Organismo Italiano di Contabilità – OIC (The Italian standard setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
United Kingdom

October 6, 2003

Re : Organismo Italiano di Contabilità (OIC): Comments on "ED 5 Insurance Contracts".

Dear David ,

I am pleased to inform you that the Executive Committee of the OIC ("Comitato Esecutivo") has issued its comments on the "ED 5 Insurance Contracts" enclosed herewith.

Please find herewith attached EFRAG's draft reply to the IASB document together with the comments of the OIC.

Yours sincerely,

Prof. Angelo Provasoli
(OIC – Chairman)

cc: Kevin Stevenson

Attachments

Question 1 – Scope

(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting by policyholders (paragraphs 2-4 of the draft IFRS and paragraphs BC40-BC51 of the Basis for Conclusions).

The Exposure Draft proposes that the IFRS would not apply to other assets and liabilities of an entity that issues insurance contracts. In particular, it would not apply to:

(i) assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*.

(ii) financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts (paragraphs BC115-BC117).

Is this scope appropriate? If not, what changes would you suggest, and why?

(b) The Exposure Draft proposes that weather derivatives should be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract (paragraph C3 of Appendix C of the draft IFRS). Would this be appropriate? If not, why not?

<u>Proposed EFRAG response:</u>

(a) ED 5 addresses insurance contracts rather than entities. We support this decision on the grounds that it specifies the basis of accounting for similar contracts, regardless of the legal structure of the entity issuing the contract.

Clause (a) (i) of Question 1 refers to the requirement that assets held to back insurance contracts must be accounted for using IAS 39 *Financial Instruments: Recognition and Measurement* (and IAS 40 *Investment Property*). In practice those assets will usually fall into the category “available-for-sale” and therefore be accounted for at fair value with gains and losses taken to equity. This will lead to a mismatch between the measurement basis of assets (normally fair value) and insurance liabilities (usually amortised cost according to current local GAAP). We believe this approach should be improved and we comment further in our response to Question 13 – *Other comments*.

Clause (a) (ii) of Question 1 relates to the scoping out of investment contracts from ED 5, because they should be accounted for under IAS 39. We agree with this but note the importance of consistency of accounting treatment of long-term financial contracts between the IFRS for insurance contracts and IAS 39 in general.

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

OIC COMMENT

Question 1

OIC agrees with the view stated by EFRAG. In particular, it deems correct the idea to restrict ED5 to insurance contracts and not to apply it to accounting by policyholders. As to assets representing insurance contracts, this should be seen as a strategic issue and we therefore agree with the choice that it deserves the necessary thorough examination in

Question 13. While doing so, we would stress the need to follow its further development very carefully at IASB level, as the current proposal is wholly unacceptable.
Regarding weather derivatives (b), it is necessary to determine whether they are insurance contracts, and where they are, to exclude them per IAS 39, in compliance with BC 41: "the same accounting rules must in principle apply to all those contracts of the same substance".

Question 2 – Definition of an Insurance Contract

The draft IFRS defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary' (Appendices A and B of the draft IFRS, paragraphs BC10-BC39 of the Basis for Conclusions and IG Example 1 in the draft Implementation Guidance).

Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?

Proposed EFRAG response:

We believe that the definition of an insurance contract set out in ED 5 when read in conjunction with the related guidance in Appendix B is acceptable.
The implementation guidance in general is helpful, but we have included some detailed comments connected with the definition of insurance contracts in our response to Question 13 – *Other comments*.

OIC COMMENT
Question 2
We agree with view stated by EFRAG concerning the acceptability of the definition of an insurance contract as proposed in ED5. In particular, we would ask for clarification on what BC 28 (b) says concerning the determining of a significant risk for the book of contracts and not on a contract-by-contract basis.
However, referring to the concrete examples presented in IG Example 1 of contracts considered to be insurance contracts, we believe that example 1.4, pure endowment, is still an insurance contract as the insurer always faces a demographic risk.
We agree with the view stated concerning example 1.2.

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?

