FÉDÉRATION FRANÇAISE DES SOCIÉTÉS D'ASSURANCES
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LE PRÉSIDENT

October 28, 2003

Dear Sir David,

The Fédération Française des Sociétés d'Assurances (FFSA) is the principal trade association of life and non-life insurance and reinsurance companies in France and its members represent more than 90% of the insurance and reinsurance premiums written on the French market. The French Insurance Association is strongly committed to the goal of developing high quality international and harmonised accounting standards and appreciates the opportunity to comment on Exposure Draft 5 – Insurance contracts (ED-5) publicly issued on 31 July 2003.

The FFSA is a member of the Comité Européen des Assurances (CEA) which represents the European insurance industry. The analyses of and the answers about ED-5 of the two trade associations have been elaborated on a constructive and interactive basis for the last two months. Therefore the FFSA supports the overall position of the CEA and shares the views of the European insurance industry about ED-5. However it is noteworthy that the FFSA has preferred to outline one specific solution to the so-called "mismatch issue" *(see answer to question 13 for more detailed comments)* among the two options presented by the CEA. In order to take into account the specificities of existing accounting of insurance liabilities, the FFSA preferentially supports the solution of temporarily creating a specific category of assets for all investments backing insurance liabilities during Phase I. This solution which indeed consists of granting insurance entities a temporary exemption to some measurements prescribed by IAS 39 is also one of the options presented by the French accounting standard setter, the Conseil National de la Comptabilité, who has notably taken into account the views of all interested parties, including notably accountants and users besides the industry.

We strongly suggest the Board to consider comments from users of the accounts, notably about the question of the mismatch. The equity of an insurance group is a major item that is monitored and analysed by credit and equity analysts in order to assess the existing and future solvency and to value properly listed companies. Not solving the mismatch issue will lead inevitably to incoherent financial reporting and therefore poor assessment by users.

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London
UNITED KINGDOM

The FFSA supports the objective of enhancing transparency and comparability of the financial statements. However, the FFSA does not support the compulsory disclosure of the fair value of insurance liabilities for all insurance entities as of 31 December 2006, while at the same time the concept of fair value for insurance contracts has not been yet finalised by the Board, but recommends the disclosure of value based information on a voluntary basis.

In connection with the French accounting standard setter (Conseil National de la Comptabilité), the FFSA has been commenting the previous exposure-draft amending IAS 32 and 39. ED-5 can not be commented separately from IAS 39 in view of the recent Board's tentative conclusions about this standard and the related exposure-draft about macro-hedging. In our previous answer, we have been partly reserving our comments about IAS 39 depending on the content of ED-5 and of the future IFRS-Insurance contracts-Phase II. We strongly invite the Board to review our current comments about IAS 39, notably our assessment of how the fair value of a financial instrument with a surrender option issued by an insurer should be accounted for. Indeed such contract even if accounted for as a financial instrument, is of a different nature than a simple deposit account due to its specific features (participating features etc...). Therefore, its surrender value should not be considered as the floor for any measurement of the liability consequent to such a contract.

The FFSA's other general considerations and specific comments about ED-5 are exposed in Q13. You will find thereafter the answers of the FFSA to the questions asked by the Board in ED-5.

Notwithstanding the content of ED-5, the FFSA would like to draw the attention of the Board to the important timing issue. The final standard of IFRS-Insurance contracts-Phase I is not expected before March 2004 - not mentioning the subsequent delay required by the European accounting regulatory committee to endorse it – whereas the standard should be applied by European insurance companies as of 1st January 2005. Although the FFSA appreciates the Board's objective to make limited improvements to accounting practices for insurance contracts, our constituents have concluded that ED5 still requires too many significant changes in IT systems in order to be ready by the mentioned deadline. Past experience (new French accounting rules in 1995, bug millennium, adoption of the euro currency) suggests that migrating IT systems, educating staff and implementing new standards require to have the standard made available two years before the date of its first implementation.

Phase I is to represent a transitional standard while the final standard for Phase II is to be developed for insurance contracts. As suggested by the Board Phase I should therefore avoid too many significant changes; therefore the FFSA suggests to concentrate all major changes with the implementation of Phase II, notably regarding the treatment of embedded derivatives and of reinsurance, in order to avoid a piece-meal approach to Phase II.

