ZURICH
FINANCIAL SERVICES

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Your reference

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ED 5 Insurance Contracts

Dear Mr. Clark,

We welcome the opportunity to contribute the comments of Zurich Financial Services on the above-mentioned exposure draft. As one of the first international insurance groups to apply International Financial Reporting Standards ("IFRS") as the primary reporting basis, we believe that we have a wealth of experience to draw on in contributing to the process of global standard-setting. Beyond this letter, we remain available for any discussions on the points contained therein, as well as any other issues concerning insurance reporting.

We understand that, in splitting the insurance standard into two phases, the International Accounting Standards Board ("IASB") has indicated that it recognizes the complexity and challenge of setting a global standard on accounting for insurance contracts. We clearly welcome this signal, but also recognize the added complexity that Phase I, as an interim step brings.

With a mandate to establish uniform and sound global reporting, we recognize that the IASB has focused first on the financial statements, including foot notes, as the primary means to communicate financial performance and standing. However, and as seen in other jurisdictions, we also believe that financial reporting and disclosure should not be restricted only to financial statements. A proliferation of disclosures in the footnotes has the potential to confuse a user of the financial statements, rather than to help. Furthermore, the level of accuracy that can be achieved for certain disclosures, because of their inherent nature as estimates, does not lend well to inclusion in the financial statements, but would suit management's commentary on financial condition and results, where all aspects can be fully analyzed and commented. We therefore propose that certain disclosures be included as supplementary information to the financial statements. Although this would mark a departure from the current structure of IFRS, we believe it would contribute to the "user-friendliness" of financial reporting. In fact paragraph S of the proposed implementation guidance does acknowledge the possible disclosure of "supplementary information", which we would understand as being outside the financial statements as a whole.

In respect of disclosure of fair values and the expiry of the exemption from (revised) IAS 8, the Board has inserted a stated date in the proposals. We can agree with this if a Phase II standard can be available in a final form, after all required due process and with sufficient time for implementation to be effective from 1.1.2007. However, we are concerned as to the consequences should Phase II not be available on time, and suggest that fair value disclosure and the expiry of the IAS 8 exemption be linked to the final reporting period under Phase I of the insurance standard.

We have set forth our responses to the questions posed in EDS in the attached appendix. The responses are numbered to correspond to the relevant questions. We have not responded to questions where we have no significant disagreement with the relevant section of the exposure draft.

Again, we congratulate you and the IASB on reaching this stage of what has been a long process, and welcome discussion with you in future.

Kind regards,

Louis Mannello
Group Controller

Otto Bauer
IFRS Project Manager

Appendix: Comments to ED 5, Insurance contracts

Question 1 Scope

Although we generally agree with the scope of ED 5 we note the following:

Exclusion of policyholders

We accept that policyholders are excluded from the first phase of the insurance project, particularly as it largely does not mandate measurement for products meeting the definition of insurance. However, we find a lack of clarity in differentiating between an insurance product versus a reinsurance product, and, hence, determining whether a non-insurance policyholder or an insurer, i.e. cedant, is involved. For example, definitions become blurred distinguishing a transaction between an insurer (or reinsurer) and a captive insurer of an industrial company, from a reinsurer transacting with another insurer.

This distinction is important in the exposure draft as, related to the example above, an industrial group buying insurance would be excluded from the standard, whereas an insurer (or cedant) would account for a reinsurance deal using the insurance standard. We believe that such a distinction is in substance artificial. To exclude policyholders from an insurance standard does not create transparency or consistency across industries in accounting for similar transactions.

At the minimum, we believe this issue emphasizes the necessity of including all policyholders in Phase II of the standard.

Warranties by retailers

Similar to the point made above with respect to the exclusion of insurance policyholders, we do not understand why product warranties should be excluded from an insurance standard when they meet the definition of insurance. This is particularly the case, as the standard is designed to apply to insurance transactions and not just insurance entities.

Asset/Liability mismatch

Although we note a potential mismatch between insurance liabilities and invested assets related to same, we believe that they are not significantly different to the mismatches which users of current internationally-recognized insurance accounting standards experience.

Question 2 - Definition of insurance contract

We have the following reservations related to the insurance definition:

Measurement of significant Insurance risk

We question whether the definition of significance should be measured based on the entire cash flows of the product involved, or more specifically on the risk-related flows. For example a large, deposit-like component bundled with a risk or mortality component, where the cash flows are interlink ,ay possibly fail the risk significance test as it is currently defined. As an example of this approach, we refer to the recently released Statement of Position, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts, issued by the American Institute of Certified Public Accountants.

Treatment of non-insurance contracts

Products not meeting the definition of insurance are treated in accordance with IAS 39. However, given the complexity of products offered by insurers and reinsurers, we do not believe that there is currently sufficient guidance provided, in either of ED5 or IAS 39, to assist preparers in accounting for such "non-insurance" products, which, for example, may still have insurance aspects that require modelling. We therefore request that implementation guidance be provided, in order to avoid large inconsistencies in the approach taken by preparers.

