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Dear Mr Clark

ED 5 – INSURANCE CONTRACTS

This is the response of Aviva plc to ED 5 " Insurance Contracts". As the world's seventh largest insurance group and the largest insurer in the UK, we are pleased to have the opportunity to comment on the proposals that will have a significant impact on the financial statements of all businesses writing insurance contracts.

Our strong preference would have been to have had a final and comprehensive standard on accounting for insurance contracts prior to having to adopt International Financial Reporting Standards ("IFRS") for the first time in 2005. This has not proved possible, and many of our comments on ED 5 reflect that the International Accounting Standards Board ("IASB" or "the Board") has issued ED5 as an interim step towards a more final solution. The fact that both the IASB and its predecessor have been unable to complete a final accounting standard for insurance contracts, despite the project having first begun in 1997, is indicative of the complexity involved in arriving at a solution that meaningfully reflects the economic reality of the insurance business.

We would not have wanted a final standard to be issued that had not been adequately debated and field tested and recognise that, by issuing ED5, the IASB has tried to ensure that extensive accounting changes will not be required twice for those contracts meeting the definition of insurance. This does mean that ED5 falls short of achieving the ultimate objective of comparability between insurers applying IAS. This will not be achieved until the Phase 2 standard becomes effective.

We remain committed to working with the IASB and all interested parties to deliver Phase 2. The compromises contained within ED 5 should not be allowed to prevail for more than the short-term. From our perspective ED 5 is an unwelcome but necessary fix for a short-term problem recognising the EU IFRS implementation timetable.

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Given the very tight deadlines in preparing for the implementation of IFRS in 2005, Aviva, along with many of its peers, is already having to address many of the practical issues of implementing ED 5. This is despite the risks this presents in terms of not having the confidence of a final standard being in place. We are already in a position to judge whether the IASB has been successful in its objective of minimising unnecessary changes in Phase 1. In a number of practical respects, which we highlight in our detailed comments, we are concerned that this is not the case and have suggested changes to mitigate this.

We have the following fundamental concerns with the exposure draft and these are detailed below:

a) Fair value disclosures

We strongly oppose the requirement to disclose the fair value of insurance contracts from 2006 within this Phase 1 standard. The Board has made clear that the method of calculating fair value is a Phase 2 issue and there is currently no clear guidance on how the IASB will interpret "fair value" in an insurance contract context. It is not appropriate to mandate a requirement within ED 5, when the guidance underpinning that requirement has still to be exposed and debated. Instead, the disclosure of fair values could be a transitional implementation requirement for Phase 2.

Even if these principles are established prior to the need to report this information, they will still need to be field-tested and systems updated accordingly. The timescales are such that this will result in a significant increase in resource and costs. The inclusion of this requirement therefore goes against the very objective that the IASB has set itself, i.e. not to impose costs that exceed the benefits of any information given. We believe this disclosure requirement should be deleted. Failing this the Board should permit the use of embedded value information to meet this requirement.

In addition we do not believe it is appropriate to require the disclosure of the fair value of investment contracts with discretionary participating features as required by IAS 32. The Board has already acknowledged, by deferring its consideration of the accounting for such features until Phase 2, the complexity of measuring such amounts, especially in the absence of any fair value accounting principles for long-term insurance contracts. This should be deferred in line with the disclosure of fair value for insurance contracts as discussed above.

b) "Sunset" Clause

We do not believe that the "sunset" clause serves any useful purpose in this (draft) standard. We welcome the IASB's commitment to finalising Phase 2 quickly, although we stress the need for proper consultation and field-testing. This should be achieved as part of a robust project plan, which the IASB should seek to develop with the industry.

If the Board achieves the Phase 2 timetable it has set itself (and the timetable is ultimately under the control of the IASB), then the "sunset" clause is redundant and serves no purpose. However, if the Board does not meet the deadline, accounting for insurance becomes unclear and will certainly lead to confusion and unnecessary work and costs amongst both preparers and users.

We recommend that the "sunset" clause is removed and that instead the IASB sets out clearly in the introduction to the standard exactly how it intends to complete the Phase 2 of the insurance standard to meet the 2007 deadline. We believe that Phase 1 requirements should prevail until Phase 2 is in place.

c) Scope and definition of an insurance contract

In Phase 1, insurers are required to apply the definition of insurance constructed by the IASB. This will result in a significant number of insurance contracts being considered financial instruments for accounting purposes and being accounted for in accordance with IAS 39. Other contracts will fall under the provision of ED 5 and, in due course, the Phase 2 insurance standard.