<u>Proposed EFRAG response:</u>

(a) and (b)

In principle we support the view that all embedded derivatives should be reflected at fair value and note that this is the overall intention under the phase II proposals. These proposals should be developed consistently with changes in IAS 39 to ensure all derivatives are reflected at fair value. However we acknowledge that, as a result of such proposals, companies may face significant implementation problems. Consequently we support the Board's view to apply the current principles under IAS 39 whereby embedded derivatives that meet the definition of insurance contracts need not be separated.

We believe that the implementation guidance developed by the Board is sufficiently clear to apply to derivatives embedded in insurance contracts.

Furthermore we note that the analysis in the implementation guidance is predicated on the host contract having the nature of a debt-like instrument. This could lead, for example, to the analysis that a unit-linked contract represents a debt-like host plus an embedded future. This is a counter-intuitive result and is at odds with the manner in which unit-linked, or variable plans are accounted for and managed in every territory internationally. In consequence, the result may lead to significant implementation issues with undue cost or effort. We suggest that further consideration is given to the nature of the host contract and, in particular, whether the direct linkage of the liabilities to equity-type performance may be better portrayed as an equity-like instrument.

If the treatment of all insurance contracts as debt like instruments is confirmed, then this can lead to circumstances where significant minimum interest rate guarantees are not separated. As noted above, we are generally in favour of such guarantees being recognised. However, we conclude that the non-separation of such guarantees is acceptable as an interim measure in order to ensure consistency with IAS 39 until the treatment of embedded derivatives in IAS 39 is itself revisited.

(c) In line with our views above on the recognition of derivatives, we believe that the Board's proposals for the disclosure requirements for such options are adequate.

(d) No other embedded derivative has been identified as requiring exemption.

OIC COMMENT
Question 3
The assumption underlying the IASB indications is that where the embedded derivative meets the definition of an insurance contract it should not be separated and it should therefore come under ED5, otherwise it should be separated and treated according to IAS 39.
We agree with this approach, but we would ask for further clarification concerning the true nature of the contracts given in the individual examples of IG EX2.

<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?

(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?

<u>Proposed EFRAG response:</u>

(a) We regard the exemption as appropriate given the current state of the Board's development of phase II of the project on insurance contracts.

In general we are not convinced of the usefulness of sunset clauses, because we can foresee potential problems in the event that phase II is delayed. It could be that entities would have to fall back to other accounting regimes or could cherry pick different principles of different GAAPs thereby creating their "own GAAP". However, we recognise the need for a high quality comprehensive standard on insurance contracts at the earliest practical time and therefore we welcome the signal from the Board to express its full commitment to issue phase II as soon as possible to accommodate application by the beginning of 2007.

(b) In general we believe that the proposals in (i), (ii) and (iii) are appropriate.

With regard to (b) (i) above our understanding is that the permission to keep such provisions for existing contracts should not cover renewals of contracts, and we therefore recommend that a change of wording of paragraph 10 (a) is made. We suggest that the last four words ("under future insurance contracts") are deleted. We believe that the requirement not to recognise catastrophe provisions or equalisation provisions under future insurance contracts may be interpreted as a permission to recognise them under current insurance contracts (which would also cover renewals of existing contracts) and to carry them forward for an unlimited time. The recommended change in wording would avoid any such misinterpretation.

With regard to proposal (b) (ii), we would welcome further clarification regarding the implementation of a loss recognition test. We support the need for loss recognition in phase I but believe that the "current estimate of future loss" needs to be clarified further. In particular, the requirement in Paragraph 11 of ED 5 may be interpreted to apply to the aggregate of the entire portfolio of insurance contracts. If this is the case, then it would be helpful if the text made this clear.

Additionally, most if not all GAAPs used in European jurisdictions require loss recognition tests but these tests are done in accordance with local GAAP rather than IAS 37. In consequence, some individual contracts may show losses under IAS 37 that are not evident under the local GAAP, even though looked at systematically, the two approaches would lead to comparable strength of provisions. We would not expect further loss recognition tests to be required under IAS 37 in these circumstances as this would be causing unnecessary work for the short period during which phase I is effective.

We believe that additional guidance should be provided on how to apply IAS 37. For example, we would expect that such tests would include all options and guarantees within the insurance contracts but it would be helpful if this were stated explicitly.

