within the insurance industry. As evidenced by the findings of the ACLI/IAA Joint Research Project an inconsistent measurement basis for assets and liabilities will result in an improper representation of underlying business reality for the earnings of life insurers. As such, informed financial statement users may not be able to perceive the actual business reality. (The current system in the U.S. is workable only because changes in fair value for Available-For-Sale securities do not flow through the income statement.)

Furthermore, although the Board has indicated in previous statements that "phase I is not intended to push insurers to adopt a fair value model before phase II is finalized…", this volatility in the financial statements may compel insurers into attempting to fair value liabilities before the Board has adopted a consistent measurement system or model.

We would first encourage the Board to reconsider either relaxing the IAS 39 held-to-maturity criteria or to establish a new category of assets held to back insurance liabilities in order to permit insurance assets to continued to be valued at amortized cost. With these proposals, the insurance industry will be permitted to utilize the same measurement basis (i.e., amortized cost) for assets and prevent unnecessary financial 'noise'. Furthermore, the acceptance of these proposals will allow the IASB additional time to develop the phase II standard. During the original discussions on this topic, the IASB members rejected these proposals as they concluded the measurement mismatch and resulting 'noise' would be a short-term issue since they anticipated the time span between phase I and phase II to be extremely limited. As current projections for phase II completion stretch as far as 2010, this is no longer a short-term issue and it is imperative that a method promoting consistent measurement be adopted within phase I. Additionally, as with several other phase I provisions, if this issue is implemented as stated in the exposure draft, insurers will face significant system changes as they work to revise their existing accounting structure by the 2005 deadline.

If the Board decides not to reconsider the options identified above, the IASWG would recommend an alternative proposal. In order to more faithfully present an insurer's financial position, while not undermining the fundamental assertions in IAS 39, we recommend that the Board consider a temporary modification to asset measurement bases as part of ED5 for assets with fixed maturities matching insurance liabilities and held at amortized cost. Strict criteria will be needed to prevent abuse and we recommend that the Board work with the NAIC and the International Association of Insurance Supervisors (IAIS) in developing these appropriate criteria for phase I.

We recognize that this solution would result in differing measurement criteria for different industries in phase I. However, it will be limited in scope, be subject to rigorous criteria for application and will disappear once phase II promulgates a robust measurement model.

Question 1 - Scope (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?

Response:

The IASWG does not believe that weather derivatives should be mandated for inclusion within the scope of IAS 39 under phase I. The IASWG believes the Board should allow insurers to follow their local GAAP in determining how to account for weather derivatives during phase I of the Insurance Contracts Project. If the Board continues with the above proposal to include these under IAS 39, insurers will be required to make significant system changes, even though phase II of the Insurance Contracts Project has not yet begun.

Furthermore, if the Board was to make this decision at this time it would preclude the Board from considering the use of a hedge effectiveness test to determine if weather derivatives should be classified in a manner similar to insurance contracts or financial instruments. Under the hedge effectiveness proposal (a proposal being considered by the NAIC) if a weather derivative contract is considered to be highly effective (i.e., it is expected to have an adverse effect) the contract would mirror the substance of an insurance contract and should be therefore be accounted for in a similar manner or in accordance with the Insurance Contract IFRS. Weather derivative contracts that are considered ineffective (i.e., not expected to adversely affect the policyholder) would then be classified as a financial instrument subject to IAS 39.

Under the current proposal, a weather derivative contract classified under IAS 39 could be virtually indistinguishable from an insurance contract if resulting in an adverse affect. As such, the IASWG recommends decisions pertaining to weather derivatives be postponed until phase II of the insurance contracts project.

Exposure Draft Recommendation: In accordance with the above discussion, the IASWG believes that paragraph C3 of Appendix C should be deleted and the scope exclusion within IAS 39 retained. A clause should also be included within the body of the insurance contract exposure draft to indicate that local GAAP should be followed with regards to the treatment of Weather Derivatives.

Additionally, the IASWG notes possible confusion on this topic in paragraph B17 (l) of Appendix B. As stated in this paragraph, '*insurance swaps and other contracts that require a payment based on climatic, geological or other physical variables that cause an adverse effect on the holder of the contract*' are considered insurance contracts. If all weather derivatives, regardless of adverse affect, are expected to be accounted for under IAS 39, the IASWG requests confirmation on the intent of the above referenced clause.