This classification decision is highly judgmental, appears irreversible, yet is made with no existing clear or proven method of accounting for either contracts that fall under IAS 39 or those that will fall under Phase 2 of the insurance contracts standard. We are particularly concerned about the lack of an established method for applying IAS 39, especially as the IASB proposals appear to have changed recently without any work done to demonstrate whether the current proposal (i.e. sometimes referred to as the 'deposit floor method') is meaningful or workable. Consequently we are concerned that many accounts preparers will tend to adopt an insurance contract classification even if this may not prove to be the most appropriate long-term interpretation of the definition. This is an understandable response given that at the current time IAS 39 is not, in our view, an appropriate accounting solution for insurance products with investment type characteristics. In our response to question 2 we propose a number of strategies the IASB could adopt to mitigate the risk of this undermining the relevance of insurance financial statements in the long-term.

d) Application of IAS 39 to long term contracts

As noted above, in the absence of any guidance on how to apply IAS 39 to the long-term insurance contracts that now fall under its scope, there remains significant uncertainty as to the effect Phase 1 will have on insurers. Of all the issues regarding the application of IAS 39, the most significant is the IASB's recent decision that sets the fair value of a financial liability with a demand feature at not less than the amount payable on demand ("the deposit floor method"). This is inappropriate for long term insurance contracts, event if they fall to be accounted for under IAS 39. The method appears inconsistent with both the going concern concept and the IASB Framework, which indicates that excessive prudence is not compatible with reliable financial statements or (economic) fair value. We would recommend that the Board reconsiders the appropriateness of this requirement.

e) Phase 2 proposals

In general we support a fair value approach to accounting for insurance. However we do not believe that the tentative conclusions reached by the IASB for Phase 2 will result in an accounting model that is economically meaningful and believe they could have a significant impact on the products offered by insurers in the future. For our long term contracts in particular, we support a move to an enhanced and improved methodology based on the existing embedded value model, which is based on a tried and tested approach designed to reflect the economic nature of our business. We have outlined our specific concerns regarding the Phase 2 tentative conclusions within our response to question 13.

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We note that the IASB has attempted to cement some of these tentative conclusions with the (draft) standard by placing restrictions upon the accounting policy changes permitted within Phase 1. We believe that such restrictions actually prevent companies from moving to a model, such as an enhanced embedded value model, that would actually be more relevant and reliable in many cases as this is more akin to a fair value accounting methodology than accounting for insurance under most GAAPs.

We are committed to working with the IASB to address and resolve the practical and conceptual difficulties some have with aspects of embedded value with a view to achieving a conceptually robust and economically meaningful basis of accounting for insurance business. However we believe that it is essential that maximum flexibility is retained within Phase 1 to enable us and others to develop such an approach that can then be fully debated as part of the Phase 2 consultation process. We therefore strongly recommend that the Board removes paragraphs 16 (c) and 16 (d), which prohibit the recognition of future investment margins and future investment management fees within the measurement of insurance liabilities, from the (draft) standard.

Our responses to the questions raised within the exposure draft are attached in appendix A to this letter.

Yours sincerely

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Appendix A: Aviva Response to the questions asked within ED5 'Insurance Contracts'

Question 1: Scope

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

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

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

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

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

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

a)

Scope of exposure draft

We believe that it is unsatisfactory that the exposure draft does not apply consistently to all aspects of accounting for insurance contracts that meet the definition. In particular we would have preferred that policyholders were included within the scope of the standard, as we believe that both parties to a transaction should apply the same principles.

Insurance is important to all businesses operating within a modern economy. Insurance can have a material impact on the wider economic environment, including the full range of companies including manufacturers, retailers and other purchasers of insurance contracts. By excluding policyholders and certain contracts that meet the definition of insurance the Board, despite their intentions, has created an industry specific standard.

We do not believe that product warranties issued by retailers should be excluded from the scope of the standard, where they clearly meet the definition of insurance. Indeed the extended warranty products offered by some retailers have the same economic substance as insurance. Furthermore we believe that it is important that the Board is clear that the standard should apply to contracts written by "captive" insurance companies, when these companies write contracts with third parties that goes beyond self-insurance.

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We recognise, however, given that the IASB has had insufficient time to debate all the issues arising, that these are lower priority items. It is essential that such matters are covered by the Phase 2 insurance standard, so that there is consistency across all aspects of accounting for contracts meeting the definition of insurance in all businesses.

Asset/liability matching

We note that the IASB has decided to exclude assets that back insurance liabilities from the scope of the standard. As has been well publicised, during Phase 1 this will result in a mis-match in the accounting bases of assets and liabilities in some cases. The financial statements produced will reflect the volatility of the valuation of those assets, even if in practice, over the longer term, assets and liabilities are well matched. This is unfortunate and could reduce the relevance of financial statements. We would encourage the Board to consider ways of removing the impact of such volatility. For example, we are aware that it has been suggested one possible approach to mitigate this is to be exempt, temporarily, fixed maturity investments backing insurance contract liabilities from the application of IAS 39. This is particularly relevant to those insurers who value their liabilities at amortised cost.

