DEUTSCHE
AKTUARVEREINIGUNG e.V.

DAV

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

October 30, 2003

Dear Sir David:

Re: ED 5 Insurance contracts

The Deutsche Aktuarvereinigung e.V. (DAV) appreciates the opportunity to contribute some remarks to the exposure draft ED 5 Insurance Contracts published by the IASB for a coming reporting standard for insurance contracts.

The DAV is the professional body of German actuaries, as well working in the life, health, casualty, investment, and pension area. The DAV joins nearly 2,000 qualified actuaries and is a fast growing organization with about 1,000 students preparing for membership.

Briefly we would like to point out our main comments as follows:

Question 2: We recommend to make use of a stringent set of terminology which is in line with the theoretical basis and current reality of insurance business and to review the definition of a significant insurance risk. Especially it should be allowed to consider probabilities of lapses as insurance risk in measuring insurance liabilities and insurance assets, if it is provable that the risk is actually random and reliably measurable.
For defining an insurance contract we recommend to adopt a more principle-based approach in developing accounting for insurance contracts, rather than referring to traditional characteristics of insurance contracts. The ways how insurers manage the risks accepted are partly based on general principles with accounting effect, which have a similar economic relevance as hedging has in banking business. These ways should be recognized consistently wherever they appear in industries. They include pooling, performance linkage, asset-liability-matching.

Question 3: The concept of embedded derivatives has been taken from financial instruments rather than from insurance business. With regard to ED 5.29 (e) we recommend to refer to policyholders' options rather than to embedded derivatives.
We recommend to change the wording of ED5.C1 which in connection with draft IAS 32.77 implies that fair values of embedded derivatives will have to be disclosed regardless of whether they are closely related or not.

IASB should develop suitable approaches to consider the risk reducing effect by effective asset-liability matching. Parts of contracts where the risk is effectively reduced by such measures should not automatically be seen as derivatives. In all cases where existing accounting policy allows consistent measurement on a basis of locked-in discount rates in the liability directly reflecting the effective interest in the linked assets measured at amortized cost, IFRSs should allow to continue the measurement of the linked assets at amortized cost for phase I.

Question 4: We recommend to link the end of the exemption period from criteria in IAS 8 to the actual beginning of phase II.

Question 5: Under ED5.16 it would be often impossible to move from an existing accounting policy to one of the approved and well-tested systems already available. We recommend to clarify in ED5.15 and 16 that it is generally preferable to move to an existing comprehensive system as established by law or a standard setter if it is seen overall as more suitable under the framework than the current system. The guidance in ED 5.16 should be applied only to changes of parts of the accounting policy. In no case, the improvement of one criteria mentioned in ED 5.14 should justify the impairment of another one.

Question 7: We recommend urgently to establish an impairment test in ED5.19 which adequately considers the connection between reinsurance contract and ceded contract. If the calculated minimum amount under the loss recognition test is larger than the carrying amount, the difference should be deducted from the reinsurance asset.

Question 9: We recommend to base the discussion of participation features on the general principle of performance-linkage. Discretion is not a relevant feature for accounting.

Question 10: We recommend to state that disclosure of fair values of insurance liabilities is not required as of Dec. 31st 2006 but for the end of the year before the new standard for phase II will be set in force.

Question 11: Regarding disclosures it is necessary to consider the complexity of insurance business worldwide and the unavoidable need of aggregation of information in the disclosures of large international groups, the main target of IAS for the time being. We recommend to verify the views about disclosures by a visit at one of those large international insurance groups, currently already applying IAS. That might prevent IASB from expressing inadequate views about what is possible to achieve in disclosing information.
The possible outcome of disclosure should be compared to the potential additional costs. The guidance regarding information about low-frequency, high-severity risks in IG47 appears insufficient.

Question 13: We believe that a principles-based accounting approach requires that at least in cases where assets and liabilities are consequently and effectively matched, a consistent

recognition and measurement is realistically possible. We see a hierarchy of connections between assets and liabilities. We recommend to consider this as a general principle and to allow similar treatment for the comparable technique of asset-liability matching in insurance industry as well.
Insurance companies will have to face three major changes in their accounting systems which are not in a logical sequence in any case. Both the density and the order should be reviewed.

We would like to emphasize our concerns about the theoretical concept of fair values as it has been discussed through the Board so far and as outlined in the Basis for Conclusions. In order to keep this memo short and readable we intend to come back to this issue in the course of discussion of phase II.

Our comment refers especially to issues which are of special importance from the German viewpoint. We would be glad to provide you with additional input on all aspects the Board would like to discuss further.

Question 1 – Scope
We agree with the comment given by the IAA.

