Exposure Draft 5 - Insurance Contracts

CNC comments

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).

We welcome the proposal that the IFRS would apply to insurance contracts and not to insurance entities as this decision is consistent with other IFRSs. We suggest however that the title of the standard be modified to refer to both insurance contracts and financial instruments with discretionary participation features : indeed, as stated in its scope, ED5 is to be applied not only to insurance contracts but also to financial instruments with a discretionary participation feature.

Consequently, we recommend that (i) the standard be entitled "insurance contracts and financial instruments with a discretionary participation feature" to avoid any misunderstanding and (ii) its wording be reviewed so that each time "insurance contracts" are referred to, it is replaced by "insurance contracts and financial instruments with a discretionary participation feature" unless there is an explicit specific treatment required for these "investment contracts".

In particular, we consider that ED5 § 6 (embedded derivatives), ED5 § 9 (temporary exemptions from some other IFRS), ED5 § 14 (changes in accounting policies), ED5 § 20 (insurance contracts acquired in a business combination) should explicitly address not only insurance contracts but also financial instruments with a discretionary participation feature (see below).

Notwithstanding this modification in the title of ED5 (Phase I), financial instruments with a discretionary participation feature are "financial instruments" and consequently will not be part of the future standard on insurance contracts as they will be covered by IAS 39 (Phase II).

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?

We disagree with the proposal that assets held to back insurance contracts should be accounted for using IAS 39 *Financial Instruments: Recognition and Measurement* . We consider the mismatch issue resulting from this proposal of paramount importance. See further comments below (Question 13.1).

We agree that "investment contracts" (financial instruments that do not expose the issuer to significant insurance risk and so do not meet the definition of insurance contracts) are not to be covered by ED5. However, we would like to underline that the measurement of these financial liabilities has to be consistent with the measurement of insurance contracts. Indeed, "investment contracts" have features in common with other contracts (i.e. insurance contracts and investment contracts with a discretionary participation feature), principally the surrender option. Measuring these contracts, either at amortised cost or fair value, requires modelling the policyholders' behaviour. This issue will specifically be addressed during Phase II of the insurance project, which leaves Phase I without guidance in this complex area (see Questions 3, 13.2.2 and 13.3 below).

(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?

We agree.

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?

Although we fully agree with the definition set out in ED 5, we fear that the Implementation Guidance contains some inconsistencies.

We especially disagree that pure endowments (IG Example 1.4) are best described as "investment contracts unless there is significant mortality risk". We are fully convinced that pure endowments comply with the definition of insurance contracts, should the insurance risk be significant :

- Such a contract refers to an uncertain future event that could adversely affect the policyholder or other beneficiary if the insured benefits were not paid on survival which is "adverse to a standard of living", and is in fact the same adversity covered by annuities.
- In such a contract with no surrender option before maturity, it is plausible that the insured event will cause a significant adverse change in the present value of the insurer's net cash flows arising from the contract. Let us assume a pure endowment for a person 20 years old guaranteed a payment of 100.000 € at the age of 60 on survival. Whatever the premium received the insurer will pay out 100.000€ if the insured survives to 60 whereas if the insured does not survive the insurer will not pay this insured benefit.

Consequently, survival will occasion the insurer a significant adverse cash flow on the occurrence of the insured event. These adverse cash flows may not only lead to ‘opportunity losses, but true losses, on a contract by contract basis, even before considering the whole portfolio. In the example presented above, if the policyholder survives at 60, the insurer will incur a loss because the level of the premium is based on an expected survival probability which is always lower than 1. Based on current mortality tables, the loss would amount to round 16 000 € if the policyholder survives.

Survival without insured benefits is a clearly identifiable source of significant insurance risk and any contracts with payments triggered by survival should be considered as insurance contracts provided that the payable amounts are triggered by the uncertain event (survival) and that the uncertain event triggers payments that are significantly greater than those that the beneficiaries insured would receive should the insured be dead.

We would also like to emphasise that this example 1.4 is typical of an inconsistency in the application of the principles relating to “significant insurance risk”. ED 5 § B21 defines a significant insurance risk as follows : “insurance risk is significant if, and only if, it is plausible that an insured event will cause a significant adverse change in the present value of the insurer’s net cash flows arising from that contract ”. ED5 refers to a significant adverse change in the present value of cash flows whereas the Implementation Guidance often refers to the existence of an insurer's "loss" (IG 1.2, 1.3, 1.5,…). This appears to be misleading and could give rise to inappropriate conclusions as for “pure endowments” for instance where the statement that : “a small possibility of a significant gain for the insurer if the policyholder dies ” should, in this example, be replaced by “a significant adverse change in the present value of cash flows if the policyholder survives to maturity”.

Finally, should pure endowment contracts not be recognised as “insurance contracts”, how should the risks relating to these contracts be accounted for and disclosed?

Question 3 – Embedded derivatives

(a) IAS 39 *Financial Instruments: Recognition and Measurement* requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:

(i) meets the definition of an insurance contract within the scope of the draft IFRS; or

(ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

However, an insurer would still be required to separate, and measure at fair value:

(i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and

(ii) an option to surrender a financial instrument that is not an insurance contract.

(paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)

Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

Although, we welcome the measurement at fair value of derivatives embedded in insurance contracts or “investment contracts” as the only method that provides transparency in the financial statements, we fear that this principle cannot be applied in Phase I because of the practical issues it raises. Noting that ED5 already considers these practical issues by proposing two exemptions (as listed in the question above) and that the Implementation Guidance aims at helping in this difficult exercise by providing guidance for derivatives embedded not only in insurance contracts but also in “investment contracts”, we still view these exemptions as too restrictive in phase I with regard to surrender options.

As stated in the Implementation Guidance (examples 2.12 and 2.13), a surrender option embedded in an insurance contract or in an investment contract has to be separated, in the latter case, if the surrender value is not approximately equal to the carrying amount at each exercise date.

Beyond the significant changes to IT systems this implies, we are seriously concerned about (i) the lack of a consensus on valuation models for surrender options (this will be a very complex issue to be addressed in Phase II) and (ii) the inconsistencies that may be introduced in Phase I requiring the fair value measurement of derivatives embedded in investment contracts with discretionary participation features, while related host contracts (excluding the embedded derivative feature) will have to be measured under existing accounting policies.

Taking this into account, and whilst sharing your concern over the transparency of financial statements, we favour keeping to existing accounting policies in Phase I to measure derivatives embedded in insurance contracts or “investment contracts”, as opposed to separating them and measuring them at fair value. We are indeed convinced that the requirement of a robust loss recognition test would be sufficient to ensure the recognition and correct measurement of any rights and obligations linked with the embedded features. These exemptions should be limited to surrender options (see question 13.2.2) and only during Phase I. We suggest the following rewording of ED5 § 6 :

“As an exception to the requirement in IAS 39, an insurer need not separate, and measure at fair value, a policyholder’s option to surrender an insurance contract or a financial instrument with a discretionary participation feature for a fixed amount (or for an amount based on a fixed amount and an interest rate) even if the exercise price differs from the carrying amount of the host insurance liability.”

With regard to unit-linked contracts, we fear that the approach proposed in the draft standard and in the Implementation Guidance (§ 2.14 and 2.15) is not adequate. Noting that the proposed approach differs widely from the way insurers presently manage these contracts, we would like to emphasise that it is also questionable in several other respects :

- Should the equity linked return be actually considered a derivative, we question how to measure this derivative and the amortised cost of the host contract. The approach requires very complex development :
    - it does not seem possible to consider – as some could have envisaged - that there are payments under a host contract that is taken to be a debt instrument together with an embedded derivative that swaps the "interest" payments to the returns on the underlying reference assets. Doing so would be in contradiction with the statement of IAS 39 Q&A 22-1 (July 2001) : “An enterprise may not identify a component that is not specified or establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not clearly present in the hybrid instrument, that is, it cannot create a cash flow that does not exist”. Furthermore, it does not correspond to the economic substance of the transaction.

- this measurement is closely linked to (i) the measurement of the surrender option (see above) and (ii) the accounting for acquisition costs and management fees (see question 13.4 below).

- Should the whole contract be measured at fair value, it would lead to a significant loss at inception if it were confirmed that IAS 39 introduces a "floor deposit value" for financial instruments with a demand feature, whilst acquisition costs are recouped, on the economic basis of the contractual terms, by future management fees (see question 13.4 below).

We would welcome a thorough investigation by the Board of all aspects of the measurement of unit-linked contracts which we understand have not yet been fully investigated. If this cannot be done within the limited time-frame before Phase I is in place, we would recommend that unit-linked contracts should continue to be accounted for under existing accounting policies during Phase I.

(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?

We consider it appropriate to exempt these derivatives from fair value measurement in phase I as far as they contain features which comply with the definition of "significant insurance risk". It would be neither consistent - where insurance contracts are to be measured under existing accounting policies - nor feasible, without undue cost and effort, to measure these derivatives at fair value 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?

We agree with the proposed disclosures about "material exposures to interest risk under embedded derivatives". However, we would like to stress that IG 58 may be seen as too demanding as it may not be feasible, without undue cost and effort, to disclose the fair value of embedded derivatives, as stated above (see Question 3 b)). As developed below (see Question 11 b)), we consider as necessary to explain that the Implementation Guidance are only illustrative and not compulsory.

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

As mentioned above and as detailed below, we recommend that equity linked return options embedded in unit-linked contracts and surrender options embedded in financial instruments containing a discretionary participation feature are not separated (whether the host contract is an insurance contract or an investment contract).

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?

This exemption appears to be appropriate in phase I and we consider that ED5 § 9 (*temporary exemptions from some other IFRS*) should explicitly address not only insurance contracts but also financial instruments with a discretionary participation feature.