An alternative would be to use a presentational adjustment within performance reporting to present results based on a longer-term investment return basis, separately from short term fluctuations, similar to the presentation used within the UK insurance reporting. We believe that this enables users to understand the impact of short-term volatility on the financial statements and is supported by analysts.

b) Weather Derivatives

We agree weather derivatives should be treated as insurance where they meet the definition.

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?

Application of the definition within Phase 1

The IASB has spent considerable time and effort constructing a definition that we believe forms a reasonable basis for establishing relevant and reliable insurance contract accounting once the Phase 2 solution is implemented. However, as noted in the introduction to this letter, preparers of financial statements will be required to apply this definition within Phase 1.

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Application of the definition within Phase 1 (continued)

This classification decision is highly judgmental, appears irreversible, yet is made with no existing clear or proven method of accounting for either contracts that fall under IAS 39 or those that will fall under Phase 2 of the insurance contracts standard. We are particularly concerned about the lack of an established method for applying IAS 39, especially as the IASB proposals appear to have changed recently without any work done to demonstrate whether the current proposal (i.e. sometimes referred to as the 'deposit floor method') is meaningful or workable. Consequently we are concerned that many accounts preparers will tend to adopt an insurance contract classification even if this may not prove to be the most appropriate long-term interpretation of the definition. This is an understandable response given that at the current time IAS 39 is not, in our view, an appropriate accounting solution for insurance products with investment type characteristics.

In light of this, preparers of financial statements should not be required to irreversibly apply the definition as part of Phase 1. This could be achieved in several practical ways;

- adopt a temporary legal form based definition of insurance and then revert to the proposed definition for Phase 2, effectively suspending the definition in phase 1; or
- all contracts written by regulated insurers that do not meet the ED 5 definition of insurance but do meet the local legal definition of insurance could be temporarily exempted from IAS 39, until the IAS 39 treatment for these contracts is established appropriately; or
- grant an opportunity to revisit the classification decision on applying Phase 2.

Our preference would be for the Board to decide to adopt the second approach, which would enable the proposed definition of insurance to be adopted now, but without IAS 39 being applied at this stage. This will result in the preparers of financial statements taking a more substance based approach to contract classification in the long term and the definition is more likely to be consistently applied. Appendix B outlines our suggested amendments to the exposure draft to effect such a change.

It is our understanding that the Board is extremely reluctant to adopt the approach outlined above. If our proposal is rejected, we would strongly urge the Board to allow redesignation of all contracts upon implementation of Phase 2, so that the classification decision can be undertaken in the context of the final proposals. This would not require an amendment to the current exposure draft but would need to be addressed as part of Phase 2.

Use of "investment contract" within the exposure draft

In any event, irrespective of the final definition of an insurance contract, we believe that care should be used when using the term investment contract when referring to the products of insurance companies. The legal definition of an insurance contract is important for both tax and regulatory purposes and legally these contracts are insurance contracts. We recognise that the Board makes clear in its basis of conclusions that the accounting definition is not relevant for any such requirements, but it is our view that the scope of the standard itself should refer to 'insurance contracts for accounting purposes' and 'insurance contracts which are financial instruments for accounting purposes' so that no confusion arises.

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Application of the definition to contracts with negative mortality risk

The standard should clarify that policies that pay less than the maturity amount if the policyholder dies within the term of the policy should be considered insurance contracts, the insured event being survival. Appendix B23 states that '*it follows that if a contract pays a death benefit exceeding the amount payable on surrender or maturity, the contract is an insurance contract…'.* However, within the implementation guidance (IG2 example 1.4), it states that if the policyholder receives a payment on survival to a specified date, but beneficiaries receive nothing if the policyholder dies before then this would not be classed as an insurance contract '*unless there is a significant probability that the holder will not survive until the specified date'.*

This results in an anomaly within the definition of insurance. If a contract pays out significantly more on death than on maturity, then the exposure draft requires the insured event of death need only be plausible to meet the definition of insurance. However where that paid on death is significantly less than that paid upon maturity, the exposure draft requires there to be a significant probability that the insured event, in this case survival, will not occur. Our recommendation would be that appendix B23 be amended to as follows:

" It follows that if a contract pays a death benefit exceeding the amount payable on surrender or maturity, or pays a maturity benefit exceeding the amount payable on death, the contract is an insurance contract unless the additional death benefit or maturity benefit is insignificant (i.e. trivial, judged by reference to the contract rather than to an entire book of contracts.) 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.'

