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Sir David Tweedie
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31 October 2003

Dear Sir David

Exposure Draft 5 Insurance Contracts ("ED 5")

We are responding to your invitation to comment on the above exposure draft on behalf of the worldwide organisation and Global IFRS Board of PricewaterhouseCoopers.

Support for a new IFRS on insurance contracts

The development of a comprehensive standard for insurance contracts must remain a top priority of the International Accounting Standards Board ("the Board"). However, we agree that the Board needs to issue an interim standard as a matter of urgency to enable insurance companies to adopt IFRS before such a standard is completed. We therefore welcome ED 5 as the first step in the process. In finalising ED 5 we would encourage the Board to ensure that their proposals do not require extensive systems changes at this stage in areas where further change is likely to be introduced as part of Phase II of the insurance project.

We welcome the Board's decision to issue a standard that deals with insurance contracts rather than insurance entities. This recognises the need for a consistent approach within the financial services sector. We consider, however, that insurance contracts have distinctive features resulting from the combination of insurance risk transfer, financing and service which is always present. The combination of these three elements supports the need for specific guidance.

We support the Board's proposal for unbundling of deposit components of some insurance contracts but welcome its limited application. A consequence of this decision is to limit comparability with other financial institutions. Thus it is essential that the definition of insurance contracts only encompasses those contracts that contain significant insurance risk. This is essential to ensure that similar contracts issued by investment entities, insurance companies and banks are recognised, measured and presented in a comparable manner.

However, in finalising ED 5, the Board needs to:

1. Clarify the definition of an insurance contract

2. Address artificial volatility resulting from the mismatched accounting treatment for assets and liabilities

3. Provide guidance on the interpretation of fair value for insurance and investment contracts and

4. Clarify the treatment of discretionary participating investment contracts.

1. Definition of an insurance contract

We support the spirit of the definition of insurance in ED 5.

It is important that the definition and the related implementation guidance are clear and concise to ensure that those contracts that are in substance investment contracts are consistently identified and accounted for under IAS 39 around the world.

In our response to question 2 we have suggested some improvements to Appendix B to ED 5 and the Draft Implementation Guidance. These suggestions are based on our practical experience of the difficulties the insurance industry around the world is encountering in seeking a consistent interpretation of the proposed definition. In particular, we recommend the use of a small vocabulary, using terminology already accepted in other standards and consistently applied, since this will improve the clarity of the definition and the related implementation guidance.

2. Asset/liability mismatching

We note from the Basis of Conclusions that the Board considers it acceptable as an interim measure not to address the mismatch that will arise between assets used to fund insurance liabilities and the insurance liabilities themselves. We are concerned that the proposed retention of existing local accounting principles for insurance liabilities while assets are accounted for under IAS 39 introduces artificial volatility whilst failing to reflect the real volatility inherent in the entity's funding policies and may result in the presentation of misleading information in the income statement and balance sheet. The performance measure and net book value of insurance entities will be less relevant and reliable as a result.

Under many current local accounting principles, the objective of matching in the income statement is achieved in one of two ways: either by carrying assets at fair value and applying current market interest rates to the determination of insurance liabilities ("unlocking" the interest rate) or by carrying the assets at amortised cost and measuring the insurance liabilities using the interest rate implicit in the funding assets at inception (thus "locking in" the interest rate). The use of locked in interest rates will result in a mismatch between the carrying value of assets and liabilities as soon as interest rates move if the assets used to fund the liabilities are carried at fair value. When interest rates fall, as in recent years, the fair value of the assets will increase, giving rise to a gain in the income statement or in equity, which will not be reflected by an increase in the carrying value of the liabilities. Since ED 5 in its loss recognition proposals does not require the use of discounted cash flows using current market interest rates, the impact of this change will also not be reflected through the loss recognition test proposed in paragraphs 11 to 13 of the exposure draft.