Question 2 – Definition of an Insurance Contract
a. We recommend to make use of a stringent set of terminology which is in line with the theoretical basis and current reality of insurance business (c.f. the answer of the IAA to question 2).
It needs to be considered that within the EU IFRSs are binding in a locally translated version. It is therefore recommended to use a clear technical terminology or – if the terminology should be principle-based rather than industry-specific – clearly expressing the issue, like risk transferee and risk transferor instead of issuer and holder of a contract.

b. We recommend to review a more general and principle-based definition of an insurance contract for phase II, since we believe that a lot of those features are not yet properly identified which are relevant for accounting of insurance contracts, but not necessarily unique here.
Examples for these features are
- pooling approach, causing that pooled business should be seen by principle as one unit of account,
- performance-linkage, contractually linking cash flows to the net earnings or parts of net earnings of one party of the contract, requiring consistent recognition and measurement of the linked cash flows by this party(cf answer to question 9),
- asset-liability matching, which should cause, wherever effectiveness is provable, that the valuation of liabilities follows that of assets (cf answer to questions 3.c and 13).

An identification of such issues and developing accounting on the basis of such principles rather than types of contracts will improve applicability and consistency of IFRSs.

c. We recommend to review the definition of a significant insurance risk. We support the direction of ED5.B21 given by the IAA:

> Insurance risk is significant if, and only if, it is plausible that one of those insured events occurs, which would cause an expected present value of all net cash flows under the contract, provided that the event occurs, (*the value under the event*) which is a significant adverse deviation from the expected present value of all net cash flows under the contract (*the comparison value*) assessed from the reporting entities point of view.
>
> If by unilateral actions the policyholder can have an influence on the net cash flow after the time of the considered insured event, similar to the impact of the insured event, the comparison value shall be calculated provided that the policyholder chooses such an action.
>
> The condition of significant insurance risk is even met if the probability of an insured event is remote or if the present value of contingent cash flows is a small proportion of the expected present value of all contractual cash inflows or all contractual cash outflows.
>
> Plausibility and significance shall be understood as qualitative rather than quantitative terms, referring to characteristics of the contract rather than providing an absolute order in probabilities of events and percentages of the comparison value.

d. B 15 states that "lapse or persistency risk … is not insurance risk“. Based on this generalizing comment IASB views lapsing as a risk which should not be considered in actuarial measurement. This statement does not reflect the circumstances of German health cost insurance correctly. Private German health cost insurance is a lifelong guaranteed coverage where the insurer accumulates a reserve for increased health cost at older age which is not refunded in case of lapsing the policy but passed to the remaining policyholders. Hence policyholders have a material disadvantage in case of lapsing the policy (e.g. a considerably higher price for similar coverage with another insurer). In addition to this, impaired health conditions often reduce the insurability. Since under normal circumstances it is not allowed that a person previously covered under private insurance enters the national health scheme, the disadvantages are so significant that cancellations occur only in very specific and random circumstances like death, unemployment, disability, etc. So in this case lapse itself is random and therefore insurable.
IASB should not exclude triggers of cash flows just based on the “label” to describe them. Insurance is based on random events, which are distributed according to a stochastic distribution function. Insurability should depend on the features of the underlying event, disregarding how they are labelled.

e. We recommend to clarify the examples in the implementation guidance. It needs to be clear that in all cases the definition of significant insurance risk has to be checked as stated in the

IFRS. Other indications, like reference to expected survival in example 1.3, significant death probability in example 1.4, or reference to contingent amounts should be avoided since they could be misunderstood as alternative tests. The example 1.4 should be phrased positively, since normally the duration of pure endowment policies will be long enough so that the net cash flow in case of survival deviates significantly from the expected net cash flow.

Question 3 – Embedded derivatives
As a general remark it should be noted that the definition of embedded derivatives in IAS 39 is based only on financial instruments within the scope of IAS 39. It is doubtful in any case whether policyholders' options under insurance contracts generally fulfill the definition of a derivative. Hence, we recommend with regard to ED 5.29 (e) to refer to policyholders' options rather than to embedded derivatives.

a. We question whether guarantees, surrender values and policyholders' rights can be seen as embedded derivatives in general. Not any option of a policyholder necessarily fulfills the definition of a derivative in IAS 39. Most options do not refer to an underlying but offer conditions which the policyholder is free to accept based on his own views. We especially would like to indicate that insurers developed very specific approaches to reduce risks and to retransfer risks to policyholders (c.f. answer to question 9 – discretionary participation features). It is relevant for users of financial reports to be informed about that specific situation rather than formally applying banking rules not suitable here.