With regard to the "sunset clause", we welcome the Board's willingness to complete the standard on insurance contracts as soon as possible, but consider this clause as highly dangerous and any application potentially costly as it cannot be assumed that the Phase II standard will be finalised on time. Should this finalisation be delayed, we anticipate enormous difficulties for entities to comply with IAS 8 in 2007 and fear that it may lead to a great lack of comparability. We also believe that efforts required to do so would detract from their capacity to co-operate fully with the IASB itself in order to provide a comprehensive and fully-field tested Phase II.

(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?

Although we recognise that equalisation and catastrophe provisions do not meet the definition of a liability, we have some concerns about the consequence of their elimination in Phase I in the absence of any transitional arrangement. We fear that the elimination of these provisions without any prescription for the measurement of liabilities on business for which these provisions were made should lead to the up-front recognition of unrealised earnings.

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) are appropriate. However, we consider that ED5 § 14 should explicitly address not only insurance contracts but also financial instruments with a discretionary participation feature.

With respect to (b), we firstly note that the proposed provision is consistent with the proposed amendment to IAS 39, under which an entity could elect at inception to designate any financial asset for inclusion in the trading category. However, we would like to stress that we do not support this proposed amendment to IAS 39 : although we support that entities should have the opportunity to measure financial assets or liabilities at amortised cost or at fair value, we consider actually that this option should be more precisely defined. Consequently, we suggest that the wording in ED5 § 35 is modified to explicit the purpose of this provision, ie the consistency between assets and liabilities measurement it is aiming at.

We secondly understand that the proposals in ED5 § 35 for reclassifying assets are intended to apply also as and when the Phase II requirements for accounting for liabilities under these contracts are introduced. Added wording in ED5 §35 should make this clear, for example:

"This reclassification is permitted if an insurer changes accounting policies when it first applies this [draft] IFRS, if it makes a subsequent policy change permitted by paragraph 14 and on applying a future IFRS on insurance contracts and financial instruments with a discretionary participation feature ".

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 consider these proposals appropriate. In the basis for conclusions (§ 35 – 36) the Board made a clear description of its objective , i.e. unbundling appears “ to be appropriate for large customised contracts, if a failure to unbundle them could lead to the complete omission from the balance sheet of material contractual rights and obligations ” but not “ for traditional life insurance contracts for which the failure to unbundle these contracts would affect the measurement of these liabilities, but not lead to their complete omission from the insurer’s balance sheet ”. Therefore, unbundling should be an exception, which is also consistent with the objective not to oblige too many IT changes in Phase I.

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 share the Board's primary objective to avoid measurement inconsistencies in Phase I. For instance, if the premium paid by the cedant is based on discounted provisions (whereas his provisions are set up on an undiscounted basis), we agree that the effect of discounting should be eliminated.

However, we stress that a gain on reinsurance should be recognised at inception if the cedant happened to incur a loss on direct business, though any anomalous effect of discounting should be eliminated. Consequently we consider that ED5 § 18 b) should be modified to make this clear.

Furthermore, we question whether a cedant should apply IAS 36 *Impairment of assets* to its rights under a reinsurance contract. We are fully convinced that impairment tests have to be carried, but are concerned that the requirements of implementing IAS 36 might not be appropriate for a consistent measurement of direct business liabilities and related assets (rights under a reinsurance contract). It could lead to a fair value of the reinsurance assets (present value of estimated cash flows) which would be inconsistent with the measurement of the related liabilities (at amortised cost under current accounting policies). Thus we propose that, during Phase I, impairment tests - considering notably credit risk - should be performed on local existing accounting policies wherever such impairment tests exist.

Finally, we would like to stress that the proposed example of unbundling given in the Implementation Guidance (IG Example 3) should be developed. Firstly, it is unclear whether the reinsurer incurs a significant insurance risk, as the experience account is established at 90 per cent of cumulative premiums or of the underwriting balance. However, if this contract actually meets the definition of an insurance contract, accounting for the deposit-like component needs to be addressed in detail, notably with respect to the following :

- criteria (and methods to be used) for splitting the deposit component from the risk transfer premiums,
- earning patterns for premiums when "instalments" are not equal from period to period, or when experience-rated premiums are paid,
- classification and measurement of the deposit components in the absence of claims and after the occurrence of losses (profit or loss sharing provisions),
- criteria for splitting loss recoveries from deposit reimbursements, when the reinsurer pays a claim.

We believe that the development of additional scenarios is necessary to clarify these issues.

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 have no specific comments but consider that ED5 § 20 should explicitly address not only insurance contracts but also financial instruments with a discretionary participation feature.

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?

As these participation features will be addressed in more depth in Phase II, we consider that it is appropriate to permit insurance and investment contracts containing these features to be accounted for under existing local practices, as an exception during the interim phase.

We also agree that an intermediate category, neither liability nor equity, should not be permitted for the unallocated surplus associated with discretionary participation features of insurance contracts or investment contracts. Although we admit that the split between equity and liability will need a careful and sometimes difficult analysis, we still consider that this split has to be made at the company level based on contractual and/ or legal provisions, its participation policy etc… The principal assumptions made for any split between shareholders and policyholders should be disclosed.