Alternatively, application of IAS 39 could be deferred to Phase II of the standard, allowing time to develop and test models and guidance for products that do not meet the definition of insurance. Phase I could still involve the reclassification of balances related to such "non-insurance" products, but allow preparers to measure their liabilities and related balances in accordance with their current accounting policies; a similar approach to how accounting for insurance products is being handled in Phase I.

Foresight of significant insurance risk

Finally, we note that paragraphs B25 and B26 point out that contracts for which the issuer can foresee that the probability or present value of a significant loss may increase over time, that such contracts are an insurance contract from inception. On the other hand, Implementation Guidance example 1.6 points to unbundling. As we believe that significant insurance risk can be foreseen on such contracts, we find B25/B26 and example 1.6 to be in contradiction Additionally, the paragraph on unbundling appears to indicate iliac the main reason for unbundling would be where all liabilities under the contract have not been recognized; this is clearly not the case for our accounting of such annuities.

Question 3— Embedded derivatives

We agree with the Board's position that embedded derivatives meeting the definition of insurance need not be unbundled from an insurance host and separately valued. However, we believe that the disclosures mentioned in paragraph IG58 lack clarity, and that the issue of disclosure is dealt with sufficiently in paragraph 29(e).

Question 4— Temporary exclusion from criteria in IAS 8

Exemption from applying paragraphs 5 and 6 of (Draft) IAS 8

We strongly agree with the exemption and believe it to be in alignment with the intention of splitting the insurance standard into two phases. However, we do not agree with an expiry date for this exemption. Should the finalization of Phase II of the insurance contracts standard be delayed, this could result in an intervening period in which Phase II will not be in force, but preparers will be forced to change their current measurement standards because of IAS 8, thus incurring significant conversion costs. Alternatively, an expiry date of January 1, 2007 would force the IASB to apply a timetable that could result in an override of the due diligence iliac is required for Phase II We do not believe that either scenario is intended by the JASB, and therefore recommend that the wording refer to the elimination of the exemption for the first effective reporting period under Phase II of the insurance contracts standard. Should Phase II become effective on January 1, 2007 as currently envisioned, this would not have any effect on the plans of the IASB but in the event of any delay, would prevent unintended additional costs and effort.

Elimination of catastrophe and equalization provisions

We agree with the elimination of certain practices that are not in accordance with the IASB framework.

Question 5— Changes in accounting policies

In respect of the continuation of non-uniform application of accounting policies we suggest requiring, in the interest of comparability, that significant cases be described in the accounting policy footnote.

Question 6— Unbundling

We welcome the Board's conclusion that unbundling all deposit components from insurance contracts would be an onerous step, and furthermore agree that it could result in accounting changes which would potentially be reversed in Phase II

However, and as the Basis for Conclusions concedes, there is no clear conceptual line unbundling It is therefore important that sufficient guidance be provided to assist preparers in understanding when unbundling will be necessary. The alternative will be much debate and significant costs to prove the need for unbundling or lack thereof. This is especially important when one considers that Phase II would potentially reverse some of these changes. The situation should be avoided where Phase I would require unbundling but that Phase II makes this step unnecessary.

Question 7— Reinsurance purchased

The Board has recognized that the proposals on reinsurance are imperfect. The main issue as we interpret it is that the proposals require the use of fair value to measure the reinsurance asset in a number of circumstances. We do not believe this is appropriate, particularly as fair value is generally planned for Phase II as noted in paragraph BG6 We therefore believe that this may create an additional inconsistency where, for example, general business is accounted for on a nominal basis, but related reinsurance assets must be at fair value. We note the following concerning the Board's proposals:

<u>Initial balance for reinsurance</u>

ED5 proposes that the initial balance for a reinsurance asset would be the amount paid. For many non-life insurers, the reinsured reserves are measured and reported at nominal value, i.e. undiscounted. The price of reinsurance however, typically includes an assessment of the expected cash flows, including anticipated investment returns. This would result in a clear mismatch between the balance of the reinsurance asset and the reinsured reserves, leading the user of the financial statements to conclude that the insurer is carrying more net risk in his balance sheet than is economically the case. We therefore propose a solution found in US GAAP, which corrects this difference by setting up a reinsurance asset that is equal to the underlying reserves, but accounts for the difference with a balancing deferred credit outside the reserves that is amortized over the statement period. This would address the Board's valid concern regarding immediate recognition of a profit on the transaction and would, however, allow insurers to give a clearer indication of their net insurance risk.

<u>Impairment testing</u>

ED5 requires the use of IAS 36 to test the impairment of reinsurance assets. IAS 36 requires the use of a net present value approach to assess the recoverability of reinsurance, which again would impose a. mismatch on non-life insurance business, and thus a significant impact on the industry. We must disagree with this approach and again refer to the intent not to impose a fair value regime in Phase I.

