Peter

For your information I enclose, as a personal contribution to the
ED5 questions, the original words I produced for the UK profession's response to ED5. Their actual response will properly be on a 'less is more' basis .

One of the things I tried to do was to consider whether the 'novel' concept of plausibility could be expressed in other words and there are drafting suggestions. However I realise that every draft carries it own set of interpretational problems.

I also recommended the use of the phrase 'insurance instrument' rather than 'insurance contract' as a source of reduced layman confusion.

Regards

Bill

ED5; Q2 – 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 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?

1. As accounting standards define an insurance contracts in a way which is inconsistent with legal definitions of an insurance contract, or contracts which are considered insurance business, we suggest that less confusion may materialise if the accounting standards refer to 'insurance instruments' rather than 'insurance contracts'. This may help with the concerns expressed in BC12.

2. We believe that the standard should set the rules and examples and guidance are there to be helpful, provided that they are in accordance with the rules established by the standard.

   Thus B18(d) says that a says that "gambling contracts that require a payment for a specified uncertain future event, but do not require , as a contractual precondition for payment, that the event adversely affects the policyholder or other beneficiary specified in the contract." This implies that a contractual pre condition is necessary to establish whether an event adversely affects the policyholder or other beneficiary. The definition of insurance contract does not refer to conditions which are written into or implied by the contract. A contractual precondition sounds like an insurable interest.

   BC22 and 23 explain the background, but BC 23 wrongly states that insurance is to reduce risk whilst gambling is to take on risk. There are a number of instances where gambling reduces risk. For example a football club is in a knock out competition and the present value of its future income after the next round is somewhere between zero and £x. If it enters a gambling contract which pays out on losing the next match, this present value changes to somewhere in the range £y to £z, where y>o and z<x. The club has reduced the risk of not earning income, the same as a business interruption insurance changes the range of future earnings.

   However the gaming product is also available to those who have no financial interest in the outcome. The contract providers make no enquiries as to whether or not the contract holder would be adversely affected. This may even be true for some insurance products.

   The reason why the adverse effect condition is inserted is, according to the final sentence of BC23, to exclude any prepaid contract the outcome of which is uncertain.

Assuming that the adverse effect condition should stay in the standard. It may be helpful to insert a clause that 'if there is no evidence that, for the generality of similar contracts, the policyholder or beneficiary is adversely affected, then the assumption should be that the contract holder is not adversely affected'.

There may be occasions where an insurance risk, at least in part, can be transferred by either an'insurance contract' or a 'gaming or similar' contract. One would not wish any accounting arbitrage to arise and there may be scope for extending the standard to allow 'insurance contract' treatment for transfers of insurance risk accepted by an insurer.

3. The standard should make clear the position of traded insurance policies with a specific reference. These are policies where originally the policyholder was 'adversely affected' but subsequently sells the policy so that the policy would not meet the definition of an insurance contract other than through a 'once an insurance policy, always an insurance policy' clause.

4. In B15, the phrase 'exposes the issuer' to insurance risk is not as clear as it might be. If a company issues a contract which will be in force for an indefinite period and on which it earns, say. An amount determined by a formula not incorporating insurance risk, then the issuer is subject to a lapse risk, indeed the issuer is 'exposed to a lapse risk'. However the policy cannot count as an insurance contract because the policyholder is not affected by the adverse event of a lapse. However if the insurer were to reinsure these contracts, then the 'reinsurance' contract would be an insurance contract because the insurer is nor the policyholder and is adversely affected by the early lapses. Thus the final sentence of B15 should be redrafted along the lines of '…unless there is evidence that the policyholder is adversely affected or otherwise establishes that it bears insurance risk'. A similar comment would relate to B16.

   We would anticipate that the condition relating to adverse effects may well encourage financial engineering to avoid reporting losses at issue which distort the underlying financial economics of the business.

5. Examples as in B17 are meant to be helpful, but we would want to know whether they are subsidiary to the primary words of the standard.

   Thus in B17(d) we would point out that although an annuity could help maintain a given standard of living through to death, this is not necessarily the case. This actually depends on a number of factors including the wealth of the individual, the desire to pass on that wealth and the alternative ways of generating income in retirement. We would consider it better not to rely on this interpretation as included in the example and 'hard code' it into the words. Could we have a B13A which says that 'For the avoidance of doubt, life contingent annuities and pensions are insurance contracts.', and then eliminate the example and its somewhat debatable assumption?

6. In B17(k) it may be best to leave the 'for example' unsaid. There could be circumstances where the change in interest rates affects the credit risks being accounted for as insurance policies and it would be an insurance contract.

7. In B21 and 22, we thought the concept of 'plausibility' was helpful to distance it from possibilities and probabilities. However recourse to the OED makes us think that the word used in this context may have to have its interpretation amplified in some way. {We could also see that translation out of English may pose further problems.}

   The OED has one definition which relates to 'deserving of applause'; we ruled this out.

   The next definition was 'generally acceptable or popular'; again we ruled this out.

   The next is 'having a show of truth, reasonableness or worth' (although it does go on to say apparently acceptable, fair-seeming or specious). Plausible thus is close to reasonable

   So does the first sentence mean "….if, under one possible (even if remote) scenario the occurrence of the insured event causes a significant change…."

   If it does, then this would allow the word 'plausible' to disappear and the reference to 'plausible scenarios' in B21 could be replaced by 'in all scenarios (including remote scenarios) that could happen'.

8. There is a reference to significant changes in the present value of a contract's cash flows. We suspect that this is a reference to an insurer's expected cash flows at the outset of the contract. There will have to be a fair bit of 'give and take' on this definition, which itself depends on how expenses are attributed to a particular policy, rather than a group of policies. If the net present value of the policy at outset is zero, having taken due allowance for risk, then any change is significant!

   [We note the asterisked footnote. This implies that if contracts are entered into simultaneously, then they are related. If there is no agreement that the insurer will only write an individual policy if the other contracts are also written simultaneously, then they are not interdependent. Should the footnote read '…contracts that are interdependent (including contracts which have been written simultaneously and which would not all have been written as individual contracts) form a single contract.]

9. The apparent consequential in B23 should be related to an individual scenario. For instance a 'plausible' scenario is that the policyholder dies in the first month of the contract. In that scenario the present value of the cash flow is negative, representing a significant adverse change in the expected cash flows of the contract. It follows that the contract may be an insurance contract even if the additional death benefit is insignificant over most of the duration of the contract. The guidance on implementation states this more clearly than the

standard.

10. We would appreciate a view on the status of the Guidance on implementing IFRS X Insurance Contracts. Does this mean if the guidance is followed, then the accounts must be in accordance with the IFRS even if it is found to be in conflict with an interpretation of the Standard? Vice Versa, if a contract is accounted for in accordance with the standard, but not in accordance with the guidance, do such accounts conform with the standard.

11. It is possible to argue that the contract described in 1.6 of IG Example 1 is an insurance policy. There is a plausible scenario that an annuity will be taken out and that the insurer suffers significant loss on the contract when the annuitant lives longer than expected. Repricing does not eliminate that risk.