As BC 104 to BC 106 explicit that discretionary participating features exist for both insurance and investment contracts, we understand that :

- the analogy to tax described in BC 1071 also prevails for investment contracts ;
- by analogy with tax (IAS 12 § 61), deferred participation should be charged or credited directly to equity if the participation relates to items that are credited or charges, in the same or different period, directly to equity.

We understand from ED5 § 2 b) and ED5 § C2 that financial instruments with a discretionary participation feature are temporarily out of the scope of IAS 39 (pending its amendments in view of the work done for Phase II), and thus temporarily out of the scope of IAS 39 for initial recognition purposes. We welcome this decision to allow premiums (and other related items) to be accounted for under existing accounting policies as this treatment is consistent with the inclusion of these contracts in ED5. Nevertheless, we understand that these contracts are still scoped into IAS 32 for disclosure purposes, which means that their fair values should be disclosed at least from December 2005 onwards. Measurement being precisely the reason that these financial instruments with discretionary participation features are excluded temporarily from IAS 39 during Phase I, we believe they should be also exempted temporarily from IAS 32 fair value disclosure requirements.

Furthermore, we disagree with the proposal in ED5 § 25 that the measurement of such financial instruments under existing accounting policies should be at no less than that measurement IAS 39 would apply to the "fixed element" they contain (see question 13.2). We are however convinced that the requirement of a robust loss recognition test -as for insurance contracts- would be sufficient to ensure the liability is recognised and not understated.

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

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

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

Although we support the disclosure of fair value, we do not understand the proposed requirement to disclose the fair value of insurance contracts as early as 2006. We consider that this disclosure requires fair value measurement principles to be precisely defined and carefully tested with preparers. We fear that this may not be completed early enough to allow insurers to develop necessary IT systems appropriately. If the objective is to require insurers to disclose information that is relevant to users, we do not consider this proposal appropriate insofar as any disclosed information would be neither compliant with definitive requirements nor comparable.

We suggest that the wording be modified so that fair value disclosure be required only once the Phase II standard is completed. In the meantime, we suggest recommending (while not requiring) the disclosure of well known information, such as “embedded values” (consistently with IG8).

[1] *“The resulting timing differences are analogous, in some respects, to temporary differences between the carrying amounts of assets and liabilities and their tax bases.”*

Moreover, as stated above and hereafter (see Questions 1 a ii) and 9), we believe that all investment contracts, whether with a discretionary participation feature or not, should be excluded temporarily from IAS 32 disclosure requirements as well as from ED5 requirements for disclosing fair value in 2006. Indeed most of these contracts – like insurance contracts - share a surrender feature, the valuation of which still needs to be defined.

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.

We agree with the proposed disclosure requirements but would like to underline the following :

- Paragraph 29(d) of the draft IFRS requires an insurer to disclose information on interest risk. When disclosing this information, we would suggest that insurance entities should not only deal with individual classes of assets and liabilities separately as suggested in IAS 32 but also draw a parallel between the exposure to interest risk of insurance liabilities and the exposure of assets backing these liabilities.
- The example given in the draft Implementation Guidance (IG example 4) illustrates a possible format for a claims development table where estimates of claims are shown for each underwriting year. In some cases, a presentation of claims development for each accident year would be more relevant, especially in Phase I when data will only be available by accident year, under existing accounting policies. We suggest that this approach should also be mentioned in the draft Implementation Guidance.

(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?

Although we support this approach, we consider it necessary that it should be clearly stated that the Implementation Guidance provisions are only indicative and illustrative but not compulsory.

Furthermore, we stress that the wording of the standard has to be harmonised with that used in the Guidance and vice versa :

- The Implementation Guidance aims only at illustrating the principles as described in the standard and not at creating new requirements. However, sometimes the wording used in the Guidance could be misleading : it appears to set mandatory requirements, which are not the objectives targeted: for instance, wording like "An insurer discloses…" seems to be more restricting than "For instance, an insurer may disclose …".
- The converse is true : principles defined in the standard should not appear to be more demanding than those contained in the Guidance. For instance, ED5 § 29 (b) requires the disclosure of "those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of future cash flows." Such a wide wording should be avoided in order to narrow and precise the spectrum of information requested, without requiring the use of the Guidance.

We also consider that some information required is confidential and that its disclosure could be prejudicial. In particular, the following information being the core business of the insurer (i.e. his know-how) should not be mandatory :

- the process used to determine the assumptions that have the greatest effect on the measurement of these amounts and quantified disclosure of those assumptions;
- policies for mitigating risks arising from insurance contracts.

(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 this proposal.

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 agree and welcome the fact that genuine activities of credit insurance, which meet the definition of insurance, will be covered by the proposed IFRS on Insurance Contracts and will therefore be treated as other insurance activities.

Question 13 – Other comments

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

13.1 - Mismatch - Measurement basis for insurance assets and liabilities

13.1.1 This issue is of paramount importance and has to be solved

We consider the mismatch issue, as described in ED5 BC 110, is crucial and are concerned that this would lead to huge difficulties in interpreting an insurer's financial statements in Phase I, failing thus to comply with the IASB'S framework.