In general, we believe that when assets are measured at fair value, insurance liabilities should be measured using current interest rates. Consequently the standard should not prohibit entities from moving to unlocked interest rates when measuring insurance liabilities. Paragraph 16 relating to the adoption of new accounting policies should be amended to permit this explicitly. As a minimum, entities should be permitted to adopt such a change in policy if they choose to do so. We recognise that the systems implications associated with a change to such a measurement method would be significant for many companies and thus it would be inconsistent with the objective of minimising systems changes during Phase I of the insurance project to make this mandatory at this stage. Consequently, where entities choose to use locked in interest rates in valuing their liabilities, they should apply current market rates in the loss recognition test to ensure that significant losses due to changes in interest rates are recognised at the same time as the gains on the related assets. Whilst this solution does not address the problem completely, it may alleviate some of the artificial volatility that will otherwise arise.

We recognise that the Board's decision not to permit a separate classification of assets held to back insurance liabilities is consistent with the treatment for similar assets held by other entities. We understand the attraction of an asset-based solution to the mismatch problem for many insurance companies and have considered the two approaches addressed by the Board in BC110: the relaxation of the criteria in IAS 39 for classifying financial assets as held to maturity or the creation of a new category of assets carried at amortised cost (namely assets held to back insurance liabilities). We accept that the former approach would be inconsistent with the principle in IAS 39 that entities must have both the intent and ability to hold assets to maturity. The latter approach would avoid a direct conflict with the classification rules in IAS 39, but we recognise that detailed rules, at least as complex as those already imposed for held to maturity assets, would need to be introduced to control the classification of assets into this category to ensure that assets that may be sold in response to changes in market prices continue to be carried at fair value. The creation of such a category would impose artificial restrictions on management's ability to manage its portfolios of assets. Nevertheless, we believe that the Board has underestimated the impact of the mismatch between assets and liabilities. A solution to this issue is a matter of considerable importance.

3. The interpretation of fair value for insurance and investment contracts

The adoption of IFRS by many insurance companies in 2005 is expected to result in a greater use of fair values. This arises primarily from the application of IAS 39 to financial assets, investment contracts and embedded derivatives in insurance contracts. Moreover, ED 5 also presently requires the disclosure of fair values for insurance contracts from 2006. It is therefore essential that the issue of a harmonised fair value measurement of liabilities across sectors be addressed now. Fair value disclosure should not be required until the issues are resolved and guidance is available.

We believe that further consideration should be given to the impact of surrender options on the fair value of investment contracts. We believe that the Board's conclusion, set out in BC 117(e) that the fair value of such a contract is not less than the amount payable on demand, fails to recognise that there is a difference in nature between a long-term interest bearing contract with an embedded surrender option and a non-interest bearing demand deposit with no fixed term. Factors such as the price at which the surrender option may be exercised, the tax implications of its exercise and the investor's expectations of future returns on the contract will all influence the fair value of the option, even without consideration of the behavioural effects implicit in a portfolio of such contracts. Some of these factors may be relevant in determining the fair value of the liabilities themselves whereas others may be viewed as a separate intangible assets relating to the customer relationship.

We do not consider that it is yet practical to determine the fair value of such liabilities with sufficient reliability to drive the accounting treatment, nor do we believe that it is yet practical to split the fair value of a portfolio of such liabilities between the fair value of the liabilities themselves and that of the related intangible asset. We therefore recommend that the Board accelerates its Measurement project and ensures that this addresses how to fair value such liabilities. Only when such a project is complete can an informed conclusion on the measurement of financial liabilities be made.

Theoretically, we believe that the fair value of an investment contract with a surrender option may be less than initial cost and therefore could give rise to a gain on initial recognition. This is consistent with the fact that insurance companies are prepared to pay significant amounts to third parties to acquire such business. The existence of a secondary market in reinsurance and the sales of portfolios of contracts at prices that do not reflect the aggregate value of the contracts supports this view.

Such a debate is considerably wider than the treatment of surrender options in investment contracts, and as such should be carried out independently from the surrender options debate. Any project on fair values needs to address such issues as entrance versus exit value, wholesale versus retail markets, market value margins, values of renewal options, customer behaviour and whether the fair value of a liability is what would be paid to someone else to assume it or the amount to immediately settle with the holder of the contract. These are not unique to the insurance industry and should be addressed on a cross-industry basis in order to ensure a consistent approach.

4. Discretionary participating investment contracts

We support the Board's decision not to address the accounting treatment of discretionary participating investment contracts at this stage. It is not clear, however, how the inter-relationship between paragraph 25 of ED 5 and IAS 39 is intended to operate. As discussed in more detail in our response to question 9, the paragraph should set out explicitly how to account for the fixed element of such a contract, rather than only on an imprecise cross reference to IAS 39.