We believe that this better reflects the fact that in both the types of contract described above there is similar insurance risk, the first, i.e. where the death benefit exceeds the maturity value, representing the insured event of death and the second, where the maturity value exceeds the death benefit, representing the insured event of survival. Both contracts expose the insurer to similar cash flow patterns depending on whether or not the insured event occurs.

We would also believe that the Board should extend this principle to temporary life contingent annuities, and to clarify in the final standard that these meet the definition of insurance.

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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

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?*

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?

(c) *Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?*

a) Proposed exemptions from IAS 39

We welcome the fact that the Board has recognised that given the issues still to be considered under Phase 2 of the insurance standard, that it would be inappropriate for insurers to attempt to unbundle and fair value embedded derivatives that meet the definition of insurance.

We also believe that surrender options of a fixed amount or of an amount based on a fixed amount and an interest rate could be deemed to be closely related to the host contract and so agree with the Board that there is no need to unbundle in these circumstances.

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However, we do not agree with paragraph 6 in full, which includes the requirement to separate out a put option or cash surrender option if its value varies with the change in a commodity or price index. This would not be appropriate for contracts such as unit-linked contracts, where the value of policyholders' liabilities matches the value of assets underpinning them and so the surrender value varies with price indices by the very nature of the contract. We would request that ED 5 is amended so that the Board confirms that there is no requirement to separate and account for separately any element of a unit linked contract, or similar contracts where the policyholder liability is related to the assets backing that liability, as an embedded derivative.

b) Embedded derivatives that transfer significant insurance risk

Given that the detailed guidance surrounding the use of fair value for insurance contracts is still to be developed we agree that it is appropriate that embedded derivatives that transfer significant insurance risk are excluded from the scope of IAS 39, even where these items are predominantly financial such as guaranteed annuity options. The valuation of such items will require sophisticated stochastic modelling techniques that will require time to developed and constructed and it would be costly if these needed to be changed as the results of decisions made within Phase 2.

c) Disclosures

The proposed disclosures regarding the embedded derivatives discussed in (b) above are sufficient. Given the difficulties in calculating fair values for such amounts as set out above, we would not wish to see a requirement to disclose fair value for such amounts, but agree that it would be useful to provide disclosure of the effect that such items could have on an insurer's financial position. In view of this we would delete paragraph IG58, as the status of this paragraph is unclear and we believe paragraph 29(e) is sufficient to improve the disclosure in this area.

d) Other exemptions

See comments under (a) above.

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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 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?

a) <u>Exemption from the hierarchy</u>

We strongly support the IASB's decision to grant an exemption from paragraph 5 and 6 of IAS 8. As the IASB points out without this exemption insurers could be forced into two costly systems changes, due to changes in accounting, in a relatively short space of time.

<u>"Sunset" Clause</u>

We have significant concerns over the use of the "sunset" clause of 1 January 2007 as set out at the start of this response and believe this should be deleted. If this exemption expires without a suitably developed Phase 2 solution in place, insurers would be faced with problems of fitting general accounting solutions around their complex products. The Board has already acknowledged, by prioritising its project on insurance, that this would result in poorer financial reporting for such business and auditors would be asked to report on compliance with an uncertain basis. Furthermore, it would be unacceptable if insurers were forced to invest the time and expense of three accounting system changes in less than a decade, firstly from the need to implement Phase 1, secondly to interpret and adopt IAS 37 in an insurance context and finally to implement the Phase 2 standard when eventually issued.

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"Sunset" Clause (continued)

If such a clause were to be included in the final standard, the IASB would have to devote resources and do everything it could to ensure that a fully developed and discussed Phase 2 standard is in place by early 2006. We would not wish to see a reduction in the consultation and discussion of Phase 2, in the context of a robust project plan that the IASB should seek to develop with the industry, as a result of the need to meet the sunset clause deadline.

We support a rapid move towards a well developed and field-tested Phase 2 solution. If this can not be achieved by 2007 then Phase I requirements should prevail. We consider the Board should replace the sunset clause with a similar strong commitment to moving to a Phase 2 solution without undue delay including an outline of how it intends to achieve this.

b) Catastrophe and equalisation provisions

We agree that it is appropriate to prohibit the use of catastrophe and equalisation provisions. We also agree that insurance liabilities should be kept in the balance sheet until they are discharged, cancelled or expired and should be stated gross of insurance assets.