Sincerely yours,

Gérard de La Martinière

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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?

FFSA's comments on Q1

The FFSA disagrees with the scope exclusion (ref. 1 (a) (i)) of assets held to back insurance contract. The FFSA believes that the basis of accounting assets held to back insurance contracts (generally speaking) shall be consistent with the basis of accounting for insurance liabilities (generally speaking). Current and expected principles of accounting for assets within IAS 39 will inevitably lead insurers to account for the vast majority of their assets at fair value whereas most of the insurance and financial liabilities with a discretionary participating feature would be accounted for under local GAAPs during Phase I. Since the French GAAPs are closely similar to an amortised cost method, this will inevitably lead to introduce a mismatch between the measurement basis of assets (at fair value) and insurance liabilities. We discuss this matter further in our comments to Q13.

Question 1 (a) (ii) raises a specific remark: as it is explained in paragraph 2 (b) of ED5, financial instruments that an entity issues with a discretionary participation feature are excluded from its scope and to be treated according to IAS 32. It should then be specified that, contrary to what IAS 32 provides, disclosure of fair value should not be made compulsory in 2005. Other aspects of financial instruments with a discretionary participation feature are examined in question 13.

We have no specific comments on the Board's proposal about weather derivatives (ref. Q1 (b)).

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Question 2 – Definition of insurance contract

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

FFSA's comments on Q2

The FFSA welcomes the endeavour of the Board to define an insurance contract thanks to a principle-based approach for the sole and exclusive accounting purposes. The definition of the insurance contract of Appendix A appears more balanced than the previous versions. Therefore the FFSA broadly supports the definition as tentatively agreed by the Board. It should allow insurance companies to determine, with their auditors, the pertaining accounting treatment for insurance and investment contracts with or without discretionary participating features.

However, some of the examples given in the implementation guidance give rise to comments. We disagree with considering "pure endowment contracts (IG § 1.4)" as an investment contract. This contract includes an insurance risk because a policyholder would be adversely affected if he had no policy to cover his needs in case of survival. This example should also lead to conclude that guaranteed minimum life contingent benefits of unit-linked contracts should be treated as insurance contracts.

The FFSA invites the Board to clarify the status of the Implementation Guidance (IG). The FFSA understands that the IG is not part of the draft IFRS; therefore the examples outlined in IG are merely illustrative and should not be viewed as mandatory or restrict the principles of the definition stated in the draft IFRS.

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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

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

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

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

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

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

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

(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). Is it appropriate to exempt these embedded derivatives from fair value measurement in phase I of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase I?

(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs IG54-IG58 of the draft Implementation

Guidance). Are these proposed disclosures adequate? If not, what changes would you suggest, and why?

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

FFSA's comments on Q3

In principle, the FFSA supports the view that all embedded derivatives should be reflected at fair value. However the FFSA notes that the requirement for separate accounting of embedded derivatives entails too many and significant change in valuation and IT systems during Phase I and, therefore, welcomes the decision not to separate embedded derivatives which meet the definition of an insurance contract. Question 3 (a) adequately presents some principles allowing not separating embedded derivatives from their host contract, which seem to us realistic.

However, since

- i) insurance liabilities will be accounted for according to local GAAPs,
- ii) it is not relevant to treat differently embedded derivatives,
- iii) separating embedded derivatives from their locally-GAAP-accounted-for-host-contract would break up the overall economic value of the contract,
- iv) separating and valuing embedded derivative of insurance contracts would inevitably prejudge the fair value of insurance contracts and derivatives that will be addressed in phase II,
- v) furthermore the risk associated with the embedded derivatives included in insurance contracts shall be captured by the loss recognition test as described in paragraphs 11 to 13 of ED-5 which will ensure that the level of insurance reserves is adequate,

the FFSA strongly suggests to postpone the requirement for an entity to separate embedded derivatives from insurance contracts and financial instruments with a discretionary participating feature, including unit linked contracts, until the phase II project concludes the valuation of these liabilities at fair value.