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In view of the complexity of the insurance industry, it is essential for sound financial reporting that the finalisation of the standard resulting from Phase I of the insurance contracts project and its application in practice are carried out in close co-operation with users, preparers and auditors with an understanding of the industry's issues. We are pleased to note that the Board has established a Task Force and recommend that it should be consulted to ensure that any changes to the proposed IFRS resulting from the exposure period are practical and appropriate.

If you have any questions in relation to this letter please do not hesitate to contact Jochen Pape, Chair of the PwC Global IFRS Board (+49 211 981 2905), or Gordon Ireland (+44 207 212 5163).

Yours faithfully

PricewaterhouseCoopers

ED 5 Insurance Contracts

Responses to detailed questions

Question 1 – Scope

(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting for 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?

Answer

(a) We agree that it is appropriate to develop an accounting standard for insurance contracts rather than for insurance undertakings.

We agree that policy holders should be excluded from the scope of ED 5 but we are concerned that the amendment to IAS 32 proposed in paragraph C1 of ED 5 does not discriminate between contracts with no insurance risk, that should be accounted for under IAS 39, and genuine insurance policies, where the premiums should be accounted for as an expense. Entities holding direct insurance contracts should also apply the insurance contract definition in ED 5 in determining the extent to which they fall within the scope of IAS 39.

We suggest amending paragraph C1 as follows:

"Paragraph 3 of [June 2002 Exposure Draft of improvements to] IAS 32 *Financial Instruments: Disclosure and Presentation* is deleted. Paragraph 1(d) is renumbered as 1(c). Paragraph 1(c) is renumbered as 1(d) and amended to read as follows:

(d) insurance contracts as defined in Appendix A of IFRS X *Insurance Contracts.* However, this Standard applies to derivatives that are embedded in insurance contracts (see IAS 39 *Financial Instruments: Recognition and Measurement*)."

(a) (i) **Assets held to back insurance contracts:** We note that ED 5 does not create special rules for assets held to back insurance contracts. We believe that it is most important for the assets backing the insurance contracts and the liabilities arising from insurance contracts to be measured on consistent bases. Failure to address this will create artificial volatility in reported equity or earnings that does not reflect the underlying economics of the business. As discussed in our covering letter, we believe that insurers should at least be permitted to minimise the effect of this by measuring liabilities using current interest rates.

We note that an anomaly still remains where assets which are contractually linked to policyholder rights under insurance or investment contracts include owner occupied properties. Under the allowed alternative treatment in IAS 16, these properties can be carried at fair value. However, until the project on reporting other comprehensive income is completed, this fair value adjustment is not reflected in the income statement but is instead taken directly to equity. The policyholders' liability, however, will incorporate an embedded derivative that will need to be carried at fair value through the income statement.

We would welcome a consequential change to IAS 16 to allow a reporting entity to choose to take revaluation gains and losses on owner occupied property to the income statement, provided that the treatment is adopted consistently for all assets of the same class.

(a) (ii) **Financial instruments issued by issuers of insurance contracts:** We believe that the scope outlined in question 1 (a) (ii) is appropriate.

(b) **Weather derivatives:** We agree that weather derivatives should be accounted for under IAS 39 unless they meet the definition of an insurance contract.

Question 2 – Definition of insurance contract

The draft IFRS defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder of 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 Guide).

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?

ED 5 Insurance Contracts

Responses to detailed questions

Answer

We agree with the spirit of the definition in ED 5. However, we believe that the wording of the definition is still open to misinterpretation, particularly in the light of the detailed implementation guidance that is attached.

We recommend the following changes to the definition and accompanying guidance to assist in its interpretation:

A small vocabulary should be used based on terms that are already widely used and understood in IFRS literature to ensure clarity in interpretation. For example, the use of the terms "plausible scenarios", "trivial", "extremely unlikely" and "insignificant" are all difficult to interpret and may be seen as having different shades of meaning that were not intended.