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:

The IASWG does not agree with the proposed insurance contract definition as stated above. Although we would agree that the IAS 32/39 definition should be revised so that it is consistent with phase I of the Insurance Contracts Project, the IASWG believes that the proposed definition should be expanded to include those contracts that contain any insurance risk.

The IASWG understands that the Board is reluctant to accept this proposal as the Board foresees financial institutions manipulating this guidance to exclude contracts from IAS 32/39. However, the IASWG does not feel that the Board has fully considered the issues that insurers will face in attempting to determine which insurance contracts will continue to be classified as an insurance contracts and which ones will be reclassified as a financial instrument under IAS 32/39. Although we sympathize with the Board's dilemma, we do not feel that the provided rationale (that this definition will prevent circumvention of IAS 32/39) justifies the consequences this requirement may place on insurance companies.

Additionally, although guidance has been provided to determine whether an insurance contract is 'significant', the underlying principles are very subjective in nature. As such, it is unrealistic to assume that insurers will be able to make consistent judgements about significance. By redefining an insurance contract to those contracts that transfer 'any' risk, or by utilizing the IASWG proposed exemption (see below) there will be no disparities over the definition of 'significant' for entities that issue insurance contracts with substantial insurance risk.

Exposure Draft Recommendation: We believe the Board should revise the insurance contract definition included in the exposure draft to encompass any insurance risk. If there is not support for that change, we would suggest the following exemption to the proposed phase I insurance contract definition:

A company, licensed as an insurer, whose primary operations involve issuing significant insurance contracts would be permitted to continue to classify all contracts containing any insurance risk as an insurance contract under the Insurance Contract phase I IFRS until phase II of the Insurance Contracts Project. (Provided that this practice is currently accepted by local GAAP.) Contracts that are issued by companies who do not meet the primary insurer classification would be excluded from IAS 32/39 if they meet the significant criteria currently proposed.

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;

(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?

<u>Response:</u>

The IASWG does not agree with the phase I exposure draft proposal to separate embedded derivatives and measure them at fair value with changes reported in profit or loss. The IASWG recognizes that investment-linked products of an insurance enterprise are unique and cannot be meaningfully separated into components (e.g., the components of an insurance contract, including any embedded derivatives cannot be divided and sold by the policyholder.) As such, all embedded derivatives within insurance contracts are closely related, and should not be separated regardless whether each component meets the definition of an insurance contract.

The IASWG is predominantly concerned that the embedded derivative clause currently included within the exposure draft will require seemingly identical insurance contracts (even those meeting the significant risk requirement) to be accounted for differently. This is evidenced with the examples included in the Draft Implementation Guidance:

IG 2.9: Embedded guarantee of minimum equity returns that is available only if the policyholder elects to take a life-contingent annuity

Result: Embedded guarantee is an insurance contract therefore <u>fair value measurement is not required</u>.

IG 2.10: Embedded guarantee of minimum equity returns available to the policyholder as either a) cash payment, b) a period certain annuity or c) a life-contingent annuity at annuity rates prevailing at the date of annuitization.

Result: Option to create a life-contingent annuity does not create an insurance risk until the policyholder opts to take the annuity. As such, the embedded guarantee is not considered an insurance contract and fair value measurement is required.

IG 2.11: Embedded guarantee of minimum equity returns available to the policyholder as either a) a cash payment, b) a period-certain annuity, or c) a life-contingent annuity at annuity rates at inception.

Result: Option to take a life-contingent annuity will be an insurance contract from inception, therefore fair value measurement is not required. However, the Board has stated that the option to take the cash or the period-certain annuity do not meet the definition of an insurance contract and are embedded derivatives. As such, if the insurer cannot reliably measure the fair value of the embedded non-insurance options, the entire contract must be measured at fair value.

In accordance with these examples, each of the situations has the potential to result in a significant insurance contract with a life-contingent annuity. However, each of the examples requires a different accounting structure and a different overall measurement. This appears inconsistent with recurring statements provided by the Board that similar transactions should be accounted for in a similar manner.