b. We understand ED5 that surrender options, guaranteed interest rates (if below the market rate at inception of the contract) and more general closely related embedded derivatives do not have to be separated and measured with their fair value. So we recommend to change the wording of ED5.C1 which implies in connection with draft IAS 32.77 that fair values of embedded derivatives will have to be disclosed regardless of whether they are closely related or not.
We urgently recommend to exempt insurance contracts from that material burden of calculation. Current accounting systems in the EU already require that contracts are measured assuming the worst possible outcome of policyholders' decisions regarding their options at a level of expected values plus significant security level. Secondly, these calculations would require significant changes in current systems which would be in use only for the few years of phase I since thereafter the whole contract has to be measured at fair value if current tentative views of the IASB are realized.

c. IASB should develop suitable approaches to consider the risk reducing effect by effective asset-liability matching, especially in case of fully matched unit-linked business, and of other approaches, similar to hedging but merely specific to insurance business. Parts of contracts where the risk is effectively reduced by such measures should not automatically be seen as derivatives. We refer here especially to unit-linked contracts or other contracts linked to a separate account of the insurer which is often even more than asset-liability matching. Here the linkage will usually fulfill requirements equivalent to IAS 39.142. We expect that the same will be true or possible to achieve for any systematic asset-liability matching approach, where both cash flows are fully matched. In all cases where existing accounting policy already requires that the insurance liabilities are measured consistently with linked assets and those liabilities are measured at fair value (e.g. US-GAAP in case of separate accounts, European GAAP), IFRSs should allow that specifically these assets are measured at fair value as well. In all cases where existing accounting policy allows consistent measurement on a basis of locked-in discount rates in the liability directly reflecting the effective interest of the linked assets measured at amortized cost, IFRSs should allow to continue the measurement of the linked assets at amortized cost for phase I.

Question 4 – Temporary exclusion from criteria in IAS 8

a. The aim to establish a final insurance standard by the beginning of 2007 seems to be very ambitious especially considering that the intent of IASB expressed in ED 5.BC7 to return to phase II of the project in the third quarter of 2003 will not be achieved. If the final standrad does not start in time the temporary exclusion from criteria in IAS 8 will automatically end forcing companies to change their accounting systems for a limited deferral period. The benefits ensuing from further significant changes of accounting policy in 2007 by adjusting it to the requirements of IAS 8.5 and 6 up to completion of phase II do definitely not justify the resulting material cost. We do not believe that the IASB seriously intended to require such changes. So we recommend to link the end of the exemption period to the actual beginning of phase II.

b. (i) We believe information about cyclical and catastrophe risk exposures to be key in many forms of insurance business. We understand that the IASB does not see that information as being in accordance with the definition of liabilities under the framework and therefore does not allow to report such information in the balance sheet. However, we recommend to allow to report such information, shown as liability under existing accounting policy, as part of equity. Even more we refer to our answer to question 11 regarding appropriate information in disclosures about cyclical and catastrophe risk exposure, which is in our opinion not sufficiently required there compared to the IASB's attitude to require all relevant information to be already reported in the disclosures.

(ii) We appreciate the possibility to use existing and well-tested approaches concerning loss recognition tests in phase I. We understand paragraphs 11 - 13 to the extent that both the loss recognition test according to US-GAAP and the principle of precaution according to the German Commercial code (HGB) and to the Actuary’s Report are sufficient to fulfill the requirements. Establishing loss recognition test systems causes a major effort especially in larger insurance groups since alternative valuation programs for all products need to be developed. Especially considering the inherent prudence in most existing systems, the outcome will rarely provide additional useful information.

Question 5 – Changes in accounting policies

a. Considering that practically all existing accounting systems, established by law or an official accounting standard setter, breach the list in ED 5.16 with regard to one or more issues, it would be often impossible to move from an existing accounting policy to one of these approved and well-tested systems. So we recommend to clarify that:

- the rules in ED 5.16 should only be applied to individual changes of the existing accounting policy. In addition, these changes are only allowed if they result in an improvement of reliability and relevance or, if just improving one of these, there is no impairment of the other one.
- changes of accounting policy are preferable which fully accept an accounting policy based on commonly used and comprehensive rules, established by law or an official accounting standard setter regardless of whether the new system fully complies with the rules in ED 5.16 as long as the new system is seen overall as preferable under the criteria of IAS 8.5 and 6.

Question 6 – Unbundling

ED5.7 and 8 do not state clearly enough that unbundling is limited to those cases where recognition rules (rather than measurement rules) of existing accounting policy do not ensure recognition of repayment duties. As German and US-GAAP accounting rules ensure this, we believe that unbundling is not an issue for German insurers.