- Appendix B to ED 5 should be amended to ensure consistency between paragraphs B18(a), B21 and B23. We agree with the conclusion in B18(a) and B23 that the legal form of a life insurance contract is not enough to justify the classification of the contract as insurance if the insurer has not accepted significant mortality risk. For example, a contract offering 101% benefit on death does not have a material impact on cash flows should the insured event occur and should not be regarded as an insurance contract. Moreover, it would be inappropriate to conclude that a contract that has a significant surrender penalty for an insignificant period of time (say one month) but where the death benefit is equal to surrender value at all other times is insurance. However, the final sentence of B21 could be interpreted as requiring the opposite.
- We note that the use of the term "net cash flows" in B21 has been interpreted as permitting the classification of contracts which transfer very limited insurance risk as insurance contracts. We recommend replacing this with "contractual cash flows". This will also ensure that transaction and other costs borne by the insurer are excluded as they do not arise directly from the contract.
- The interpretation guidance should require the identification of the insured event as the first step in the application of the insurance contract definition test. This is particularly relevant where the definition depends on whether survivorship or death is identified as the insured event.
- Example 1.4 is inconsistent with paragraph B23 in that, in the former, there has to be a significant probability that the holder will not survive until the specified date whereas, in the latter, death need only be plausible. We consider that the two should be consistent and therefore recommend that the treatment of the contract in Example 1.4 be amended to read as follows: "Insurance contract, unless there is an insignificant probability that the policyholder will not survive until the specified date". Moreover, the comparison of cash flows should be made not only at maturity, as implied in Example 1.4, but at any moment when there is more than an insignificant probability of survival.
- Paragraph B23 and Example 1.2 should be amended to clarify that a contract should not be classified as insurance simply because the insurer has the discretion under the contract to adjust the surrender benefit to reflect up-front acquisition costs or to make market value adjustments, for example in response to falls in

> equity markets. This should be distinguished from the situation where pre-defined surrender value charges consistently result in a difference in payout than in the event of death. In such cases we recognise that there may be significant insurance risk.

We attach as an appendix to this letter our proposed redrafting of paragraphs B21 to B26 to address the issues we discuss above.

In addition, we recommend the inclusion of examples of property and casualty reinsurance contracts and life reinsurance contracts in the Draft Implementation Guidance. This is a complex area with quota share, stop loss, financial and other types of reinsurance. Clarification is needed to address when such reinsurance becomes insurance under the Board's definition. In particular, the Draft Implementation Guidance should clarify that the aggregation of direct contracts pooled into a reinsurance contract should not result in the classification of the reinsurance contract as financing simply because the effect of aggregation may reduce the probability of loss and hence influence the decision as to the level of insurance risk transferred.

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?

Answer

We agree with the exemptions outlined in question 3 (a) (i). However, clarification is needed to address the circumstance where the deposit component has been unbundled and is subject to IAS 39. If the contract is subject to unbundling and the surrender value option relates to the deposit component, we would expect this derivative to be accounted for in accordance with IAS 39 to be consistent with prepayment options in other financial instruments.

In relation to question 3 (b) we agree that the exemption is appropriate.

In relation to question 3 (c) we broadly agree with the Board's proposals. However, we would welcome the introduction of guidance on the level of aggregation appropriate in relation to these disclosures.

We believe that further consideration should be given to exempting surrender options embedded in discretionary contracts (question 3 (d)). In principle, we agree that such options should be accounted for separately if they are not exercisable at accreted amount but in practice we believe that the valuation of such options is more complex than for normal prepayment options in view of the many behavioural, contractual, fiscal and other non-financial factors that will determine their exercise. Consequently, we recommend that such options are also exempted from the scope of IAS 39. This would be consistent with the proposed exemption of the host contract from the scope of IAS 39 at this stage.

In addition, we would welcome clarification that embedded derivatives should be regarded as insurance contracts in their own right, and thus be exempted from the requirement for separation, where the cash flows of the derivative and the host insurance contract are interdependent.

ED 5 Insurance Contracts

Responses to detailed questions

Question 4 – Temporary exclusion from criteria in IAS 8

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for:

(i) insurance contracts (including reinsurance contracts) that it issues; and

(ii) reinsurance contracts that it holds.

(paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions).

Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?

(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 and 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?