Financial analysts will naturally request and obtain information on sensitivities to market volatility. However, recording the effects of asset value volatilities alone in an insurer's accounts, as the Board proposes for phase I, without also recording the corresponding effects of market volatilities on the fair values of insurance liabilities, which the Board postpones to Phase II may lead to potentially serious media[2] misrepresentation of an insurer's financial position[3] and could also well lead to unjustified reactions on financial markets.

Insurers will be forced to explain the one-sided approach the Board is proposing. This will inevitably also raise the question of whether an insurer's accounts prepared on the basis of this approach do in fact give a true and fair view of the financial situation and results of an insurer. The credibility of both the insurer's accounts and the Board's proposals can only suffer as a result.

This issue is of paramount importance and has to be solved, failing which it would lead to a questionable standard for insurance in Phase I.

13.1.2 Existing IAS 39 held-to-maturity classification is not a solution to the mismatch issue

We regret that the proposed solutions were rejected by the Board and note the arguments developed by the Board in § BC 110. With regard to the first proposal (*relax the criteria in IAS 39 for classifying financial assets as held-to-maturity)*, we would like to emphasise that we do not agree that "*an insurer may be able to classify some of its financial assets as held-to-maturity if, in addition to meeting the other conditions set out in IAS 39, it concludes that an unexpected increase in lapses or claims would not compel it to sell those assets*".

Insurers are not actually able to determine the precise timing of claims and surrenders : insurers manage these on a global basis knowing that specific differences can occur in each period but that they generally compensate on a global basis.

---

[2] Media meaning here "users" as defined in the IASB Framework § 8: investors, employees, lenders, suppliers, customers, governments and public

[3] "*Information about financial position [ie financial structure and solvency notably] is primarily provided in a balance sheet*" (Framework § 16 & 19)

Should an insurer anticipate that surrenders and claims amount globally to 2% a year –in numbers and amounts –over an twelve year period covered by contracts, he might then designate at inception 22% of the initial unique premium as “available for sale” Such a classification would not be representative of financial management of the assets and would lead to fair value measurement of a significant proportion of the assets backing insurance liabilities.

In order to comply with the accounting standards, he might otherwise be supposed to buy assets with different maturity dates on the following basis : Year 1 : 2% / Year 2 : 2% / … / Year 12 (the maturity date of the contract): 88%. Were such assets always available on the market, such a decision would still not be consistent with the real financial management required of a company. The company has to be able to respond adequately to fluctuations in the actual distributions of surrenders and claims, both in timing and amount - with or without effects on expected values, as they occur.

And what of standard deviations from expected values e.g. "unexpectedly" high surrenders? Is the insurer then supposed to be very "conservative" at inception and designate, for instance, 30% of assets as “available for sale”?

None of the above mentioned possibilities would adequately represent the financial management of a company nor reflect the economic substance of its transactions. Neither would they solve the “spurious volatility” issue.

13.1.3 “Unlocked” discounting of insurance liabilities is also not a solution to the mismatch issue

Some might envisage solving the mismatch issue through discounting insurance liabilities. We do not see the “unlocked” discounting of insurance liabilities as a possible answer to the mismatch issue for the following reasons :

- Discounting requires determining the discount rate which is a question for resolution in Phase II. In the absence of additional guidance, there is uncertainty about what is acceptable in Phase I : which rate? which market value margin?… and thus a lack of reliability and comparability.
- With regard to investment contracts with a discretionary participation feature, this issue is still more contentious as the discount rate is closely linked to the participation feature and to policyholder behaviour. This is equally true of any participating or performance-linked contract
- Should these conceptual issues be solved, we must emphasise the fact that the implementation of such discounting would entail considerable developments in IT systems.
- Introducing “unlocked” discounting of all insurance liabilities would be a step towards Phase II but it is uncertain whether practical decisions then required in Phase I would not have to be modified when Phase II is completed : this would therefore appear to be in contradiction with the objectives set for Phase I.

13.1.4 Suggested solutions to the mismatch issue

Having reviewed the different drawbacks of each proposed solution we believe that the lack of a given solution is an inherent part of the decision in Phase I to consider compulsory the measurement of financial assets under IAS 39. We fear that this decision is conceptually inappropriate as long as insurance contracts and financial instruments with a discretionary participation feature are measured under existing accounting policies on a different basis.

13.1.4.1 Temporary exemption to IAS 39 for assets backing "insurance liabilities"[4]

Given the continuance of existing accounting policies to measure "insurance liabilities" in Phase I, we believe that the best solution is to grant insurers a temporary exemption to IAS 39 for assets backing "insurance liabilities", thereby allowing them to retain existing accounting policies for matching asset valuations.

This proposal contains two sub-proposals :

a) Assets backing "insurance liabilities" defined without restriction : we consider this the best approach insofar as :

- it fully complies with the assets and liabilities management of insurance business
- it is the most consistent approach in Phase I : whereas liabilities will be accounted for under existing accounting policies, so also will financial assets.

b) Assets backing "insurance liabilities" defined as limited to fixed maturity investments : if the Board were to consider that consistency between assets and liabilities should be limited to components bearing the same type of risk (ie interest risk), we would consider it possible to retain this second proposal, although it appears to us less consistent for the reasons explained in a) above.