Secondly, we recommend to establish more principle-based requirements for unbundling. The DSOP recommends, what we support, to use the portfolio as unit of account in case of insurance contracts, since insurance contracts are - from the insurers' point of view - only valuable and utilizable altogether as a pool. It would not be reasonable to split contracts up before applying the insurance standard. As most other standards, the insurance standard should provide full guidance for the whole contract. If parts of insurance contracts have similar features as considered in other standards, that should not be reflected by unbundling but by styling accounting standards consistently, i.e. the insurance standard provides comparable solutions for same circumstances as other IFRSs. Under the “substance over form”-rule in the framework, legal insurance contracts should only be unbundled before applying IFRSs if the contract contains two or more contracts in the sense of IAS 32.6. In that case, it should be checked for each independent part which IFRS applies. For that purpose it is recommended to extend the criteria requiring the unbundling in ED5.7, as it does not cover properly the condition for separating one legal contract in two or more contracts within the meaning of IAS 32.6. Especially in unit-linked business the cash flows from the unit account influence the size of insurance cover needed and so the cash flows of insurance components. So we recommend to change the relevant part to:

“... if the cash flows from the insurance component and the cash flows from the deposit component do not affect each other ...“.

Only in this case actually two contracts exist within the meaning of IAS 32.6.

Question 7 – Reinsurance
We are very concerned about the rule in ED 5.19, requiring an independent measurement of reinsurance assets and ceded liabilities. We agree that it is necessary to check the recoverability of any reinsurance asset but we do not believe that the way chosen is adequate.

We believe that the IASB has not yet taken adequately notice of the principle of "performance-linkage", i.e. a contractual determination of cash flows under one contract based on cash flows of one party in an off-setting manner. We will explain that feature in more detail in our answer to question 9. This means that the reinsurance contract establishes a direct and explicit right to get full compensation for any cash flow occurred under the ceded contract. We believe that by principle any performance-linked cash flow should follow the underlying linked cash flow in recognition and measurement, except additional provisions for credit risk if required.

The inadequate consequence of ignoring the principle of "performance-linkage" can be very clearly shown in case of reinsurance. Independent measurement of both sides results in the fact that the original risk is nearly reported double as high instead of reducing the insurer's risk exposure by taking reinsurance (c.f. enclosure 1).

Therefore we urgently recommend to establish an impairment test which is adequately considering the connection between reinsurance contract and ceded contract. The approach most simple and easiest to realize would be to apply the required loss recognition test a second time, but this time to the net amount of ceded liabilities reduced by the related reinsurance asset. If the calculated minimal amount under the loss recognition test is larger than the carrying amount, the difference should be deducted from the reinsurance asset.

The rules to avoid an initial profit from differences between accounting and pricing, mainly referring to discounting questions, do not appear as being relevant if a proper loss recognition test is applied. The condition that initial net gains from reinsurance are accepted in the size of reinsurer's share in acquisition cost paid by the cedant is neither sufficient nor sensible. Initial net gains from reinsurance occur as well under existing accounting policies, if the ceded liability is overstated (e.g. by requiring a minimum deposit floor as usual in European regulatory accounting as excessive prudence measure). The insurance contract therefore causes a loss at outset which is not seen as realistic by market participants, the reinsurer therefore being willing to "share" in that initial loss since future compensation is expected. Such an initial net gain from reinsurance taken, off-setting the artificial loss from accepting the ceded contract, should be as well exempted from deferral. In addition, further guidance would be required as to how the acquisition cost related to the ceded part of the contract should be determined and whether this refers as well to reinsurance taken some time after outset of the ceded business.

Considering that a remarkable part of the international reinsurance market is reporting under German law and therefore many German actuaries are involved in that business, we would ask to establish rules which are more adequate regarding the complexity of the reinsurance business and recommend an intensive discussion and investigation of the issues before an IFRS is established for these topics.

Question 8 – Insurance contracts acquired in a business combination
We agree with the comment given by the IAA.

Question 9 – Discretionary participation features
Participation features are very common and important in Continental Europe and especially in Germany. Participating business is strictly regulated in Continental Europe, as well as in some states of the USA, like New York. For instance, life and main business lines of health insurance in Germany are legally required to allocate at least 90 % of the pre-allocation surplus - as far as it stems from investment income - to policyholders and policyholders are entitled to be adequately participated in any other surplus.

First, we recommend to prohibit an intermediary category in the balance sheet, not only for business complying with the definition of discretionary participation feature but for any business and to add this to paragraph 10.