Answer

Exemption from IASB Framework up to 31 December 2006

The Board should reconsider the "sunset" proposal. We support the Board in setting for itself a challenging target to deliver Phase II of this insurance project. However, there are very substantial issues to resolve and it may not prove possible to complete all aspects with proper due process within the time available. There is a substantial risk that the pressure of a sunset clause may be perceived to lead to inadequate time being spent on parts of its Phase II proposals and/or insufficient dialogue with the Board's constituents. The Board could be subject to significant embarrassment and criticism if an amendment has to be introduced at a late stage to defer or remove the sunset clause in 2006 if the target proves impractical.

Paragraph 9 of ED 5 should be expanded to expressly permit the continuation of accounting policies for deferred acquisition costs associated with insurance contracts.

Prohibition of catastrophe and equalisation reserves

We agree with the decision to eliminate certain catastrophe and equalisation reserves that are common under some local GAAP mainly for property and casualty business. They do not meet the IASB Framework's definition of a liability, since they are mechanisms to set aside or restrict access by shareholders to funds in order to ensure adequate funding for future claims.

We recommend, however, that the requirement is not limited to the specific terms "Catastrophe and Equalisation reserves" since different terminology for the same reserves may be used in some territories. We therefore suggest that in paragraph 10 the words "or similar separate reserves which would not meet the definition of a liability under the framework" are added to capture any similar provision for future losses on future contracts.

We note that in certain jurisdictions equalisation or catastrophe "provisions" are required by regulators to be set up for extant contracts. We do not agree that such provisions should only be eliminated for future contracts. Rather we consider that whilst prudent assumptions may still be made in Phase I for catastrophes which might reasonably arise in un-expired periods of risk on contracts in existence at the balance sheet date, the setting aside of a separate "reserve" categorised as a catastrophe or equalisation reserve can not be acceptable whether in relation to extant or future contracts.

We believe that additional note disclosure should be required in cases where companies have posted such reserves under local GAAP. This would enable investors to have a better understanding of the financial condition of the company and aid comparison of companies from different countries. Similar disclosures are already found in IAS 30 (paragraphs 50 to 52) requiring banks to disclose reserves established under local circumstances or legislation which are not permitted as reductions in the carrying value of assets or as liabilities under IFRS.

Loss recognition test

In relation to the proposal under question 4 (b) (ii), we agree with the principle of introducing a compulsory loss recognition test whenever the pre-existing accounting policies do not require one.

We believe it should be made clear that all contractual cash flows, including contingent cash flows (e.g. guaranteed annuity options and those associated with embedded derivatives that are not accounted for separately) should be considered in the compulsory test in paragraph 11.

We also note that the level of aggregation on which the loss recognition test has to be performed is only referred to in the Basis for conclusions BC67 (b). Our opinion is that the level of aggregation is an important feature when considering loss recognition testing and therefore recommend that guidance should be included in paragraph 11 of ED 5.

Furthermore, we think that changing the term "existing" accounting policies into "pre-existing" accounting policies in paragraph 12 of ED5 would refer more clearly to the accounting policies in place before application of the IFRS for insurance contracts.

De-recognition and offset
We agree with the proposals outlined in question 4 (b) (iii).

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?

Answer

We agree with the proposals set out in question 5.

It is unclear whether paragraph 16 only permits a change to an accounting policy if all other requirements of paragraph 16 are complied with, including for instance the elimination of excessive prudence. We believe that a change in accounting policy that moves away from any of the treatments discussed in the paragraph should be encouraged, even if other aspects remain unchanged. Therefore we would recommend that paragraph 16 be redrafted as follows:

> *"An insurer may continue using existing accounting policies that involve the following, but a new accounting policy that* ***introduces*** *any of them does not satisfy the requirements of paragraph 14:"*

We understand that allowing non-uniform accounting policies for insurance liabilities is necessary to achieve the objectives in paragraph 1(a). However, it is unclear in paragraph 16 whether a change made in accordance with paragraph 15 would need to be made in all subsidiaries or whether it can be made in certain subsidiaries as long as it does not create greater diversity in non-uniform accounting policies. We support the latter interpretation at this stage as it would encourage the earlier adoption of accounting policies that comply with IAS 8.

ED 5 Insurance Contracts

Responses to detailed questions

Question 6 – Unbundling

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

(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?