Furthermore, the IASWG feels compelled to remind the Board that the establishment of these complex guidelines will be costly, time consuming, and will ultimately influence the existing insurance market as well as the insurer's capital management strategies and requirements. Proposing these requirements for inclusion in phase I (with a 2005 implementation deadline) is not realistic. The insurance industry must be given sufficient time to implement these changes and possibly decide on modifications within their business practices and insurance products if they do not desire to provide options that may require treatment under IAS 32/39.

Exposure Draft Recommendation: In accordance with the rationale previously provided, the IASWG disagrees with the guidance included in paragraph 5 of the exposure draft and believes it should be amended so that the separation of an embedded derivatives within an insurance contract is not required for phase I.

If the Board does not agree with the IASWG recommendation, the Board should clarify the guidance included in paragraphs 5-6 of the exposure draft. Users who are relying on the finalized IFRS to account for insurance contracts will not be able to determine those contracts that require separation of embedded derivatives and those that do not. Although we understand the Board's reluctance to include anything in the standard that may compromise the IASB's definition of a 'principle-based approach', the standard is too generic to enable the comparability of financial statements. Therefore, at a minimum, reference to the guidance included in the Draft Implementation Guidance should be included within the standard. Furthermore, we would request the IASB to utilize the available resources in developing implementation guidance. As we understand that the IASB is not comprised of 'insurance experts', the Board should utilize the knowledge of the NAIC, the IAIS, the International Actuarial Association (IAA), and other insurance regulators/practitioners in developing the necessary guidance for insurance companies.

Additionally, the IASWG would request the Board to clarify the guidance included in paragraph B26 of the exposure draft:

> *If the issuer can foresee at inception that the probability or present value of a significant loss may increase over time, the contract is an insurance contract from inception, even if the expected (i.e., probability-weighted average) present value of the loss is very small at inception. In other words, if an event can occur that makes insurance risk significant, the contract is an insurance contract from inception.*

As illustrated in the examples included in this comment letter, each example includes a foreseeable event (at inception) that could cause the contract to include significant insurance risk. As such, if we are correctly interpreting paragraph B26, *("…if an event can occur that makes insurance risk significant, the contract is an insurance contract from inception")* each of these examples should be classified as an insurance contract, without requiring fair value measurement, and the Draft Implementation Guidance should be revised.

Question 3 – Embedded Derivatives (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?

Response:

The IASWG agrees with this exception.

(As noted in the response to Question 4(a) the IASWG does not support the separation of any investment-linked component from an insurance contract.)

Question 3 – Embedded Derivatives (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?

Response:

Although not clearly stated in the proposed IFRS, paragraph IG58 of the Draft Implementation Guidance indicates that disclosures about embedded derivatives retained in the host contract would require sensitivity analysis on interest and market risks, the fair value of the embedded derivative, and information about the levels when the exposures begin to have a material effect on the fair value of insurance liabilities. The IASWG foresees potential problems with this guidance as the Board has not currently developed the measurement guidance or standard for calculating the fair value of an insurance liability. (Under the proposed IFRS any embedded derivatives not separated are considered closely related to the host contract or meet the definition of an insurance contract.) As such, disclosures regarding the fair value of the embedded derivates and the effect of the fair value of the insurance liabilities will be arbitrary and possibly misleading to users of the financial statements. Without measurement guidance or standards for the calculation of insurance liabilities, reliable comparability of these financial statement disclosures will be impossible. In order to prevent misinterpretation, the fair value disclosures should be eliminated from these disclosure requirements until the Board has thoroughly addressed fair value measurement (presumably in phase II of the Insurance Contracts Project).

Furthermore, all issued IFRS should include the guidance necessary for preparers to adequately report the financial statements, including sufficient discussion of the disclosure objectives along with sample illustrations of their application. As the standard is written, it would be impossible to know the extent to which fair value disclosures are required without utilizing the implementation guidance. As previously stated, the intent to limit the guidance in the standard on the premise of following a 'principle-based approach' actually prevents the Board from issuing a principle-based standard. Principle-based standards must be sufficiently detailed to allow for comparability. As such, additional guidance should be included in the standard.

Question 3 – Embedded Derivatives (d)

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

Response:

The IASWG believes that the separation of any investment-linked components from a host insurance contract should not be required in phase I of the insurance contracts project.

