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Dear Mr Clark

ED5 INSURANCE CONTRACTS

We welcome this opportunity to comment on the IASB's proposals for accounting for insurance business set out in ED5.

We generally welcome the approach taken in ED5 to provide a framework for insurers to report under International Financial Reporting Standards from 2005 in the absence of a full standard on accounting for insurance contracts. However we have some significant concerns with ED5 that are set out below within the responses to the specific questions posed.

<u>Question 1 – Scope</u>

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

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

(i) ***assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 Financial Instruments: Recognition and Measurement and IAS 40 Investment Property.***
(ii) ***financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts (paragraphs BC115-BC117).***

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

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

The application of IAS39 to contracts that do not satisfy the definition of an 'insurance contract' and do not contain discretionary participation features is unclear and will represent a significant systems implementation challenge for many insurers. This is partly due to on-going uncertainties regarding how to apply IAS39 to such contracts. In this regard we are concerned that the guidance on the application of IAS39's fair value measurement basis contained in BC117 results in a valuation basis which we believe does not satisfy the definition of 'fair value' as set out IAS39 (Para 8), due to the proposed deposit floor in BC117e.

The distinction between insurance contracts and investment contracts has a potentially significant impact on revenue recognition within an insurer's income statement where existing accounting policies recognise all contributions received as revenue whilst deposit accounting is to be adopted for contracts subject to IAS 39. We believe there is significant scope for inconsistencies between companies in the approach taken to revenue recognition for similar types of contracts depending on how contracts have been structured and whether companies choose to voluntarily unbundle contracts satisfying the 'insurance contract' definition but which contain a significant investment element. This scope for inconsistency has the potential to undermine the clarity and comparability of insurers' financial statements.

We accept that there is a need to develop a consistent standard for revenue recognition, as for liability measurement, across all long-term savings and investment products. Phase II will address revenue recognition for insurance contracts but during Phase I the approach taken in ED5 (BC115) of requiring deposit accounting for contracts subject to IAS 39 is likely to increase inconsistencies between companies.

Question 2 – Definition of an Insurance Contract

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

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

We note that the guidance on the test for significance of insurance risk in B21-B24 is ambiguous. Where death is the insured event it is not clear whether the amount to be compared against the present value of expected net cash flows in B21 is the change in those cash flows as a result of the insured event or the excess of this latter amount over the change which would have resulted had the contract been terminated at the option of the policyholder on the same date. Furthermore B23 suggests a test based on gross cash flows under the contract.

We also note an inconsistency between B26 and IG 2 (Example 1.6) which asserts that deferred annuities, where the policyholder can elect to receive a life-contingent annuity at rates prevailing when the annuity begins, are not insurance contracts from inception. B26 notes that ‘if the issuer can foresee at inception that the probability or present value of a significant loss may increase over time the contract is insurance from inception…’. UK tax regulations require a minimum proportion of the accumulated fund under a deferred pension annuity to be converted into a lifelong annuity. Where the conversion is made on the basis of annuity rates prevailing at the time of conversion, there may be no reason to expect those rates to differ significantly from those available elsewhere in the market. It may therefore be expected that a significant proportion of contract holders will choose not to transfer the fund to another annuity company. The issuing company could therefore anticipate bearing the longevity risk in respect of those contract holders. Applying B26 to these contracts could therefore justify classification as insurance from inception.

<u>Question 3 – Embedded derivatives</u>

(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?***

We note ED5's assertion in IG4 Example 2.15 that a policyholder option to surrender a contract for an account value based on the fair value of a pool of equity investments is an embedded derivative. Unit-linked business written by insurers satisfies this description. However this is not an intuitive way of describing such contracts and is likely to lead to confusion regarding the measurement requirement for insurance contracts that include unit-linked liabilities. Where the existing accounting policy for unit-linked business values the liability based on the fair value of the pool of equities, no separation of this embedded derivative should be required.

The application of IAS39's 'closely related' criteria to interest rate floors within insurance contracts and contracts with discretionary participation features will be based on an analysis of whether such features were in or out of the money at the inception of the contract. This could lead to spurious distinctions between those contracts where fair valuation of these features is required and those where it is not required.

In effect the proposals in ED5 will lead to the requirement during Phase I to separate and fair value only some of the embedded guarantees and options within contracts issued by insurers. This will be a temporary requirement given that Phase II is expected to require the fair valuation of these liabilities. Given that the loss recognition test required by Paragraphs 11-13 provides a safeguard that the carrying value of the liability is sufficient we believe that during Phase I insurance contracts and investment contracts containing discretionary participation features should be exempted from the embedded derivative requirements of IAS39.

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

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

(i) ***insurance contracts (including reinsurance contracts) that it issues; and***
(ii) ***reinsurance contracts that it holds.***

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

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

(b) ***Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:***

(i) eliminate catastrophe and equalisation provisions.

(ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies.

(iii) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC58-BC75 of the Basis for Conclusions).

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

We do not believe that it is helpful to include a time limit on the exemption from IAS 8. This exemption should remain in place until Phase II is finalised.

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?

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

Question 6 – Unbundling

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

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

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

(c) ***Is it clear when unbundling would be required? If not, what changes should***

be made to the description of the criteria?

We agree with the proposals in ED5 that insurers should only be required to unbundle deposit components from insurance contracts where the application of existing accounting policies does not require the recognition of an obligation to repay amounts received.

Question 7 – Reinsurance

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?

We do not agree with the proposal that the value placed on the rights under a reinsurance contract at inception be restricted to the amount paid to the reinsurer. Where insurance contract liabilities are valued on a prudent basis under existing accounting policies and are then reinsured, a consistent accounting basis is achieved by recognising the rights under the insurance contract based on similarly prudent assumptions.

Question 8 – Insurance contracts acquired in a business combination

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?

We believe these proposals are appropriate.

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

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

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

We welcome the approach taken in ED5, to defer consideration of how unallocated surplus should be analysed between liability and equity until Phase II. Our interpretation of ED5 as drafted is that insurers will have the freedom during Phase I to carry the entire unallocated surplus as a liability.

We believe that it is not appropriate to apply IAS 32's requirement to disclose the fair value of investment contracts with discretionary participation features as consideration of the measurement of such contracts has been deferred to Phase II.

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

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

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

We do not believe it is appropriate to require the disclosure of the fair value of insurance contracts in advance of the finalisation of Phase II. Sufficient time should be allowed to field test the Phase II fair value proposals and to allow companies to develop the systems required prior to requiring the inclusion of the fair value of insurance contracts and contracts with discretionary participation features in the financial statements.

<u>Question 11 –Other disclosures</u>

(a) ***The Exposure Draft proposes requirements for disclosures about the amounts in the insurer's financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of***

the draft Implementation Guidance).

Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.

To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.

(b) ***The proposed disclosures are framed as high level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements.***

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

(c) ***As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS (paragraphs 34, BC134 and BC135).***

Should any changes be made to this transitional relief? If so, what changes and why?

We agree with the principles set out in Paragraphs 26 and 28. We note the need, as expressed in IG34, for "a balance between overburdening the financial statements with excessive detail and obscuring significant information as a result of too much aggregation". We are therefore concerned that the proposed disclosures set out in the implementation guidance, which in their entirety would represent excessive detail, become viewed as mandatory rather than advisory.

Question 12 – Financial Guarantees

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

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

We have no comments on this proposal.

Question 13 – Other comments

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

We have no further comments.

Yours sincerely

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