Answer

We agree with the proposals. Whilst the benefits of unbundling are significant, we consider that any further move towards unbundling would be unhelpful at this stage.

Question 7 – Reinsurance purchased

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).

Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?

Answer

We do not agree with the proposals relating to reinsurance purchased. Reinsurance contracts are principally insurance contracts, as indicated in paragraph 2(a) of the exposure draft, and as such should be treated consistently with other insurance contracts in accordance with local GAAP until Phase II of the Insurance project has addressed the appropriate accounting treatment. We note from BC90 that the Board's primary concern appears to be the risk of reporting a gain on buying reinsurance which is not representationally faithful because no economic gain occurred at that time. However, we note that this gain arises only as a correction of a previously overstated liability and therefore results in a more appropriate reflection of the entity's real exposure. The retention of local GAAP for such contracts would also minimise the systems changes required as a result of Phase I of the project, particularly since it is clear that the Board does not regard its proposals in paragraph 18 as permanent.

In the event that the Board decides to retain the proposals in paragraphs 18 and 19 of the exposure draft, we believe that the proposed drafting itself requires some amendment. In particular, paragraph 18(b) creates anomalies for certain types of contract and should be redrafted accordingly.

The anomaly can be illustrated by considering the example of a quota share term life reinsurance contract to which the insurance company can cede business written both prior to and subsequent to the inception of the reinsurance contract. Under such a contract, all business, irrespective of the date on which it was written, may cover periods of risk arising subsequent to the inception of the reinsurance contract. Under local GAAP the liability for the direct insurer will frequently be set at a level which creates a loss, frequently referred to as “strain”. If the reinsurance contract reduces that strain, it is likely that profit will be recognised at the time business is ceded to the reinsurance contract on business written both prior and post the inception of the reinsurance contract in relation to future periods.

We consider it appropriate to recognise profit relating to the transfer of risk in respect of future periods as this is consistent with the treatment of other reinsurance contracts which only cover business written subsequently. In order to ensure that there is no difference in accounting for future periods of risk, paragraph 18(b) needs to be redrafted to recognise that gain recognition is appropriate to the extent that the reinsurance covers such periods, irrespective of when the business was initially written. If, however, the Board intended there to be no gain recognition on any retroactive reinsurance, paragraph 18(b) should at least be redrafted to limit it to the business written prior to the inception of the reinsurance.

Furthermore we believe the rights resulting from a reinsurance contract meet the definition of financial assets under IAS 32 since they represent a contractual right to receive cash or another financial asset from another enterprise. Therefore we believe that, if the Board retains its proposed approach to reinsurance, it should amend paragraph 19 to require impairment to be measured in accordance with IAS 39 rather than IAS 36.

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

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

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

(b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets.* Its subsequent measurement would need to be consistent with the measurement of the related insurance

> **liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.**

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

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

Answer

We note that the general principles of fair valuing an acquired insurance business are not consistently applied around the world. Some countries make attempts to fair value such liabilities but others appear not to do so. In that respect, we welcome the clarification introduced with ED 5 that establishes the principle of fair value for the acquisition of insurance contracts.

We have considered the proposal in ED 5 paragraphs 20 to 23 and in particular the permission to allow an expanded presentation as set out in paragraph 20. Paragraphs BC93 et seq. set out the Board's rationale for allowing this relief from the general principle that assets and liabilities should be separately fair valued in accounting for a business combination. We agree with the principle of allowing this relief in the circumstances set out in BC93. However, we believe that paragraph 20 of ED5 potentially extends the relief to other circumstances which could lead to the inclusion of artificial assets on the balance sheet.

We do not support the creation of an asset balance which results simply from the discounting of a liability where the accounting policy of the reporting entity is to carry its liabilities at undiscounted amounts. Similarly, the application of excessive prudence in determining liabilities should not give rise to a debit balance in a business combination. We recommend that such adjustments should be presented as deductions from the liability balances determined under local GAAP rather than as assets.