Second, we recommend to base the discussion of participation features on the general principle of performance-linkage (c.f. enclosure 2). As the IAA we emphasize that "performance-linkage" is a general concept where actual cash flows of one party determine, through a legal or constructive obligation, the cash flows of that party with regard to another party in an off-setting manner, i.e. specifically transferring incremental deviations of cash flows to the counterparty. Under this definition, it is clear that unit-linked contracts are generally not performance-linked, since the linked performance is not specifically that of a contract party. We recommend especially to refer to US-GAAP for guidance which has solved the problem for New York and some other states in a manner that those insurers applying US-GAAP to their business in Europe experienced the adequacy of this approach for participating business in general in all its different forms, especially the consistency with the approaches for deferred taxes and minority interest.

ED 5 defines a discretionary participation feature obviously seen as the main problem of accounting for participating business. We do not see a fundamental problem there. Any amount paid in future based on a discretionary decision made in future does not reflect an obligation today and is therefore not qualified as liability under framework. As far as there is a legal or constructive obligation to participate policyholders in the performance of the entity, it is performance-linkage and therefore comes under the approach described in enclosure 2. It is necessary to indicate to users of reports clearly which amounts are subject to future decisions and to report these as equity rather than as liability.

Difficulties can arise if the obligation is based on a management decision about the cause of surplus, since the purpose of participation is to refund policyholders' overpriced premiums which had been charged to cope with potential future adverse developments of the risk exposure during the long contract term. It is therefore nearly impossible to determine precisely whether surplus results from good management of the insurer or from unneeded premiums, since the development was less adverse as conservatively assumed in pricing. In that case it is necessary to apply estimations about future management's judgment when it comes to determining the liability.

We would like to comment further on the issues of performance linkage and of discretion of the insurer during the discussion of phase II.

Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities
Assuming that the coming IFRS for phase II will be in force for business years starting on January 1st 2007, the requirement to disclose the fair value in the annual statement of 2006 does not appear unreasonable. The annual report of 2007 has to include exactly that value as prior year reference value, and especially quarterly reporting entities have to report already on March 31st 2007 the fair value and the prior year value of March 31st 2006.

Germany has some experience with applying completely new sets of accounting to existing business. German GAAP allows to use IAS or US-GAAP in consolidated reports instead of the legal German rules. Some large internationally operating insurance groups have chosen to make use of this rule. It took more than two years until the first reports were published in IAS resp. US-GAAP, considering the material technical effort and staff training needs. It is expected that the future final IFRS for insurance contracts will deviate materially from current approaches and is absolutely new ground for most insurers in the world.
So a reasonable timetable for implementing the final IFRS might be:

in 2004	start of analysing IFRS requirements in order to implement IT systems and to collect additional data needed
in 2005	training of staff and development of new IT
Jan 2006	new data being collected
End of 2006	new IT active.

It seems to be necessary that work on the final IFRS be finished in the first quarter of 2004 with a stable and applicable theory of fair values in hand, and assurance is given by the IASB that no further significant change will be made. We expect considerable investigation and analysis being conducted before the first line can be programmed and many people need to be trained before systems can be applied. Considering the current position we do not believe that companies will start such a huge project without having reliable information about the final standard.

Especially if rules are established requiring new approaches like stochastic simulation, replicating portfolios etc. more time will be necessary. Experience in Germany showed, that often after completion of technical work, at least one test report i.e. a further year of preparation is recommendable before an adequate quality is achieved.

As a consequence we don't believe this timetable to be realistic especially as even the target of the IASB, to proceed with the project already in the third quarter of 2003, will not be reached. We believe that the IASB will allow for a sufficient interim time after having published the final standard and before it becoming effective, considering the important workload to be achieved before fair values can be reported.

We recommend to state that disclosure of fair values of insurance liabilities and insurance assets is not required as of Dec. 31st 2006 but by the end of the year before the new standard will be set in force. Setting this "variable" avoids a target which will already be illusory at issuing date of the IFRS for phase I. However, it would also be possible to require disclosure in the transition rules of phase II assuming that this standard will be published a reasonable time before fully set in force.

Regardless of this recommendation and of our general hesitation to see fair values as the most appropriate measure for insurance contracts we clearly support that fair values have to be reported as early as possible, since analysis of time series is key for insurance financial reports.

A second problem arising with the disclosure of fair values based on preliminary guidance is the question how auditors should ensure the comparability of these fair values if insurers start to implement procedures without adequate knowledge and guidance.