Loss recognition test

We agree with the Board that it is appropriate to include a form of loss recognition test within the Phase 1 insurance standard so that insurers recognise material and reasonably foreseeable losses. However given that accounting policies will vary across the world it is difficult to formulate the requirements behind such a test. We believe the provision as drafted could lead to confusion in those countries where regulatory requirements mean that reserves are sufficiently prudent but a different form of loss recognition test is applied. We recommend that the requirement is amended so that rather than requiring a formal loss recognition test to be carried out, an entity need only demonstrate that its method of calculating insurance contract liabilities is sufficient to meet its expectations of net future cash flows after allowing for DAC and any intangible assets.

We note that the Board does not intend to specify on which level such a loss recognition test should be carried out. In our view is that it is appropriate to use a portfolio level given that insurance represents a pooling of risks.

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?

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a) Changes in accounting policy

We agree with the general principle that changes in accounting policies should only be made if they are more relevant and reliable. However the restrictions contained within paragraph 16 seem out of place in an interim standard that is focusing on maintaining the status quo until the Phase 2 standard is issued.

We believe the Board should clarify exactly what constitutes a change in accounting policy for the purpose of paragraph 16. For example, we understand that some parties are interpreting that a change in presentation of an entity's results, such as an expansion of the general insurance result from a single line to a multi-line presentation constitutes such an accounting policy change, which we believe is inappropriate. We would ask that the Board clarifies its intention in this regard, but should be mindful of the significant cost implications of applying the interpretation outlined above. We believe that the standard should permit incremental accounting policy changes.

Accounting policy restrictions and embedded value

The Board seems to have focused on the elements of embedded value reporting with which it disagrees. This is a methodology developed principally by the UK life insurance industry to find a more relevant and reliable way of presenting their results than that provided by their local GAAP. The question arises as to why the Board chose to focus on this in Phase 1 and did not list the elements of other insurance accounting bases (for example US GAAP) with which it disagrees. Our observation of IASB meetings suggest that this is because these principles have been presented to the Board in an unbalanced fashion and have not yet been given the consideration they deserve.

We believe that much of paragraph 16 deals with issues that should be considered as part of Phase 2. In our view expectations about the performance of assets and the cash flows expected to arise from the policy, including investment management fees are essential parts of the fair value of any insurance contract, if such fair value is to be economically meaningful. We recognise, however, that this debatable and the right context for such a debate is in the context of the due process of setting a Phase 2 standard.

In the meantime, we believe a move to an enhanced and improved embedded value would actually be more relevant and reliable in many cases as this is more akin to a fair value accounting methodology than accounting for insurance under most GAAPs. Any insurers considering such a change would clearly do so in the context of the likely requirements of Phase 2, which they would eventually be obliged to follow. Unfortunately, however, the restrictions in paragraphs 16 (c) and (d) will prevent us from developing embedded value reporting in the context of our IFRS accounts. This is a retrograde step that will undermine any efforts we might wish to make to move towards more relevant financial reporting.

b) Redesignation of assets upon Phase 2

We welcome the Board's decision to allow insurers to redesignate their investments upon a change in accounting policy for valuing insurance liabilities. However we would prefer that the clause be extended so that redesignation into any investment category was permitted.

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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?

We welcome the Board's recognition that to require unbundling of all deposit components from insurance contracts would be an onerous requirement and would require costly system changes that may need to be reversed upon the introduction of Phase 2. Furthermore once Phase 2 is introduced the accounting for insurance and investment contracts are likely to move to a more comparable fair value basis and so the need for unbundling will be removed. Hence we agree with the Board's statement within BC34 that unbundling should only be required when it is easiest to perform and the effect is likely to be greatest.

We would however note that exactly which types of contract should be unbundled is ambiguous and is likely to be the subject of much debate. To avoid this our preference would be that no insurance contracts should need to be unbundled during Phase 1, especially as the need to recognise obligations under a contract is already addressed through loss recognition tests.

We believe that, at a minimum, the requirement to unbundle should be redrafted so that there is a requirement to unbundle only if the cash flows of the insurance component do not impact at all with the cash flows of the deposit component.

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?

The Board acknowledges in paragraph BC92 that its proposals are conceptually imperfect and will not be required for Phase 2. It, therefore, seems inappropriate for the Board to adopt these proposals when its objective is not to create accounting changes that are likely to be reversed in the near future.

Furthermore, although we agree that there is an anomaly in the accounting for reinsurance contracts, in an accounting framework that is focused on the balance sheet it seems inappropriate to value the asset arising from a reinsurance contract in a manner that is inconsistent with the underlying liability that is being reinsured. The loss recognition test should be sufficient to ensure excess profits are not recognised.