OIC COMMENT

Question 4

We agree with the views stated by EFRAG. We do not agree that 1 January 2007 should be the deadline for the end of Phase I. That date should be a programme objective, which if achieved should trigger Phase II. However, if it is not achieved, it should not have any consequences on decisions concerning Phase I.

Re point b(i), unlike EFRAG, we believe that it would not be acceptable to exclude equalisation provisions from exemption.

To this end, we would favour a modification to the Framework concerning liabilities so as to take account of the true intrusive nature of this item, which to all effects is a liability.

Question 5 – Changes in accounting policies

The draft IFRS:

(a) proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).

(b) proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss (paragraph 35 of the draft IFRS).

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

Proposed EFRAG response:

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

We do not agree that entities should be able to use non-uniform accounting policies for the insurance liabilities and related deferred acquisition cost assets of subsidiaries (as described in paragraph 16 (e)), because it reduces the relevance and reliability of financial statements (as the IASB Board argues in BC88). However, taking into account the objective of ED 5, which is to grant temporary exemption from certain international accounting practices in order to avoid system changes that might no longer be needed in phase II of the project, we accept this for an interim period. We acknowledge that it is not possible to switch to an accounting policy of using non-uniform accounting policies if an entity already uses uniform accounting policies for insurance contracts across its subsidiaries.

OIC COMMENT

Question 5

We agree with the view stated by EFRAG, even though it needs to be borne in mind that such an approach may lead to non-uniform accounting in the absence of a definite model for determining the fair value of liabilities.

Question 6 – Unbundling

The draft IFRS proposes that an insurer should unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet (paragraphs 7 and 8 of the draft IFRS, paragraphs BC30-BC37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).

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

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

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

Proposed EFRAG response:

(a) We regard the current proposal in paragraph 7 of ED 5 as an improvement to previous draft proposals as it recognises that unbundling is required only when the bundled nature of the plan obscures the proper accounting for the obligations.

However, EFRAG does not favour the unbundling of insurance contracts in principle, except in cases where the structure of the contract is clearly artificial. This is because insurance contracts are, in general, designed, priced and managed as packages of benefits and, in consequence, any unbundling required solely for accounting purposes would necessarily be artificial.

Where the structure of a contract does obscure the accounting for the deposit element and unbundling of the insurance and investment components may be required, we believe the criterion should be that "the cash flows of the insurance component and the investment component do not interact" rather than the current one-sided proposal to test if "the cash flows from the insurance component do not affect the cash flows from the deposit component". This change would lead to a more balanced approach and leave bundled a number of traditional products, where the one-sided test might apply unnecessarily.

(b) We do not believe that unbundling should be required in any other cases and we agree that surrender values should not be unbundled from traditional life contracts.

(c) Subject to the comments made under (a), we believe it is clear when unbundling is required during phase I.

OIC COMMENT
Question 6
We agree with the view stated by EFRAG. In particular, it is important to point out that the unbundling of insurance contracts containing a deposit element for solely accounting purposes is artificial as the contract is a unitary whole, except where the contract itself is also artificial.

<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?

<u>Proposed EFRAG response:</u>

We do not believe that these proposals are appropriate in the sense that the proposed treatment of certain aspects of the reinsurance of insurance contracts under phase I does not consider in detail the entire accounting for reinsurance, which will only be done for phase II.
For example, under many existing GAAPs for insurance, the insurer's liability for direct insurance contracts is based on the conservative assessment of future conditions. This approach leads to losses being reported at outset. If a reinsurance treaty subsequently takes a proportion of that liability and the cedant accounts for that treaty on a consistent basis, then the loss at outset is partially reversed on the same proportionate basis.

The current proposals in paragraph 18 of ED 5 will lead to the loss at outset on direct business being recognised but not the subsequent partial reversal if the business is reinsured. This will lead to the creation of artificial losses at outset and the bolstering of earnings in subsequent periods for reinsured contracts.

Further, the proposed spreading of profits for reinsurance contracts over future periods represents a significant additional systems requirement for phase I that would not be used subsequently in phase II. This is contrary to one of the key objectives of phase I.