We recognise that the acquired contracts will frequently be valued by acquirers including contractual cash flows that would not normally be included in arriving at a fair value under IAS 39. Companies will also often place a value on the investment margins they expect to obtain from the acquired portfolio. These assessments are frequently integrated into a portfolio valuation model that also eliminates the excessive prudence normally included in the local GAAP measurement of the liability. However, in those circumstances, it is not possible to extract the elements that reduce the liability. The comments in BC 94 to BC 99 do not make this entirely clear and we would welcome redrafting of these paragraphs.

We believe that the financial statements should disclose how acquired insurance contracts are measured post acquisition under the entity's accounting policies.

In particular, we agree that subsequent measurements of the acquired rights and obligations should take into account the unwinding of the difference between the fair values of the acquired insurance contracts and the measurement of the same rights and obligations under the entity's existing accounting policies. The unwinding should be consistent with the measurement of the related insurance liability as stated in paragraph 22 (b) of ED 5.

Question 9 – Discretionary participation features

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

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

Answer

We agree that it is not possible to establish appropriate accounting requirements for contracts with participating features until Phase II of the insurance project. At that stage it may be necessary to revisit the concepts of equity and liability since the current definitions do not appear to offer a satisfactory and reliable accounting treatment for these features.

It is essential that a strong burden of proof should be on the entity to demonstrate that the policyholders do not have an effective lien on the excess of assets over the established guaranteed obligations at the balance sheet date in determining the split between equity and liability, to ensure that an adequate liability is established.

Whether or not the unallocated surplus is split, disclosure of the policy selected, amounts involved and funds available for shareholder distributions in the notes to the financial statements is essential.

We support the Board's decision not to address the accounting treatment of discretionary participating investment contracts at this stage. IAS 39 is not designed to deal with such contracts and we support the proposal to defer establishing the accounting treatment of such contracts under Phase II.

We support the Board's proposal to ensure that a minimum liability is established for the fixed element but we do not consider it adequate to rely on a cross-reference to IAS 39 to establish measurement principles for this. The proposed amendments to IAS 39 recognise two possible methods for accounting for a liability – amortised cost and fair value – with a presumption that amortised cost is the primary policy for such instruments. However, it is not clear how the amortised cost of the fixed element of discretionary participating contracts should be measured, particularly in the light of our concerns about the lack of a reliable fair value methodology for the embedded surrender option if this is not exempted from the need for bifurcation.

In any event, for the reasons set out in our covering letter, we do not believe it is appropriate to use the surrender floor as the measure of the minimum liability. Any such proposal would pre-empt the discussion of the fair value of such contracts and does not reflect the real exposure of the insurance company to transfer financial assets in settlement of the liability.

To avoid confusion created by a cross-reference to a standard that was not intended to deal with such contracts, the standard should establish in its own right the accounting treatment for the minimum liability that would be acceptable for such contracts.

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

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

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

Answer

We accept the merits of fair value disclosures even if the recording of insurance assets and liabilities is not at fair value. However, we believe that it is premature to require fair value disclosure of insurance assets and liabilities before the Board has resolved significant issues about fair value measurement and has provided detailed guidance on the methodology used to perform such measurements. The proper sequence of events in order to produce relevant, reliable and comparable financial information should include debate and due process on the best methodology to produce fair value measurements, the issuance of guidance and a period of implementation (for preparers, users and auditors) before such disclosure is required in audited financial statements. We urge the Board to develop this guidance as soon as possible. In any event, fair value disclosure should not be required until the issues are resolved and guidance is available

In addition, we believe that it is equally inappropriate to require fair value disclosures for discretionary participating investment contracts for which there is no active market in the absence of any guidance on how these should be valued. This should be considered as part of the Measurement project and any requirement to disclose the fair values of such contracts should also be postponed until that project has been completed and subjected to appropriate due process.

Without the appropriate guidance significant additional disclosure of the methodology used would be necessary in addition to the more useful disclosures of underlying assumptions. This additional disclosure has the potential to be so voluminous as to discourage the user of financial statements to read them. We are also concerned about the auditability of these disclosures in the absence of an accepted methodology to allow the auditor to evaluate the reliability and relevance of those disclosures.

Question 11 – Other disclosures

ED 5 Insurance Contracts

Responses to detailed questions

(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 dsclosures 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?