This is particularly the case with regards to the requirement to apply IAS 36 'Impairment of Assets' to rights under a reinsurance contract. This could be interpreted as requiring a net present value approach to valuing the reinsurance asset representing a receivable for claims paid or to be paid, whereas the underlying liability can remain undiscounted under ED 5. This would have a significant impact on the accounting practices of the insurance industry that is likely to be reversed under Phase 2. This change would also have significant system implications.

To avoid any confusion we suggest that paragraphs 18 and 19 should be removed from the final Phase 1 standard.

At a minimum we believe that paragraph 18 (d) should be amended so that any deferral of profit upon inception of a reinsurance contract should be reflected as a separate deferred income liability, rather than a reduction in the value of the reinsurance asset established. As noted above we believe that it is important that assets and liabilities relating to the same underlying insurance contracts should be measured on a consistent basis. The setting up of such a deferred income liability would be consistent with other accounting bases such as US GAAP.

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?

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We believe that it is appropriate to measure at fair value insurance assets and liabilities acquired as part of a business combination and welcome the Board's recognition that a significant change to the accounting applied to such acquisitions would not be practical as part of Phase 1. However, the proposals contain no guidance on how such fair values should be measured. The guidance refers to VOBA and PVIF, but is silent on how the acquisition of general insurance business should be treated. Furthermore it is unclear whether an entity should continue to use its existing accounting policy to calculate VOBA or PVIF amounts, or whether it should be based on the Board's tentative conclusions included within the Basis of Conclusions for Phase 2. We would like to see the Board provide guidance on how such amounts should be measured.

In any event we believe that entities should be allowed to revisit the accounting of historic acquisitions upon implementation of Phase 2, so that it can restate the fair value of insurance assets and liabilities acquired to be consistent with the definition of fair value in Phase 2. This would require a corresponding adjustment to goodwill. If such a restatement were not permitted, insurers' accounts would be prepared using two definitions of fair value, one for purchase accounting and another for historic accounting. We consider that this is inappropriate in the context of relevant and reliable accounting.

The weakness of having an interim standard means that it is difficult to resolve the issues outlined above. If the Board is unable to provide definitive guidance on the definition of fair value at this stage we strongly recommend that an additional clause is added to paragraph 20 which says:

> ' Until the Phase 2 insurance standard is issued, companies should use existing accounting policies to calculate the intangible asset referred to above. Any changes to these policies should meet the general requirements within paragraphs 14-17 on changes to accounting policies. Upon adoption of Phase 2, companies will be permitted to revisit acquisition accounting to bring the fair values of insurance assets and liabilities acquired into line with the requirements of the Phase 2 standard, with a corresponding adjustment to goodwill.'

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?

We agree with the Board that the time to consider the accounting treatment of discretionary participation features is Phase 2 of the insurance standard. We believe that this should apply to all aspects of accounting for such contracts, including disclosure and so that IAS 32 should not apply to such contracts under Phase 1. This should be made clear in paragraph 2 of the exposure draft. In our view, the disclosure requirements of the exposure draft are sufficient to cover contracts containing discretionary participation features.

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In any event we strongly oppose the requirement within IAS 32 to disclose fair value for contracts with discretionary participating features that do not meet the definition of insurance. The Board has already acknowledged, by deferring its consideration of the accounting for such features until Phase 2, the complexity of measuring such amounts, especially in the absence of any fair value accounting principles for long-term insurance contracts. The requirement to disclose fair value for such contracts should be deferred until Phase 2. Paragraph C 4 of the (draft) standard should be updated so that the following sentence is inserted after the sentence ending *"… distinction between financial liabilities and equity instruments."*

> " Furthermore such contracts are exempt from the requirement in paragraph [77] to disclose fair value."

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

As noted at the start of this letter we are fundamentally opposed to the requirement to disclose the fair value of insurance contracts as part of Phase 1 of the insurance standard. It is not appropriate to mandate such a requirement in a standard that provides no guidance on how that fair value should be calculated. Such a requirement would be more appropriate as a transitional arrangement in the final standard on insurance accounting.

We welcome the Board's move to fair value model in Phase 2 but we believe that given the time required and cost of changing systems to produce such fair value information, no such disclosures should be provided until the Phase 2 standard has been issued. We note that the exposure draft of IAS 32 provides an exemption from valuing unquoted investments at fair value if this cannot be reliably measured. Furthermore, within BC 109(d) of the (draft) standard, it is noted that the IASC agreed that fair value need not be applied to the measurement of originated loans and receivables due to the difficulties in estimating the fair value of such items. Until Phase 2 is finalised, there will be no firm definition of fair value and insurers are likely to take different views on its meaning. We therefore believe that such amounts cannot be reliably measured and will result in the publication of financial statements that are inconsistent across the industry.