We therefore recommend that in general the treatment of all aspects of reinsurance accounting should be addressed in phase II and not in phase I. This would allow reinsurance accounting to be changed consistently with the approach adopted for direct business in phase II thereby avoiding the creation of anomalous results and the need to create financial systems solely for phase I. We would, however, like to maintain the requirement that financial reinsurance is treated as a financial rather than insurance transaction.

OIC COMMENT
Question 7
We agree with the view stated by EFRAG: reinsurance should be exempted in Phase I. This is of strategic significance. Applying a different accounting approach to reinsurance compared with insurance contracts would mean ignoring the fact that insurance and reinsurance are closely interlinked in the insurance business, and such an approach would generate incorrect accounting data.
Therefore, also Para. 19 should be applied only in Phase II.

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

IAS 22 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 *Business Combinations* proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and

(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. Its subsequent measurement would need to be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.

The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).

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

<u>Proposed EFRAG response:</u>

We regard these proposals as appropriate.

On a point of clarification, paragraph 20 of ED 5 permits, but does not require, an expanded presentation, that splits the fair value of acquired insurance contracts into two components. BC93 identifies the second component as the present value of in force business. This is a particular example arising in the acquisition of a portfolio of life insurance contracts. However, similar issues arise in other types of insurance business acquisitions. For example, a company acquiring a portfolio of general insurance provisions/claims with an accounting policy that does not discount provisions/claims might recognise an intangible asset (being the difference between the value of the liability in accordance with the acquirer's accounting policy and the fair value of the liability). Confirmation that this intangible asset and potentially other such assets are permitted under the ED 5 would be useful.

We understand that phase I will not exempt insurance assets and liabilities from the requirement for an acquirer to measure assets and liabilities acquired in a business combination in accordance with ED 3 *Business Combinations*. We support this general approach. However, the illustrative example B.3 in ED 3 seems to give rise to an anomaly. Applying, by analogy, the illustrative example B.3 "Customer contracts and the related customer relationships" to insurance contracts, an open book of insurance contracts would be recognised as an intangible asset in a business combination.

However, under ED 3 paragraph 43, it is a precondition that such an asset meets the definition in IAS 38 *Intangible Assets*. Phase I will require the application of IAS 38, which requires control and therefore excludes customer relationships (paragraph 15 of the proposed amendments). For this reason we understand that the portfolio to be valued in the insurance project is limited to the closed book.

We would welcome clarification as to whether an open or closed book approach is seen as most appropriate.

OIC COMMENT
Question 8
We agree with the view stated by EFRAG.
In particular, we would stress the need to clarify whether Intangible Asset applies only to the closed book.

<u>Question 9 – Discretionary participation features</u>

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.

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

<u>Proposed EFRAG response:</u>

We support the temporary exemption for contracts with discretionary participating features as an interim measure until phase II is implemented and we agree that an intermediate category, neither liability nor equity, should not be permitted for the unallocated surpluses associated with discretionary participating features in insurance contracts (paragraph 24 (b)).

The mismatch – which we refer to in detail under Question 13 – *Other comments* - caused by the use of different measurement bases for assets and liabilities in profit participating contracts would not arise if the unallocated surplus (unrealised gains and profits) were to be regarded as constructive obligations regardless of the nature of the discretionary features and even though the allocation of unrealised profits or losses to shareholders or policyholders is still to be made. We believe that, where unrealised gains and losses resulting from carrying assets at fair value relate to participating contracts with discretionary features during phase I they shall be regarded as constructive obligations and not as equity. We note that in some instances doubt may arise as to whether certain discretionary participation features constitute constructive obligations. We ask the Board to clarify in the final standard that such discretionary features should be regarded as constructive obligations if market practice makes the payment of the benefits reasonably certain. If this approach to participation rights can be regarded as an improvement it can be regarded as a change in accounting policies permitted under phase I (paragraph 14 of ED 5).

Paragraph 25 of ED 5 requires the application of paragraph 24 to investment contracts that contain both a discretionary participation feature and a fixed element that requires non-discretionary payments. Paragraph 24 (d) requires the issuer of such a contract to continue its existing accounting policies for such contracts subject to the exceptions listed. This results in the continuation of an existing accounting policy of accounting for such contracts as premiums and appears to conflict with the principles applying to other investment contracts. We would appreciate confirmation that this basis of revenue recognition is intended.