Answer

We agree with the principles of the disclosures set out in paragraphs 26 and 27. We believe transparency in reporting is vital to reliable and relevant financial reporting. Guidance needs to be given on the level of aggregation that is appropriate to ensure that excessive disclosures are not made. The nature of insurance business is such that determining what might be a term or condition of any insurance contract that might have a material effect on the amount timing and uncertainty of future of future cash flows is a very significant challenge. We support a clearer statement on the purpose of the Implementation Guidance and, in particular, on the way it should be used to determine relevant succinct information.

We are concerned to note the precedent set by the disclosure requirements in paragraph 29 (c) (iii) relating to claims development. It is unusual to require disclosures relating to periods that predate the comparative period in audited financial statements and we consider that this may give rise to particular difficulties where there is a change of auditors. We believe it is more appropriate for such information to be included in the MD&A, as is the case in the US, and we would therefore encourage the Board to reconsider the decision to require this disclosure in the financial statements.

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

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

Answer

We agree with the proposal that IAS 39 should apply to all guarantees that are not formed as insurance contracts.

Question 13 – Other comments

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

Answer

We note that ED 5 makes reference to acquisition costs but that these are not defined in Appendix A. The following definition is included in BC71 and we suggest that it is included as a definition in Appendix A:

> *"Acquisition costs are the costs that an insurer incurs to sell, underwrite and initiate a new insurance contract."*

Significant insurance risk

B21 Insurance risk is significant if, and only if, the change in the insurer's contractual cash flows determined by the occurrence of the insured event is significant compared to the insurer's contractual cash flows that could arise at the same point in time from the non-occurrence of the insured event. If there are no contractual cash flows that can arise from the contract at that point in time (in both the case of the insured event occurring or not), the present value of corresponding future cash flows should be used to test if the insurance risk is significant. This condition must be met over a significant period of the total contractual exposure. In making this assessment only contractual cash flows arising from the occurrence or non-occurrence of the insured event are considered.

B22 An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements.* Thus, insurance risk may be significant even if there is a minimal probability of material losses for a whole book of contracts.

B23 It follows that if a contract pays a death benefit exceeding the amount payable on surrender or maturity, the contract is an insurance contract unless the additional death benefit is insignificant (when judged by reference to the contract rather than to an entire book of contracts). In relation to surrender values, this condition is met only if the surrender value is based on pre-defined non-discretionary surrender value charges. Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant.

B24 Paragraph B21 refers to the insurer's contractual cash flows arising from the occurrence and non-occurrence of the insured event. Insurance risk may arise solely as a result of changes of timing of cash flows. An example is whole life insurance for a fixed amount (in other words, insurance that provides a fixed death benefit whenever the policyholder dies, with no expiry date for the cover). It is certain that the policyholder will die, but the date of death is unknown. In this circumstance, the cash flows are adverse to the insurer as a result of the insured event occurring earlier. For these contracts the value to be considered as the contractual cash flows arising from the non-occurrence of the insured event is the present value (probability weighted) of the future contractual cash flows at the point in time the insured event occurs. In order for the insurance risk to be significant the change in cash flow on death must be significant compared to the value associated to the non-occurrence of the insured event calculated as explained above. This condition must be met for a significant period of time.

Changes in the level of insurance risk

B25 A contract that qualifies as an insurance contract, whether at inception or later, remains an insurance contract until all rights and obligations are extinguished or expire. If a contract did not qualify as an insurance contract at inception, the issuer shall reclassify it subsequently as an insurance contract if, and only if, the change in the insurer's contractual cash flows determined by the occurrence of the insured event becomes a substantial proportion of all of the insurer's contractual cash flows that could arise at the same point in time over from the non-occurrence of the insured event. This condition must be met over a significant period of the total contractual exposure. (see paragraph B21).

B26 If the issuer can foresee at inception an increase over time in the probability of a change in the insurer's contractual cash flows determined by the occurrence of the insured event compared to the insurer's contractual cash flows that could arise at the same point in time from the non-occurrence of the insured event, the contract is an insurance contract from inception, even if the expected change in the insurer's contractual cash flows determined by the occurrence of the insured event is very small at inception when compared to the insurer's contractual cash flows that could arise at the same point in time from the non-occurrence of the insured event. In other words, if an event can occur that makes insurance risk significant, the contract is an insurance contract from inception.

* For this purpose, contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.