Question 11 –Other disclosures

Aggregation

Disclosure as required in ED5 cannot mean preventing competitiveness of insurance companies by forcing them to disclose internal information (e.g. company's own mortality tables, reinsurance agreements, underwriting rules and standards) which weakens their position toward competitors. ED5 should provide a fair balance between companies' natural interest in keeping sensitive data secret and investors' (and competitors') interest in getting access to internal information. It is more important for investors to be informed about the effect of measures rather than to be informed about the measure itself since investors are regularly unable to judge on this, in the same manner as factories do not report their (secret) production process but just the financial result.

The main problem of disclosures in insurance business, as demonstrated in case of current reports of international groups under IAS or US-GAAP, is the variety of insurance business.

The unavoidable aggregation of information to an extent where the volume of information provided is still useful does not allow that detailed information about individual products or homogenous product groups is provided. It is very difficult to find categories of information according to which the provided data are meaningful at the unavoidable aggregation level.

Insurance products are known to be complex and difficult to understand. They are styled according to local traditions, local needs regarding contract law, tax law, regulatory law and social security law and specific local risk exposure. Although insurance products are offered under certain labels which pretend to be available in most countries, the actual risk exposure from contracts with the same label may deviate extremely from country to country. E.g. a German deferred annuity has nothing in common with an US-deferred annuity except for the name. The different construction results in a completely different risk exposure. That is true for most life and health insurance products. In non-life, the risk exposure from products might be similar, but there the number of products is legion. Third-party liability covering physicists contains a fully different risk exposure than third-party liability for private individuals.

The implementation guidance creates the feeling that it was written keeping in mind a small, specialized local insurer, rather than considering the main disclosure problem of aggregation for the main appliers of IAS which are, in the first instance, large consolidated groups. Insofar we do not consider the implementation guidance as helpful but misleading. It pretends to create a possibility to provide useful information which is actually not available.

Providing disclosures about insurance business on an international level requires intensive studies and we recommend to start a field test in one of the international insurance groups currently reporting under IAS, as to which information could be provided and which are still useful at the unavoidable aggregation level.

IT system changes
It is worthwhile to change systems to provide useful information, although it should be kept in mind that requirements towards system changes should be kept as small as possible with regard to the short interim time. Nevertheless we fear that much of the information required or "recommended" in the implementation guidance will cause material system changes while the aggregated outcome will be meaningless in the end.

Requirements to report "material" or "greatest effect" issues (c.f. ED5.27c) first require the knowledge about what is material. This can only be determined at a group level. Considering the extreme variety of potential material issues, it requires to collect all data about all potentially material issues from all subsidiaries and subsequently decide at a group level about the information to be disclosed. But in any case, each subsidiary has to develop and collect data for all potentially material issues. Hence, we recommend to avoid any reference to "material" or "greatest effect" here, since this is not a suitable basis.

Disclosures for cyclical or catastrophe risk exposures

Considering the elimination of equalization and catastrophe reserves in the balance sheet, the guidance regarding information about low-frequency, high-severity risks in IG47 appears insufficient with regard to the importance of this information for users of insurers' financial reports. Assuming that in phase II as well there will be no possibility to report such information in the balance sheet as liability, we recommend to require detailed disclosure about such risks already known to comply with the objective in ED 5.1(b). It is especially necessary to disclose to which extent the reported insurance result in the income statement would have been changed, if the expected net claim had occurred. Without that information, a reasonable judgment about the performance of the insurer is impossible. In addition, to get an idea which potential variation might impact the income statement, the effect of the expected maximum net claim within 10 years projection time should be disclosed and the amount of accumulated differences between insurance result and expected result of the past 10 years, adequately supplemented by interest, normalized in proportion to the current business in force.

Question 12 – Financial Guarantees
We agree with the comment given by the IAA.

Question 13 – Other comments
Reference to insurance assets and insurance liabilities
Many paragraphs just refer to insurance liabilities, some to insurance liabilities and deferred acquisition cost, others to insurance liabilities, deferred acquisition cost and intangible assets and finally some to insurance liabilities and insurance assets. We recommend to review all references to insurance liabilities or insurance assets as to whether they should stand as they are or may be phrased more generally. It needs to be noted that existing accounting policies establish many different liabilities and assets, which need to be generally addressed regardless of which name or reason is used for establishing these items. E.g., deferral of acquisition cost is prohibited in Germany, but it is allowed under the German asset-liability measurement approach to report an insurance contract initially as asset (Zillmer asset), similar to a fair value which is assumed to be normally an asset at outset as well.

Volatility in the balance sheet
German companies applying the local Commercial code HGB (liabilities at amortised cost) will face difficulties as differences in the measurement basis of assets and liabilities will distort the continuous development of equity. Companies reporting already on US-GAAP basis have been able to cope with this volatility, but there are many medium sized German insurers applying HGB.