OIC COMMENT
Question 9
The IASB intends to postpone to Phase II the question concerning the nature, liability or equity, of unallocated surpluses as they are result of unrealised gains and losses (BC 103). EFRAG argues that they should be treated as constructive obligations beginning in Phase I. We agree with EFRAG.

<u>Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities</u>

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraphs IG60 and IG61 of the draft Implementation Guidance).

Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?

<u>Proposed EFRAG response:</u>

Whilst we recognise the Board's proposal to require disclosure of fair value of insurance liabilities as an interim step towards phase II we believe it is unreasonable to require fair value of insurance liabilities to be disclosed when IASB itself has not determined how those fair values should be arrived at. There is at present a variety of views as to what is meant by fair value in this context (e.g. entry value or exit value) and practical difficulties in setting up models to determine these values (because there is no active market for insurance contracts). To leave the meaning open is to invite different interpretations leading to non-comparable and possibly unreliable information.
We understand the Board intends to resolve this point by completing the phase II standard before phase I comes into force. However this means that in the phase I standard IASB is asking for a mandate to interpret its own requirement before explaining what that interpretation may be. For that reason we believe the disclosure requirement should be introduced only when it is understood (by IASB and preparers) what is called for and IASB has exposed the detailed requirement for public comment.

We recommend instead that the Board should encourage the disclosure of value-based information including information about the key assumptions and the methodology used to arrive at those values. We believe that many insurance companies already provide such information (e.g. embedded values) on a voluntary basis.

OIC COMMENT
Question 10
We agree with the view stated by EFRAG.
Indeed, it would be possible to make such disclosures in 2006 only if the methods of determining fair value were already defined by that date.

<u>Question 11 –Other disclosures</u>

(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?

<u>Proposed EFRAG response:</u>

(a) Overall we support the proposed disclosures in (a), (b) and (c) set out in paragraphs 26 to 29 of ED 5 provided such disclosures are balanced between qualitative and quantitative information.

However we believe that certain requirements are broad and could be interpreted to be too burdensome for entities if the Implementation Guidance is not carefully considered together with the wording of the proposed IFRS. For example paragraph 29 (b) requires the disclosure of "those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of future cash flows." In our view this is so widely drawn that it could be taken to require a mass of detailed information about different policy conditions and the potential effectiveness of exclusion clause (as determined in a variety of court cases). The Implementation Guidance in IG38 and 39 suggests that what is required is more limited and general in nature and is required only for "each broad class of insurance liabilities and reinsurance assets held", It would be helpful if the wording of the standard were to be conformed with that currently in the guidance notes, especially since the Implementation Guidance does not form part of the standard.

There are some disclosures that we regard as sufficiently important to investors that the additional burden is justifiable. In particular, we support the requirement of information on positive or negative claim provision run-offs although we note that the actual information required may differ in detail from that required for US GAAP.

(b) We regard this approach as appropriate.

(c) We do not believe that any changes should be made to the transitional relief.

OIC COMMENT
Question 11
We agree with the view stated by EFRAG. Some of the data required would involve preparing a mass of detailed information at considerable expense - one can imagine the difficulties in drawing up the consolidated accounts of an international group - and some of it may be of a commercially sensitive nature. However, it should be noted that it is sufficient to disclose the claims development for the preceding 5 years where there is no significant backlog; claims dating back more than 5 years can be summarised together.
It would be useful to provide clarification on disclosure on financial risks relating to insurance contracts, which should be correlated to disclosure under IAS 32 on financial instruments.

Question 12 – Financial Guarantees

The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS 39 *Financial Instruments: Recognition and Measurement* to a financial guarantee that it gives to the transferee in connection with the transfer (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or liabilities.

Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

Proposed EFRAG response:

We agree with the Board's proposal that provides a clear distinction between financial guarantees given by a transferor of non-financial assets or liabilities and a credit insurance given by a credit insurer. As a result, the genuine activities of credit insurance, which meets the definition of insurance, will be covered by the proposed IFRS on Insurance Contracts and therefore will be treated as other insurance contracts. Similarly, financial guarantees provided by industries other than the insurance industry, for example banks, would also be treated as insurance contracts, if they meet the definition.