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

We agree and believe it appropriate to use fair value to measure acquired assets and liabilities as part of a business combination. We note that the implementation guidance and even US GAAP provide some assistance in respect of acquisitions of life business. However, there is little guidance available in respect of non-life business, and what this could mean. We therefore would request more guidance in a final standard as to the accounting for the acquisition of general business.

Question 9— Discretionary participation features

We welcome the IASB's proposals for Phase I given the obvious conceptual difficulties. In the interests of transparency, however, we also would support disclosure of the policy that the preparer chooses for the classification of unallocated surplus.

Question 10 — Disclosure of the fair value of insurance assets and insurance liabilities

We accept the disclosure of fair value on the understanding that it is intended as a transitional provision for the last financial statement date prior to the planned effective date of Phase II. Just as in question 4, however, we are concerned with setting an absolute date in this respect. Should Phase II be delayed, there would be an intervening phase during which preparers will be forced to disclose fair values without a dear standard, resulting in inconsistencies across the industry. The longer the delay, the more preparers will continually need to adjust their methodologies at each successive reporting period in light of the status of the fair value standard, with obvious consequent costs involved. We thus request confirmation that disclosure of fair values is required for the last reporting period prior to the effective date of Phase II of the insurance contracts standard. Should Phase II become effective on January 1, 2007 after the requisite research and discussion, this would not have any effect on the timing of disclosure of fair value; but in the event of any delay, would prevent any confusion over the uncertainties in methodology.

Question 11 — Other disclosures

We support the notion that users of financial statements require fair and transparent disclosure of information presented. Paragraphs 26 to 29 clearly offer insurance companies an opportunity to explain more of the risks inherent in their business. However, we find the disclosures required, as explained by the implementation guidance, to be quite onerous and costly to implement.

Effect of changes in assumption and sensitivities

Although appealing to a user, the manner in which the proposed disclosure on effects of changes in assumptions arid sensitivity analysis are overly broad and far-reaching. Insurance liabilities involve many complex assumptions and judgements. To possibly address all of them would be exceedingly costly from a financial reporting standpoint. Furthermore, the benefit of such disclosure is maximized for a reader when it **is** restricted to disclosures on certain key variables. We therefore propose that a final standard be more specific by requesting preparers to focus on the key assumptions in their reserving process, such as discount rates, mortality, etc.

Schedule of cash flows

Implementation Guidance paragraph 39 requests disclosure of cash flow information in the equivalent of a maturity table as used for debt or lease obligations. Although the information is theoretically quite useful, the inherent nature of the data used in the reserving process is not adequate for the user of financial statements. Reserving, which would use the cash flows disclosed, is a complex process dealing with uncertainty, requiring the use of informed estimates and judgements. Such processes involve estimates that have a very high volatility, be it for the nominal amounts of the expected flows, as well as their timing. In contrast, a debt maturity schedule shows the maturity dates of debt instruments for which the amounts and timing are dearly laid out in a contract; this is not the case for cash flow estimates used in the reserving process. We therefore do not find this disclosure reliable enough for readers of financial information, as the detail presented could provide misleading information on the value of the reporting entity. As an alternative, we believe that more summarized information, such as the duration of a general business portfolio, would provide equally useful information but without sacrificing quality.

Claims development

The requirement for disclosure of claims development lacks clarity as to whether it will continue as a requirement in Phase II. Although many groups have such development information for their general business, particularly those who have registered their shares for trading on an American stock exchange, this information is normally prepared on an accident year basis. Because of the high cost of information systems needed to comply with this disclosure requirement, more guidance could be given to clarify the intentions of the IASB in respect of the issue of accident year versus underwriting year. The implementation guidance shows information prepared on an underwriting year basis, without commenting on the possibility of disclosure on an accident year basis. Especially given the short time frame to implement Phase I we would ask for confirmation of flexibility on this issue, provided clear disclosure of the basis is given.

Location of disclosures

Disclosures are traditionally located in the footnotes to the financial statements, if not the main parts of the financial statements. The volume and nature of the proposed disclosures, however, present a large increase in the amount of specific information given and could lead to a dilution of the financial statements taken as a whole. Some of the disclosures, for example, claims development are only required as supplemental information outside the financial statements in jurisdictions which already request such information, such as in the United States for SEC registrants. We consider that inclusion in the management commentary section of a company's annual report would allow for suitable accompanying commentary to assist the reader in the analysis of a cable of figures for example. We therefore propose that the future standard allow the inclusion of such information as supplementary information, thus preserving the summary nature of the financial statements, yet providing users with the detailed information that they need in a manner that facilitates enhanced analysis.

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

We have no comments on this issue.

Question 13— Other Comments

Application of IAS 29

As mentioned earlier, the application of IAS *39* to products not meeting the definition of insurance proposed is unclear in terms of available guidance. We further note that the possible imposition of a deposit floor for such product liabilities could result in a valuation that does not reflect the anticipated behavior of the policyholders involved.