It should be noted that we do support the disclosure of value-based reporting, such as that prepared in accordance with the embedded value methodology. Our preference would be for such information to be included within the Operating and Financial Review or as supplementary information at the discretion of the preparer. However, at a minimum the Board should permit embedded value information to meet the fair value disclosure requirement above if this disclosure requirement remains in the final standard.

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Question 11 – Other disclosures

(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?

a) <u>Disclosure principles</u>

We are generally supportive of the IASB's proposals set out in paragraph 26-29, which will promote transparency and comparability. However we believe that it is important that disclosures should balance qualitative and quantitative information, which should be user-friendly but not cause undue cost or effort. We have a number of specific concerns over the relevance of some of the disclosure requirements, as set out below:

Paragraph 29 (b) – the requirement to disclose the terms and conditions of insurance contracts will be impractical in anything other than very broad terms for a large multi-national group such as Aviva. We would note that we already disclose this in the regulatory returns for those parties that are interested in this information. We recommend that this paragraph be deleted as impractical.

Paragraph 29 (c) (i) – We see such a requirement as impractical in a large Group where varying accounting assumptions are used across countries and different lines of business. The time and cost implications of re-running actuarial valuation systems several times, in order to provide such sensitivity analysis, will impose costs that will far outweigh any benefit to the user. We recommend that the inclusion of such quantitative information be required only where practical and the Board includes a statement that a qualitative discussion of the variables involved is sufficient to meet this requirement.

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Paragraph 29 (c) (iii) – We believe that this requirement is onerous and will be extremely costly for insurers to prepare. In countries where claims development tables are already provided, such as in the US, such information is provided only for general insurance business and is included within the management commentary attached to the financial statements. The effect of producing historic data to an auditable standard will be onerous for many insurance companies, particularly those who have undergone significant acquisitions or disposals in recent periods.

We do not believe that such information is relevant or meaningful for any aspect of life insurance business and so any disclosure requirement should be restricted specifically to general business only. Such information is only meaningful if disclosed both gross and net of reinsurance.

If the Board insists that claims development tables must be included within the financial statements, further clarification is required on which basis should be used to prepare them. It is assumed that the basis to be selected (namely accident or underwriting) should be consistent with the Basis of Account used by an insurer under Phase 1. For UK GAAP this is an accident year basis. However, the IASB is not specific on the requirement and indeed shows only one example based on an underwriting year within the implementation guidance. Given that Phase 2 may see insurers move to an underwriting year basis, we are keen that maximum flexibility is maintained for Phase 1 when providing claims development information as we believe it is only appropriate to harmonise disclosure when all insurers adopt the same accounting policies. Therefore we would wish the IASB to confirm within the final standard that insurers have complete discretion on how they present on claims development information. For example they could include further examples within the implementation guidance or confirm that alternative presentations, such as that required under US GAAP, would be an acceptable basis of preparation.

Paragraph 29(d) – We believe that this requirement is more appropriately addressed as part of the project on "Financial risk and other amendments to financial instrument disclosures", which will change the requirements of IAS 32. In order that insurers do not need to make two changes to their systems in a relatively short time span we recommend that the requirement is deferred until a final risk standard is published.

b) <u>Implementation guidance</u>

We support principal based standards and so welcome the general guidance provided within paragraphs 26-29 on disclosure, subject to our comments above. The status of the implementation guidance included within IG 7 –IG 59 is, however, unclear and we believe the Board should explicitly state that it has no official standing and hence that compliance with it is not mandatory. If it is positioned in this way, then the guidance is helpful. If however, the guidance is mandatory we believe it is far too detailed and moves the IASB to a rule-based approach to standard setting. For example the requirement within IG 39 to provide analysis of the maturity of insurance liabilities seems particularly detailed and of limited relevance in an insurance context, where such a table will fail to inform the user of the inherent uncertainties involved. In this case qualitative disclosures would be much more appropriate.

We believe that the exact level and nature of disclosure should be left to the individual entity to determine, as they will be able to best assess what is most relevant and reliable. A number of professional firms are already interpreting the guidance as a definitive checklist as opposed to general guidance on how to interpret the disclosure requirements. The Board needs to indicate that this was not its intention.

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If, however, the Board believes that in order to comply with IFRS, an entity must give all the disclosures within the implementation guidance, this is an onerous requirement which contradicts the objectives set at the start of the standard, namely that the cost of providing disclosure information should not exceed the benefit to users.

Many of the disclosure requirements would be best placed in an Operating and Financial Review ("OFR") This would enable companies to ensure a discussion on risk covers all aspects of their business and would be consistent with other reporting frameworks including SEC reporting. We recognise that the IAS framework does not currently include an OFR but that this is likely to be considered in the future. The standard should at least provide this option.

c) Transitional arrangements

The need to go back 5 years for claims development is an onerous requirement. We would prefer that a prospective basis be permitted in order to build up claims development information over time. This will enable companies to alter systems to collect the required information going-forward and avoid costly work to recreate historic data.