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:

The IASWG agrees with the Board's decision to exempt insurance contracts from paragraphs 5 and 6 of the draft IAS 8. However, the IASWG does not agree with the stated limited life of January 1, 2007 included in paragraph BC57 of the Basis for Conclusions. This 'sunset clause' does not appear consistent with the Board's rationale for exempting this guidance in paragraph BC53:

In the absence of additional guidance in phase I, there might be some uncertainty about what is acceptable. Establishing what is acceptable may involve costs and some insurers might make major changes in 2005 followed by significant changes when phase II is in place. To avoid unnecessary disruption in phase I that would not ease the transition to phase II, the Board proposes to limit the need for insurers to change their existing accounting policies for insurance contracts.

As it is unlikely that phase II will be completed by January 1, 2007, insurers will again be required to make significant system changes that may become obsolete when phase II is finally completed. Furthermore, the exposure draft does not contain any guidance as to what extent the 'hierarchy' will override the Board's provisions granted in phase I. As an example, phase I of the insurance contracts project explicitly permits insurers to measure insurance liabilities on an undiscounted basis. (The Board has stated this allowance is inconsistent with the Framework provisions.) Will the expiration of the IAS 8 exemption revoke this privilege? After discussing the impact of the 'sunset clause' with different members and representatives of the IASB, it is apparent that the overall conclusion to this question varies significantly. Before the 'sunset clause' can be adopted, the IASWG believes it is crucial for the Board to agree on the impact this deadline will have on the phase I standard. This phase I impact must then be communicated in order to receive appropriate comments from the industry.

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

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 equalization 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?

<u>Response:</u>

The IASWG does not object to the elements that would be excluded within the IAS 8 exemption. Catastrophe and equalization provisions are currently not permitted in US GAAP or statutory accounting. However, the NAIC continues to consider the concept of a voluntary catastrophe reserve provided that federal tax legislation permits tax-deductibility of the reserve. The purpose of this provision is to provide an incentive for insurers to write in catastrophe prone areas resulting in greater availability of insurance and increased risk-bearing capacity to cover catastrophic exposure. Any future adoption is contingent on enabling federal tax legislation.

The NAIC has noted that the Board's decision to eliminate catastrophe and equalization reserves is based on a conclusion that is not scheduled to be taken until phase II. It appears that this is an attempt to preclude an issue prematurely.

The IASWG would encourage the Board to further consider opportunities in which the offsetting of reinsurance assets and reinsurance liabilities would be permitted. The NAIC currently permits ceded reinsurance premiums payable to be deducted from amounts due from the reinsurer, such as amounts due on assumed reinsurance, when a legal right to offset exists. A legal right to offset exists when the following conditions are met:

- Each of the two parties owes the other determinable amounts;
- The reporting party has the right to offset the amount owed with the amount owed by the other party;
- The reporting party intends to offset;
- The right to offset is enforceable by law.

The NAIC does not permit the offsetting of reinsurance recoverables on paid losses.

<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 recognized in profit or loss (paragraph 35 of the draft IFRS).

Are these proposals appropriate? If not, what changes would you propose and why?

<u>Response:</u>

The IASWG agrees with the Board's conclusion reflected in BC76 of the Basis for Conclusions that there is no need to exempt insurers from the requirement to justify changes in accounting policies.

The IASWG disagrees with all paragraphs reflected in the exposure draft that may compel an insurer to begin attempting to fair value insurance liabilities when no measurement guidance or standards pertaining to fair value exist. The IASWG believes that paragraph 35 is a premature inclusion for the insurance contract standard as it suggests that fair value will be the adopted standard for phase II. As recently conveyed by the IASB Chair, the IASB has not made a formal decision for phase II measurement. As such, any clauses that may, in effect, require or persuade an insurer to move towards fair value in phase I should be stricken from the standard.

Question 6 – Unbundling (a)

The draft IFRS proposes that an insurer should unbundle (i.e. 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).

Is unbundling appropriate and feasible in these cases? If not, what changes would you propose and why?

Response:

The IASWG disagrees with the proposal to require insurers to unbundle insurance and deposit components from insurance contracts. In addition to the arguments presented below, we also agree with the previously provided arguments stated in paragraph BC33 of the Basis for Conclusions.

As an insurance contract is an inclusive contract, once issued, the insurer cannot unilaterally terminate or sell parts of the contract. Therefore, all cash flows are attributed to the entire insurance contract and should not be separated between the various components.