OIC COMMENT
Question 12
We agree with the view stated by EFRAG. Irrespective of who gives the financial guarantees, the criterion determining their exclusion from IAS 39 should be whether the contract meets the definition of an insurance contract or not.

Question 13 – Other comments

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

1. Mismatch - Measurement basis for insurance assets and liabilities

The interaction between IAS 39, including the current proposed changes, and ED 5 creates a measurement mismatch for insurance contracts. This results from the recognition in phase I, that insurance liabilities will continue to be measured under existing accounting policies, which usually adopt some form of amortised cost approach, while the assets backing these insurance liabilities will, in most practical circumstances, need to be held on an available-for-sale basis, which results in the assets being held on the balance sheet at market value. This will result in volatility, often for artificial reasons, in equity. We describe the volatility as artificial because, even when the assets and liabilities are perfectly matched, movement in equity would occur solely due to the different measurement bases.

The impact of the mismatch can be significant. By way of illustration, the impact on a well-matched book of annuities in payment of a 1% change in interest rates could be of the order of 7% to 10% of technical provisions. The impact of such a change on a well-matched block of traditional non-participating plans could be of the order of 3% to 5% of technical provisions.

We also note the paper prepared by the IAA (International Actuarial Association) and ACLI (American Council of Life Insurers (the link to the source of the paper is: www.actuaries.org/public/en/documents/papers.cfm) that provides an illustration of the impact on equity that a measurement mismatch can produce based on actual historical U.S. interest rate movements. While not endorsing the paper in its entirety, we believe that the illustrations of volatility describe well the potential impact that interest changes will produce on equity if the mismatch is allowed to remain.

In practice most European insurance companies account for the investments held for insurance and investment products in the same way. The industry has therefore sought exemption (until phase II of the project is complete) from certain IAS 39 requirements - particularly seeking ways in which investments matching insurance liabilities can continue to be accounted for at cost in phase I. The following suggestions from the insurance industry have been considered by the IASB staff:

1) Relax the IAS 39 criteria with regard to the tainting of financial assets as held-to-maturity;

2) Create a new category of assets carried at amortised cost: assets held to back insurance liabilities;

3) Create a category of “available-for-settlement” liabilities, analogous to available-for-sale assets;

4) Permit fair value hedge accounting when a non-derivative is used as hedging instrument to hedge interest-rate risk.

To date the IASB has not felt able to accept these suggestions because there is no wish to extend the exceptions to the general principle that investments be marked to market.

EFRAG is aware that a number of major European insurance companies already apply US GAAP and are required therefore to include their investments held to match insurance liabilities at fair value and so are experienced in coping with the volatility issue to the point that users of financial statements expect investments to increase or decrease in line with market conditions. However, users also recognise that insurance is a long-term business and their liabilities will fall due “on average” some time in the medium to long-term future. It is therefore normal to discount such liabilities to reflect present values. EFRAG therefore discussed whether the mismatch problem could be avoided if, at the same time as moving to the use of fair values for investments, insurers discounted their insurance liabilities (using a risk free rate of interest). The advantage of such an approach is that it overcomes the mismatch problem without requiring any changes to existing standards (e.g. IAS 39). However, only a few companies currently discount their liabilities for the non-life business and most of the companies currently discounting their liabilities for the life business do not update interest rates used on a regular basis. Therefore the implementation of such a proposal would present considerable practical difficulties. It would be a step towards fair valuation of insurance liabilities but may well not reflect the approach which the Board will finally decide to use for phase II. Since it is also not intended that phase I should require changes which may be reversed in phase II we do not suggest that this idea be further developed in phase I.

However, we believe that the mismatch issue is sufficiently important that it should be further addressed and have therefore explored other approaches.

As regards the mismatch in the area of profit participating contracts and how it could be avoided in phase I we refer to our answer to Question 9 – *Discretionary participation features*. However, if our proposal to regard the unallocated surplus of participating contracts as constructive obligations were to be accepted by the Board, there would remain a large area of contracts – non-participating plans and all non-life contracts - for which a mismatch would still arise.