13.1.4.2 Temporary exemption to IAS 39 "tainting rules" for held-to-maturity assets backing "insurance liabilities"

Should these proposals be rejected, we believe that the only remaining solution would be, although already rejected by the Board, to include in ED5 a temporary exception for phase I allowing insurers to sell held-to-maturity interest-bearing assets held to back "insurance liabilities" without triggering the "tainting" rules if the only reason for the sale was to meet surrenders or claims :

- At inception, the insurer may be able to demonstrate that he has the "positive intent and ability" to hold these assets until maturity of the insurance or investment contracts – or replace them with other such assets where he can subsequently obtain assets with maturity dates that correspond more closely to the contract maturity dates. This demonstration should obviously be documented.
- In most cases, assets should come to maturity at the same dates as liabilities. Financial management by insurance companies obviously already includes "duration analysis" of asset and contract portfolios and drives asset replacement for matching maturity dates.

[4] "Insurance liabilities" meaning "insurance contracts" and "investment contracts with a participation feature"

- If surrenders or claims were to occur before the expected maturity, the insurer should be allowed to sell the corresponding assets before maturity without triggering the "tainting" rules, provided that adequate documented and factual reasons for this sale are disclosed.
- In this case, the insurer would have to "amortise" the capital gains / losses resulting from the sold asset over its residual period to maturity.

Under both proposals (see § 13.1.4.1 and 13.1.4.2 above), assets should comply with the requirements of IAS 39 in the following respects :

- Initial measurement of financial assets
- Impairment and uncollectability of financial assets
- Hedging accounting
- Disclosures
- Embedded derivatives requiring separation

13.2 - Measurement of financial instruments with a discretionary participation feature

13.2.1 Measurement of the fixed element

ED5 applies to financial instruments that contain a discretionary participation feature [ED5 § 2(b)]. ED5 § 25 specifies that the measurement of such financial instruments under existing accounting policies should be no less than that measurement IAS 39 would apply to the "fixed element" they contain (i. e. amortised cost or fair value). The latter amount is considered the floor carrying value of the overall liability. ED5 §25 permits not determining the IAS 39 measurement of the fixed element if the total reported liability under existing accounting policies is "clearly higher".

For the following reasons, we consider that references to the IAS 39 measurement of the fixed element should be struck from paragraph 25 :

- ED5 scopes in financial instruments with a discretionary participation feature and removes them temporarily from the scope of IAS 39. Despite this, a "partial measurement" under IAS 39 is then required of an undefined "fixed element" which is in itself contradictory.
- In practice, it would be necessary to separate the "fixed element" from the participation feature as it would be difficult to prove that the total reported liability under existing accounting policies is clearly higher than the IAS 39 measurement of the fixed element. The need to compute the IAS 39 measurement of the fixed element would effectively void the relief intended under paragraph 24(a)[5] to avoid the difficulties of separating the components envisaged in financial instruments with discretionary participation features. This "unbundling" would certainly require insurers to make major changes in their EDP systems, which contradict the overriding objective of the Board *[ED5 § 1(b)]*.

---

[5] which leaves the insurer free to decide whether or not to report separately the fixed element and the discretionary feature

- Difficulties of application and differing interpretations between insurers would certainly arise as the term "clearly higher" is imprecise as is the term "fixed element".

The risk of understating liabilities of investment contracts with a participating feature is addressed in the loss recognition test [ED5 § 11-13]. We therefore think that it would be much simpler and much more consistent with the overall objective of ED5 and the deferral of measurement considerations to Phase II for both insurance contracts and all contracts with discretionary participation features to apply this loss recognition test also to financial instruments with a discretionary participation feature thereby providing an acceptable and viable replacement of the requirement to measure the fixed element under IAS 39.

13.2.2. Measurement of the surrender option at fair value

A proposed draft amendment to IAS 39 [BC 117 (c)] indicates that if the amortised cost of the contractual liability differs from its surrender value, the investor's option to surrender should be measured at fair value, unless the surrender value is approximately the same as the carrying amount at each date.

However, we have no common accepted guidance on how calculate the fair value of any surrender option in a financial instrument with a discretionary participation feature, just as we have no common accepted guidance on how to evaluate the fair value of the instrument itself.

Furthermore the value of the option correlates inseparably to both components (the "fixed element" and the participation feature).The fair valuation of such instruments, as for insurance contracts with or without such features, still remains a question for Phase II.

In addition there is no consensual guidance on how to evaluate the amortised cost of the contractual liability of such financial instruments and we understand that amortised cost will be also considered as a possible basis for measurement in Phase II.

In all events, and for the same reasons, we again consider that applying the loss recognition test set out in paragraphs 11-13 would adequately and viably correspond to the objectives of the Board.

13.3 - Fair value measurement of financial liabilities - Deposit floor

We do not understand the rationale underlying the introduction of a "deposit floor" in the fair value measurement of a financial liability with a demand feature (ED5 BC 117 e)).