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 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 the treatment of a financial guarantee given in connection with the transfer of non-financial assets or liabilities.

Question 13 – Other Comments

Tentative conclusions for Phase 2

We do not believe that the tentative conclusions for Phase 2 should be included as part of the Phase 1 standard, especially as the industry debate to date has focused on the more immediate issue of the Phase 1 proposals.

However, given that they have been included we would note that we disagree with the following conclusions:

a) As noted in our response to question 5 above, we believe that expectations about the performance of assets are an essential component of the fair value of an insurance contract. [BC 6 (c) (ii)]
b) We do not believe that the fair value measurement of an insurance contract should reflect the credit characteristics of that contract, as this will lead to the anomalous position of an insurer with a poorer credit rating measuring its liabilities at a lower amount than, all other things being equal, an insurer with a better credit rating. [BC 6 (c) (iv)]
c) It would be difficult to develop an approach where the measurement of fair value would include an adjustment for the premium that marketplace participants would demand for risks and mark-up in addition to the expected cash flows, as it would be difficult to measure the amount of any allowance required. We believe that risk can be satisfactorily allowed for via the discount rate. [BC 6 (c) (iii)]
d) We believe that the limitation of profit recognition upon initial recognition of an insurance contract is clearly inconsistent with a fair value approach based on an asset/liability model. [BC 6 (b) (ii)]
e) We do not agree with the principle BC6 (d) which takes into account only "contractual" cash flows when fair valuing an insurance contract. Problems arise with the interpretation of "contractual". In fact, all cash flows receivable under an insurance contract are "contractual" If, however, a narrower principle were adopted, the basis on which persistency could be recognised for accounting purposes would be inconsistent with policyholder behaviour and the manner in which life business is operated, particularly with regard to costs and pricing. It would be more appropriate to incorporate lapse assumptions on a best estimate basis, which is consistent with the IAS 37 basis of setting provisions.

We are also concerned about the Board's emerging proposals in relation to general insurance business, in particular the practical issues surrounding market consistency. We welcome that the ED 5 is silent on market value margin issues.

IAS 39 as applied to long term contracts – 'Deposit Floor' methodology

As noted at the start of this letter, IAS 39 was never written to accommodate the accounting for the long-term contracts that now come under its scope. It is therefore VERY difficult to apply the requirements of this standard in the absence of further detailed guidance. Furthermore, there have been recent proposals, such as the deposit floor, where the full implications are yet to be fully tested and understood.

Paragraph BC 117(e) states that the fair value of a financial liability with a demand feature is not less than the amount payable on demand. However we believe that this is inconsistent with nature of long term insurance products which are priced on the basis of expected surrender rates. Indeed we believe such an approach is inconsistent with fair value measurement and in essence requires insurers to take the most prudent approach to valuing liabilities. This conflicts with paragraph 16 of ED 5, where accounting policies containing excessive prudence are said not be relevant and reliable.

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Appendix B: Consequential amendments to Insurance Contracts Exposure Draft as a result of the changes proposed within the Aviva response to question 2

Question 2: Definition of insurance

In our response to question 2, we proposed that IASB temporarily change the scope of IAS 32 and IAS 39 until Phase 2. To effect this change we recommend that the IASB changes paragraph 3(d) of IAS 32 (as outlined in C1 of ED5) to read:

> ' d) insurance contracts within the scope of IFRS X Insurance and, until such time that a Phase 2 insurance standard becomes fully effective, contracts issued by a regulated insurer that meet the legal or regulatory definition of insurance as defined in the country under which the regulation of a specified contract falls. However, this standard applies to derivatives that are embedded in insurance contracts or contracts issued by an insurer that are exempted as they meet their local legal or regulatory definition as described above.'

We would also make a corresponding amendment to IAS 39 paragraph 1 (e) (as outlined in C2 as ED 5) as follows:

> 'e) rights and obligations under a contract that is within the scope of IFRS X *Insurance Contracts* because the contract is an insurance contract or contains a discretionary participation feature and, until such time that a Phase 2 insurance standard becomes fully effective, rights and obligations under a contract issued by a regulated insurer that meets the legal or regulatory definition of insurance as defined in the country under which the regulation of that contract falls. However, this standard applies to a derivative that is embedded in such a contract if the derivative is not itself either a) an insurance contract within the scope of IFRS X or b) a contract issued by an insurer that is exempted from this standard as it meets the local legal or regulatory definition as described above.'