We believe that a principles-based accounting approach requires that at least in cases where assets and liabilities are consequently and effectively matched, a consistent recognition and measurement is required. We see a hierarchy of connections between assets and liabilities:

1. Legal transfer of items to another party causes elimination of related assets and liabilities.
2. Performance-linkage, i.e. specifically transferring a cash flow of the entity rather than the underlying item to another party, requires consistent measurement of the transferred cash flow and the linked cash flow, including credit risk.
3. Asset-liability matching, i.e. acquiring cash flows which are expected to be negatively correlated to own cash flows, but not directly and specifically linked to own cash flows, requires consistent measurement of matched assets and liabilities, if the effectiveness is positively proved and matching is consistenly applied.

Up to now, IFRSs considered the third item only by referring to banking approaches of hedging. We recommend to consider this as a general principle and to allow similar treatment for the comparable technique of asset-liability matching in insurance industry as well.

Strain on insurers' resources
At the moment it seems that companies have to deal with the introduction of three different standards in the near future:

- 2005 IFRS Insurance contracts phase I
- 2006 IFRS Performance reporting
- 2007 IFRS Insurance contracts phase II.

This is opposed to the Board’s idea of avoiding too many changes in standards within such a short period of time. Furthermore the sequence of standards seems illogical: Performance reporting should be the last step which is built on the successful introduction of the insurance standard. We recommend to change the sequence in order to avoid a possibly forth step “Changes in Performance reporting to cope with IFRS insurance contracts phase II”.

During the discussion of phase II we would like to comment in more detail on the tentative views for phase II in the Basics for Conclusions.

Sincerely,
Maria Heep-Altiner
Rainer Fürhaupter
Martin Balleer

Enclosures

Enclosure 1

Amendment to question 7: Consequences of ignoring the principle of "performance linkage" in reinsurance

While the IAA refers in its response mainly to problems caused by ED 5.19 in case of reinsuring undiscounted non-life claims reserves, we would like to indicate that this paragraph does already cause major inconsistencies in normal quota reinsurance of discounted life reserves. For that purpose we provide an example to demonstrate the difference in measurement between the value in use of an asset and the usual measurement of discounted insurance liabilities.

We assume that a direct insurer takes quota reinsurance of 50% on its portfolio of certain insurance contracts, where the total amount of liabilities for future benefits is 200. The insurer estimated the expected value of future benefits to be 160 and according to accounting requirements added a margin for risk and uncertainty of 40, reflecting the risk price market participants would charge for the inherent deviation risk. As a consequence, the estimated expected value of amounts payable under the reinsurance contract are 80, i.e. 50% of 160. The reinsurer charges the market price of the deviation risk as reinsurance premium, i.e. the reinsurance premium is 80 plus 50% of the margin for risk and uncertainty, i.e. 20, equals 100. Under all currently known accounting approaches, adequately considering the consistency of measurement of performance-linked items, the reinsurance asset would be determined as 100, i.e. 50%, the ceded part, of the reported liability of 200. (Incidentally, this is as well the reinsurance premium, i.e. here measurement at cost equals fair value measurement, since the theoretical market price was charged.)

Application of ED 5.19 would mean that an impairment has to be checked. First the value in use has to be determined, since there is no market price observable in deep and liquid markets. The value in use is according IAS 36.48 the estimated expected value of future payments by the reinsurer, i.e. 80 ***minus*** a margin for risk and uncertainty according to the risk aversion of market participants. Assuming that the risk aversion of market participants represent 20% of the expected value, the maximum amount of the reinsurance asset will be not more than 64 under ED 5.19. Since this amount is lower than the currently reported amount, it has to be written off, causing a loss from reinsurance in an amount of 36. Instead of demonstrating that the insurer has reduced its risk exposure by taking reinsurance, independent measurement of both sides result in the fact that the original risk is nearly reported twice. That is a necessary and unavoidable effect if depending and off-setting cash flows are measured independently.

The reinsurance asset is remarkably impaired by credit risk, i.e. the estimated expected payment of the reinsurer is just 60. In that case the loss recognition test may be applied to the net cash flow from ceded business and reinsurance contract, resulting in an expected amount of 20, the minimum amount of the net liability. The carrying amount is zero, since the reinsurance asset equals the ceded liability. In that case the reinsurance asset has to be reduced by 20, resulting in an amount of 80. This means that the cedant registers a loss of 20 from reinsurance. That is correct since the cedant paid an excessive reinsurance premium. Considering the high credit risk, the cedant should not have paid more than 80 to the reinsurer.