13.3.1. The fair value of a book of contracts cannot be the simple sum of individual surrender values : surrender patterns have to be considered

Introducing a floor on the fair value measurement (i.e. the immediate surrender value) possibly represents a legalistic interpretation of its current worth in the hands of the policyholder. However, the situation of the insurer is quite different as he pools individual risks. This means that although it is impossible to determine the timing of the surrender of an individual contract, the expected surrender pattern of a portfolio of contracts is determinable. Using the portfolio as the unit of account, as the principles already established in IAS 39 for groups of assets and the Board's clarifications (ED5 BC117) intend, gives fair values which cannot be the simple sum of individual surrender values.

This is all the more consistent with fair value techniques (i.e. based on a stochastic approach) which weigh all surrender scenarios. In these techniques, the risk of future surrenders is already taken into account in the resulting fair value. It is unnecessary and redundant to require any floor.

13.3.2. The introduction of a deposit floor would lead to several measurement inconsistencies in insurers' financial statements

If this modification were to be made in IAS 39, it would lead to several inconsistencies in insurers' financial statements :

- Where transaction costs are significant, the amortised cost of a liability with a demand feature could be less than the amount payable on demand whereas the fair value of the same liability could not be at any time and in all events would not be on inception. This decision appears to be neither consistent within the IASB standards nor does it reflect the economic characteristics of a portfolio of contracts.
- This fair value measurement can be seen as highly divergent from fair value concepts (i.e. present value of the probability-weighted expected cash flows in the absence of active market) as envisaged for Phase II. The deposit-floor concept was proposed in the Issues Paper for an asset and liability measurement model – which was not based on fair values – but based on the prospective measurement of insurance liabilities, and limited to the minimum amount resulting from a retrospective approach.

We would like to emphasise that implementing a decision to impose a "floor value" will create an additional mismatch issue in a fair value approach of assets and liabilities.

13.3.3. This proposal is not consistent with existing standards and with Phase II tentative conclusions

The introduction of the "deposit floor" appears to contradict existing standards which consider expected surrender patterns :

- The exclusion of surrender patterns in the fair value measurement of non-insurance contracts that are scoped into IAS 39 is inconsistent with the proposed guidance (ED5 BC 117 a)) with respect to amortised cost under IAS 39 which includes surrender patterns. Phase II might also most likely include surrender patterns in the fair value measurement of insurance contracts and financial instruments with a discretionary participation feature (ED5 BC6).
- We understood the cancellation of the current §86 of IAS 32 was even meant to allow for the introduction of surrender patterns as in the measurement of: "*the fair value of a deposit liability without a specified maturity is the amount payable on demand at the reporting date*"(specification struck from the amended version of IAS 32). In all events we note that all contracts issued by insurers embody a "specified maturity" as well as a "death guarantee" (whether significant or not) and that these contracts do not constitute a (short-term) deposit liability.
- The introduction of an expected value (i.e. probability weighted average of all cash flows) is consistent with IAS 19 where the measurement reflects the enterprise's estimate of the future employee turnover or again with IAS 37 which requires that provisions should be measured on a basis that reflects the enterprise's best estimate of the cost of settling the liability, i.e. present value of the probability-weighted expected cash flows.

Discounting future cash flows was never considered as being a way to anticipate profit but rather as the integration of time value in the measurement of liabilities and this is the reason why is was required by other standards.

13.3.4. Surrender issues have to be carefully addressed in Phase II

We acknowledge that factoring expected surrender patterns for fair value measurement raises substantial issues that need to be addressed in order to ensure overall reliability and comparability in the measurement of liabilities:

- expected surrender patterns are closely linked to the gap between market interest rates and the return policyholders can expect on their contracts and therefore closely linked to interest rate variations, policy terms and conditions etc. These patterns will be all the more difficult to calibrate as there is no experience of a significant rise in interest rates in recent past years;
- unexpected surrenders may also occur as result of many diverse events : for instance after changes in tax laws or even as the result of a newspaper article : this probability and the impact for this kind of event are difficult to estimate and to rationalise;
- surrender models depend also on policyholders' behaviour which is quite complex to model as it could not be simply compared to a financial arbitrage. Therefore it sometimes would appear not to be rational.

Thus, measurement of fair value may be very sensitive to slight differences in assumptions and models, for which insurers may lack market information. Therefore, time is necessary to work out a commonly agreed approach to model surrenders. But we note that the framework and many current standards (IAS 19, IAS 37…) already require models which are very sensitive to key assumptions and a fair value including based on surrender patterns would simply be on line with those standards.

13.3.5. Conclusion

In conclusion, we suggest suppressing the deposit floor requirement based on the following considerations :

- although "investment contracts" may contain an immediate demand feature, it should be noted that they also contain specific features such as maturity dates, renewals, death guarantees, participation feature, tax incentives,... All of which influence surrender patterns. These issues are to be addressed in Phase II. Taking a decision in Phase I would most likely lead to reversing this decision in Phase II, which is contradictory with the objective of Phase I.
- the fair value measurement of some financial liabilities may perhaps be considered equal to the immediate amount available on demand, if those liabilities do not contain the specific features detailed above. The absence of a deposit floor might not lead in such cases to a measurement which is materially different to the amount available on demand.