Furthermore, the unbundling proposal is inconsistent with the Board's definition of an insurance contract. Per the exposure draft, a contract that exposes the insurer to financial risk, in addition to significant insurance risk, is an insurance contract. However, with the unbundling proposal, it appears that the Board expects contracts with investment and insurance components to be considered two individual contracts that fall within two separate international standards.

Question 6 – Unbundling (b)

Should unbundling be required in any other cases? If so, when and why?

Response:

As the IASWG disagrees with the overall concept of unbundling insurance contracts for the reasons identified in the previous question, we would request removal of the entire unbundling requirement for phase I.

Question 6 – Unbundling (c)

Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

Response:

The IASWG does not believe the current guidance clearly indicates when unbundling should occur. Although the Basis for Conclusions indicates the exposure draft proposes unbundling "*when it is easiest to perform and the effect is likely to be the greatest*", the stated requirements will not be 'easy' to implement by the insurer. The proposed guidance is extremely subjective, and as admitted by the Board, there is no clear conceptual line between the cases when unbundling is required and the cases when unbundling is not required (paragraph BC35). As such, insurers, in an attempt to satisfy this requirement, will make arbitrary decisions on when different aspects of contracts should be reported separately under IAS 39. To retain the fundamental need for consistency among insurers, we would encourage the Board to eliminate the unbundling requirements within phase I. In phase II, only after a clear line has been drawn to identify contracts that require unbundling, should this issue be addressed.

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:

Paragraph 19 of the exposure draft requires that the cedant apply IAS 36 *Impairment of Assets* to its rights under a reinsurance contract. IAS 36 requires that receivables be measured at the higher of the asset's net selling price or value in use. Because there is no active market in reinsurance recoverables balances, net selling price is not an option and value in use would be the default measurement criteria. IAS 36 paragraph 26 states that the value in use is measured by discounting estimating future cash flows until the ultimate disposal of the asset.

This treatment will result in a significant mismatch of assets and liabilities recorded by cedants in phase I. This result will have acute negative financial impact on insurers that cede long-tailed liability risks such as products liability, worker's compensation and other liability exposures. Since cedants will record the insurance liabilities at ultimate (i.e. undiscounted expected losses) and will be required to record the reinsurance recoverable on a discounted basis, prudent use of reinsurance to manage overall insurance risk will result in a significant and immediate financial penalty. Such a significant accounting penalty will surely result in less use of reinsurance and may have a significant disruptive effect on the insurance and reinsurance markets. Moreover, we believe this treatment essentially requires implementation of phase II measurement criteria in phase I.

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?

Response:

The IASWG does not object to the requirement stated in (a); to record a liability in accordance with the insurer's accounting policies for liabilities acquired in a business combination.

The IASWG does not agree with the guidance included in (b); to report an intangible asset, representing the fair value of the contractual rights or obligations acquired, to the extent that the liability does not reflect that fair value.

As previously indicated, the IASB has not developed measurement guidance or a standard for the calculation of insurance liabilities. Additionally, as evidenced by past discussions by the Board, determination of the 'appropriate' method to measure fair value will be a very extensive, time-consuming project. As such, the IASWG does not believe it will be beneficial if fair value assessments of liabilities were required in phase I. Similar to the other arguments included within this letter, such an assessment at this time would be arbitrary and possibly meaningless to the users of the financial statements. Given the uncertainties of the 'appropriate' fair value measurement method, and the resulting inconsistencies of fair value calculations amongst the various insurers, we would request the Board to eliminate this requirement for liabilities acquired in a business combination.

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?

Response:

The IASWG does not see any disadvantages in the suggested short-term resolution proposed in the phase I exposure draft. As noted in the paragraph BC108 of the Basis for Conclusions, if a participating factor lacks the discretionary aspect it is considered an embedded derivative subject to IAS 39. Although additional guidance is included within Appendix A: Defined Terms, we would request additional examples of what constitutes a discretionary or a non-discretionary participation feature included within the Draft Implementation Guidance. As written, the calculations would fail the consistency tests we believe are necessary in any accounting system. In addition, it would require insurers to set up substantive system changes that would only be needed in phase I. Clearly, this does not fall within the scope of phase I as stated by the IASB. If the IASB adopts the IASWG recommendation to include 'any' insurance risk, this problem would not occur.

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?