Having reviewed the available solutions to address the mismatch for these remaining contracts, we believe that the best solution is that noted by the staff in the first bullet point above – a very restricted relaxation of the tainting rules that constrain the held-to-maturity category of financial instruments in IAS 39. That relaxation would be limited to the short period during which phase I applies. Under this solution a certain number of fixed interest rate instruments held by insurance entities to match insurance liabilities (using well defined criteria to demonstrate the matching designation) could be designated at outset as held-to-maturity. This designation should be subject to strict criteria which force companies to implement a system that makes sure that specific assets (held to back insurance liabilities) are designated to specific liabilities. An unexpected sale of such designated financial assets before maturity date should not be the trigger for the tainting rules that constrain the held-to-maturity category if and only if the sale is a necessary reaction by the management to an unexpected and significant change in insurance risk (e.g. change in mortality or lapse rates). Any general practice of managing portfolios to optimise interest rate returns depending on current fluctuations of financial markets should not fall within the described exemption. This means that simple mis-estimations should not be hidden under this system.

Accordingly, we ask the Board to reconsider a solution that would allow the measurement of assets held to back insurance contracts to be measured at amortised cost under strict criteria as described above and would be limited to phase I only.

2. Deferred acquisition cost

We believe that the treatment of deferred acquisition cost for insurance and investment contracts under phase I should be harmonised. Entities still do not differentiate between investment and insurance contracts in their accounting systems and a different treatment of acquisition costs would force them to implement major system changes only for phase I, which we believe is costly and burdensome.

For cost/benefit reasons we do not believe that these changes should be made just for phase I. While recognising the impact on other financial institutions, we propose that IAS 39 be amended in the context of the amortised cost approach, to permit the deferral of internal and external acquisition costs for all contracts in line with other standards such as IAS 18 *Revenues*, which would be allowed for all industries. However, deferral should only apply where costs can be directly attributed to the sale of a contract. The costs would be amortised in line with revenue recognition.

3. Definition of an Insurance Contract

Whilst we regard the definition of an insurance contract when read together with the implementation guidance as acceptable we make the following specific observations:

(i) We are concerned that the case where the death benefit exceeds the surrender amount (IG Example 1.2) is too widely drawn in that it will catch almost any contract that has a redemption penalty that is waived on death. This would affect many loans and mortgages otherwise accounted under IAS 39. We would suggest that the example should be re-framed to refer to surrenders where the penalty is in excess of the recovery of outstanding acquisition costs.

(ii) We disagree that pure endowments (IG Example 1.4) are best described as "investment contracts unless there is significant mortality risk". Such policies make no payment unless the policyholder survives to the maturity of the policy and they are priced on the assumption that a proportion of policyholders will fail to survive until maturity of the policy. If a larger than expected proportion does survive to maturity, then the insurance company would make a significant loss. Conversely, if a smaller proportion survives the company would make a significant profit. In each case the risk is significant and it is an insurance risk rather than an investment risk.

OIC COMMENT
Question 13
1. Mismatch between assets and liabilities
We agree with the view stated by EFRAG. As it has been already said, this is the main strategic issue. The question of the mismatch between liabilities, which can be valued at final cost in Phase I, and the assets representing them, which are to be valued according to the rules of IAS 39 (at fair value unless the assets are held to maturity), is one of strategic importance. It is essential that the solution chosen should not create problems that are greater than those it seeks to address.
The assets representing technical provisions are "tied" to ensure cover for future commitments to the policyholders. European regulations lay down precise qualitative and quantitative limits for every asset within the whole. It would be unreasonable to consider any surplus arising from valuing the assets at fair value as a profit, and vice versa as a loss, against unchanged liabilities and above all against a constraint on such assets held to cover liabilities towards policyholders.
EFRAG's proposal to value the assets in the same way as those held to maturity, with disposal only where there is a significant change in risk, is acceptable. It should be supplemented by considering the possibility of disposing of the assets also as a consequence of a change in market risk, provided that the entity shows that its overall management of asset risk is clearly coherent with its management of liability risk.
2. Deferred acquisition cost
We agree with the view stated by EFRAG to allow the harmonised treatment of acquisition costs and investment contracts because of the excessive costs of introducing changes into the accounting systems in Phase I.
3. Definition of an insurance contract
This issue has already been covered in the comments on Question 2.