Enclosure 2

Amendment to question 9: – Discretionary participation features
The main problem of performance-linkage is the recognition and measurement of future payments determined under the performance-linkage feature. It should be a principle, that such fully effective contractual transfers of deviation risks to another party should be recognized and measured consistently with the underlying cash flow. Up to the time where IASB has fully investigated that topic and determined a proper principle-based solution, we recommend to rule in phase I as follows.

Addition to Appendix A

Performance-linkage	A form of risk transfer of deviation risks of performance of one party (the risk transferor) under a contract (performance-linked contract) to the other party (the risk transferee) where the payment to be made or received under the contract (performance-linked payment) depends contractually (performance-linked feature) and specifically on cash flows (underlying performance) of the risk transferor in an off-setting manner.

Par ED5.24 and ED5.25 should be changed as follows:

24. Some insurance contracts contain a performance-linkage, (re-) transferring parts of the deviation risk borne by the insurer to the policyholder in addition to other payments, which are not linked to the performance of the insurer. Since the underlying performance under the performance-linked feature is a variable specific to the insurer, the feature is not an embedded derivative according IAS 39.

    Unit-linked contracts or other contracts, where the amount payable to policyholders is determined contractually by the performance of market values of specified investments or other indices, which are not directly linked to the performance of the insurer, are not performance-linked. Even if the insurer holds the investments, without being legally obliged to do so, this is no performance-linkage but asset-liability matching. Only if the insurer is legally obliged to hold the investments and it is sufficiently ensured that these investments are used for complying with the obligations to policyholders in a way that the difference to performance-linkage is not relevant under the "substance over form"-rule, the contract should be treated like performance-linked contracts.

    In case of a performance-linked contract, the risk transferor:
    (a) may, but need not, report the performance-linked payments separately from any other payment under the contract.
    (b) shall classify positive unallocated reported underlying performance according to the performance-linked feature as either liability or equity, reflecting all legal and constructive obligations to provide future performance-linked payments as a result of

the reported underlying performance. This IFRS does not specify how amounts shall be reported for which no legal or constructive obligation to forward to policyholders is provable. Negative unallocated reported underlying performance shall be treated following the rules for deferred tax assets analogously, assuming that the rules for performance-linkage of the contract are rules for determining income tax.

(c) shall, if the contract contains an embedded derivative within the scope of IAS 39, apply IAS 39 to that embedded derivative.

(d) shall, in all respects not described in paragraphs 10-13 and 24 (a)-(c), continue its existing accounting policies for such contracts, unless it demonstrates that a change in those accounting policies would result in more relevant and reliable financial statements, as required by paragraph 14.

25. The requirements in paragraph 24 also apply to the issuer of a financial instrument that is not an insurance contract and contains performance-linked feature. In addition, the issuer shall recognise a liability measured at no less than the measurement that IAS 39 would apply to the payments, which are not performance-linked. The issuer need not determine the IAS 39 measurement of the fixed element if the total reported liability is clearly higher.

The problem of unallocated reported underlying performance consists of three parts:

- First, the measurement criteria for performance might deviate from IFRSs causing timing differences between that measurement basis and IFRSs reports, similar to timing differences between the measurement basis of taxation and IFRSs. Such timing differences are referred to in FAS 60.42 and a suitable solution is found by establishing a liability in the size of the expected share of policyholders in the anticipated or deferred performance under legal and constructive obligations. The treatment is similar to the treatment of such timing differences in case of taxation or minority interest.
- Second, some parts of already reported performance under the measurement rules for performance under the feature might not be allocated ultimately to individual policyholders but it is already legally determined that those amounts will belong ultimately to policyholders. In that case, the amount is a liability, except there is the ability of the insurer to utilize parts of those amounts to recover future losses. It needs to be decided analogously to deferred taxes, what the amount of the liability is.
- Third, parts of that already reported performance under the feature is not yet ultimately allocated to the community of policyholders, i.e. the decision which part belongs to policyholders and which part belongs to the insurer has not been made yet. In that case, similar to the first case, an estimation is needed about the ultimate ownership under legal and constructive obligations.

It needs to be noted that the general recognition of the principle of performance-linkage in IFRSs solves both the question how policyholders should account for insurance taken, and how cedants should account for reinsurance taken. Performance-linkage is a feature mainly used in insurance business, but in some isolated areas this principle can be observed as well:

- Income tax is a performance-linked payment and the best approach to account for any performance-linkage is in accordance with accounting for income tax in IAS 12.
- Minority interest is a performance-linkage and the common situation compared with income tax is obvious as the accounting requirements in IAS 22 show.
- IAS 19.104 rules that qualified insurance policies, which provide a performance-linked coverage of pension plans, shall be recognized and measured consistently with the covered cash flow. That is the best example how accounting by policyholders can be styled properly.