Response:

Although the IASWG applauds the Board in their decision to remove the previously proposed 2005 fair value disclosure requirements, the IASWG does not support the current proposal to begin requiring fair value assessments of insurance contracts as of December 31, 2006. Originally, when this issue was proposed, it was supported by a presumption that phase II of the insurance contracts project would immediately begin after phase I with final completion expected in 2005. However, as evidenced by several statements of the Board, phase II of the insurance contracts project has been halted and it is now uncertain when this guidance will be finalized. As such, the proposed phase I requirement to include fair value disclosures in 2006 is premature. The Board should either remove this requirement entirely from phase I or restate the requirement to indicate that whenever phase II has been adopted, or when the IASB has concluded on measurement guidance or a standard to calculate fair value, disclosure of the fair value of insurance assets and liabilities will be required.

As stated by a Board member during a recent IASB meeting, the proposed fair value disclosure requirements are valid and worthy in their own right, even without a determination of how to calculate fair value. The IASWG would disagree with this statement. Without a consistent approach for the measurement and determination of fair value, these disclosures will be arbitrary and seemingly worthless to the financial statement users. Furthermore, reliance on these figures may prove to be detrimental if the user does not fully comprehend how the fair value was calculated.

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.

Response:

After a review of the 19 pages of required disclosures, the IASWG did not see any proposals to which we would actively object. We have observed, however, that while some of the paragraphs focus on the disclosure objectives, others focus more on lists and illustrations. Several of the list-based paragraphs include disclosure requirements that are not necessary or reflective of the 'normal' disclosures expected of an insurer. We would request the IASB to further reconsider these disclosures and enlist the assistance of insurance experts (i.e., the NAIC, IAIS, IAA, etc…) in determining those disclosures that are necessary to adequately convey the financial strength and operations of the insurer.

We also suggest that the disclosure guidance that focuses on the disclosure objectives be included in the final standard, while any sample illustrations (such as lists of items to be disclosed) be clearly labeled as illustrative only. This would prevent the international standards from implicitly forcing a single detailed disclosure format for all insurance products. We have observed significant differences in insurance products across jurisdictions that make a single standardized disclosure format impractical and uninformative.

Question 11 – Other disclosures (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?

Response:

As mentioned previously, the IASWG believes that all issued IFRS should include the guidance necessary for preparers to adequately report the financial statements. Implementation guidance should include non-binding illustrations to support the standard, but should not be necessary to understand the basic requirements of the standard. The IASWG does not believe that the current guidance included within the phase I exposure draft is sufficient for preparers to develop and report the disclosures desired by the Board. (This is evident as there are 19 pages of implementation guidance for the disclosure requirements.) Although it may compromise the IASBs definition of a 'principle-based approach', at a minimum, since the Insurance Contracts IRFS is not inclusive, reference to the other IFRS containing disclosure guidelines that insurers are required to follow should be included within the standard.

(Similar to other comments, the IASWG would request the IASB to consider utilizing the expertise of the NAIC, the IAIS, IAA, or other insurance regulators/practitioners in developing the implementation guidance.)

Question 11 – Other disclosures (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:

The IASWG does not object to this provision.

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:

The IASWG supports the Board's decision to include contracts that require the holder to be exposed to, and have incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due, within the confines of the insurance contract IFRS and not IAS 39.

The IASWG does not object to the guidance that any financial guarantee, regardless of legal form, that results from the transfer of financial or non-financial assets or liabilities should be within the scope of IAS 39.

Question 13 – Other comments

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

Response:

The IASWG has no additional comments at this time.

We appreciate the opportunity to comment on the Insurance Contract phase I exposure draft. Should you have any questions, please contact me at (501) 371-2667, or Julie Gann (NAIC) at (816) 783-8125. We look forward to receiving your replies to our comments. Your responses may be distributed electronically to jgann@naic.org or to Mel.Anderson@mail.state.ar.us or they may be mailed to the NAIC headquarters at the following address:

NAIC Executive Headquarters
Attn: Julie Gann
2301 McGee Street, Suite 800
Kansas City, MO 64108-2662

We would encourage the Board to host a roundtable discussion, or otherwise open session with active participation from the commentators, to discuss the concerns identified with phase I. The NAIC would certainly participate in any such opportunity.

Sincerely,

Mel Anderson
Chair, NAIC International Accounting Standards Working Group