13.4 - Measurement of “investment contracts”

Beyond the above mentioned issues that are specific to investment contracts with a participation feature, we must question how investment contracts are supposed to be measured under IAS 39. This particularly relates in Phase I to unit-linked contracts, as IG 1.9 states that “Investment contracts in which payments are contractually linked (with no discretion) to returns on a specified pool of assets held by the issuer are subject to IAS 39” and that “the link to the investment return creates an embedded derivative that typically requires separation”.

13.4.1. Fair value measurement

If these contracts were to be measured **at fair value**, insurers would face many issues that will be addressed for Phase II, among them modelling the policyholders’ behaviour, simulating the future unit values in order to compute the present value of future fees, etc… considering that the contract does not constitute a "demand deposit" *per se (see § 13.3 above for additional issues).*

BC 117 (d) (e) (f) (g) only provide partial guidance as to which cash flows should be projected in order to compute the fair value of investment contracts, and in particular unit linked contracts : as to which income (front end fees, management fees,…) and as to which expenses (origination costs, cost of servicing…). For example, does (f) mean that contractual rights to receive management fees should be recognised less related costs up to an amount equal to origination costs paid?

We fear that the absence of guidance would lead in Phase I to a lack of comparability arising from different interpretations and would like to stress that these issues have to be carefully addressed in Phase II with a view to allowing for consistent treatment of insurance and investment contracts.

13.4.2. Amortised cost measurement

If these contracts were to be measured **at amortised cost**, we do not know how to proceed where unit-linked contracts are to be viewed as a hybrid instrument that combines a debt instrument and an embedded derivative, e.g. the equity-linked return available on surrender or maturity, as proposed in IG 1.9 and IG 2.8. Indeed this "embedded derivative" would seem to constitute the whole contract as an equity-linked return is available both on surrender and maturity.

As for fair value measurement under IAS 39 for these contracts, BC 117 does not provide sufficient guidance in order to compute their amortised cost.

We would welcome a thorough investigation by the Board of all aspects of the measurement of unit-linked contracts which have not yet been fully investigated. If this cannot be done within the limited timeframe before Phase I is in place, we would recommend that unit-linked contracts should continue to be accounted for under existing accounting policies during Phase I.

13.5 - Unit-linked contracts "invested" in investment property – additional mismatch issue

Some unit-linked contracts are "invested" in investment property. If insurers were to elect to measure the liabilities under these contracts at fair value, it would be consistent to measure the corresponding investment property as an asset at fair value also.

However, it should be noted that IAS 40 Investment property states in § 27 that "*after initial recognition, an enterprise that chooses the fair value model should measure all of its investment property at its fair value, except in the exceptional cases described in § 47*" (inability to determine the fair value).

Consequently insurers, having opted for consistent asset and unit-linked contract liabilities at fair values, would be required to measure all of their investment property at fair value although some investment property should be measured at "cost" because the corresponding liabilities are also measured, under existing accounting policies, at "cost".

We recommend that an exception is introduced in ED5 to allow insurers to measure at amortised cost the part of investment property which does not back liabilities under unit-linked contracts, independently of the option chosen for assets actually backing the unit-linked contracts.

13.6 - Acquisition costs

We welcome the Board's decision made in July with respect to transaction costs :

" *The Board tentatively agreed that transaction costs should be defined as "incremental costs that are directly attributable to the acquisition or disposal of a financial asset or financial liability. The Board also tentatively agreed that the Standard should clarify that transaction costs are included in the measurement of items other than those measured at fair value with changes in fair value recognised in profit or loss.* "

This decision should permit a consistent treatment between insurance and investment contracts whilst enabling the recognition of incremental internal and external acquisition costs in the computation of investment contract liabilities when measured at amortised cost. We actually understand that internal costs should be considered when they can be directly attributed to the sale of a contract.

With regard to fair value measurement, we note that BC 117 (f) states : "*if future investment management fees and related costs are in line with current fees charged, and costs incurred, by other market participants for similar services, it is likely, unless there is market evidence to the contrary, that the fair value at inception of the contractual right to those fees equals the origination costs paid*".

As stated above (see Question 13.4.1) does this not mean that the contractual rights to future management fees should be recognised less related costs up to an amount equal to origination costs paid?

13.7 - First time application of ED5

As the Board allowed entities adopting IFRSs for the first time in 2005 not to restate comparative financial statements to incorporate the requirements of IAS 39, we recommend that a similar exception is introduced in ED5.

A significant part of an insurer's liabilities may actually comply with IAS 39. It would not be consistent to require restating comparative financial statements for insurance contracts and yet not require a comparative presentation for all of an insurer's assets and liabilities coming under IAS 39.

However, as decided for IAS 39, "*insurers would be required to provide a reconciliation between amounts recognised at the end of the comparative period (for an entity with a December year-end, 31 December 2004) and those recognised at the beginning of the next period (for an entity with a December year-end, 1 January 2005)*".