According to what we exposed in answering to question 3 (a), we have no further comments for both questions 3 (b) and (d). Regarding disclosure (ref. (3) c)), the FFSA suggests to rely on local GAAPs and the associated loss recognition test – when existing – which provide with sufficient range of methods to analyse the sensitivity of embedded derivatives. The FFSA is willing to give illustrative examples of such disclosures about French contracts issued by insurance entities should the Board feel necessary to precise the examples of the implementation guidance.

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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?

<u>FFSA's comments on Q4</u>

We support temporary exemptions of IAS 8 "Accounting policies" for insurance contracts and also for financial instruments with a discretionary participating feature (the latter instruments although part of the scope are not mentioned when mentioning the exemption). However, the FFSA judges inappropriate the so called "sunset clause" expressed in question 4 (a) that will reinstate the hierarchy of IAS 8 at the beginning of 2007. Ai it is unlikely that the final IFRS for insurance contracts (phase II) would be finalised by this deadline (including IT changes…), the "sunset clause" will lead to another significant change undermining the quest for a high quality insurance standard, creating undue cost and effort and misleading users of accounts. It is of paramount importance to first finalise the Phase II-IFRS before setting a time limit to the temporary exclusion from criteria in IAS 8.

The FFSA acknowledge that the definition of a liability as stated by the framework of the IASB hardly makes it possible to consider catastrophe and equalisation reserves as liabilities (ref. 4 (b) (i)). However the FFSA would like to draw the attention of the Board to one of the characteristic of the economic management of insurance companies. Insurance companies underwrite and manage insurance risk on a mutualised basis either on a geographical basis or a time basis. Not allowing recording and recognising this specificity would lead users to lose some information about the management of the underwritten risks. The FFSA regrets that there is no proposition to substitute these reserves by another mechanism which takes in account low frequency-high severity risks. At least, segregation of this component should be permitted.

The FFSA does not feel that there will be a need for an additional loss recognition test (ref. 4 (b) (ii)) for local accounting regulations demands French insurance companies to test and recognise any potential loss.

Question 4 (b) (iii) raises no particular comment.

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<u>Question 5 – Changes in accounting policies</u>

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?

<u>FFSA's comments on Q5</u>

Notwithstanding our remarks about the fair value of financial liabilities (ref. Q13), the FFSA considers the Board's proposals in 5 (a) and (b) as adequate, except that it should be extended to financial instruments with discretionary participation features.

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<u>Question 6 – Unbundling</u>

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?

<u>FFSA's comments on Q6</u>

The FFSA is opposed to the unbundling of the products as it will pre-empt the conclusions on the valuation of insurance liabilities in phase II. Currently unbundling would introduce unnecessary complexity into accounting. Therefore the FFSA welcomes the Board's current proposals to limit unbundling.

Moreover, the current implementation guidance does not clearly indicate when unbundling is required (question 6 c). Since no one can come up with such a clear objective guidance, the FFSA suggests postponing unbundling until phase II has been finalised. The FFSA acknowledge that "financial reinsurance" is an issue. However existing accounting policies dealing with this matter in certain countries have identified these contracts as a whole with respect to the extent of "insurance risk" present. There is no precedent for "unbundling components" however relevant this might be but the question of not prejudicing this issue prior to Phase II is all the more evident as reinsurance is not the principal objective of Phase I and its accounting requires considerable conceptual clarification for Phase II.

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<u>Question 7 – Reinsurance purchased</u>

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?

<u>FFSA's comments on Q7</u>

The FFSA understands the Board's concerns about reporting anomalies which could exist when provisions are measured on a basis involving discount or not, and sold to a reinsurer on another basis. However, the FFSA disagrees with the concept of amending during phase I one term of the relationship between the insurer and the re-insurer that will materialize into two different accounting principles within the financial statements of insurance companies. In order to avoid a piece-meal approach to phase II and to keep consistent accounting principles, the FFSA suggests delaying the treatment of reinsurance until phase II is finalised.

Indeed the requirement of paragraph 18 (d) of ED-5 can only lead to create losses at the issue of the contract because the partial reversal effect if the business is reinsured would not be recognised. This will not reflect the economics of the transaction with the reinsurer and the subsequent increase of the earnings in subsequent periods for reinsured contracts. Also the FFSA notes that the Board's proposals would inevitably lead to IT changes which will only be required for Phase I whereas the objective of the goal is to avoid such temporary changes that Phase II would reverse.

Likewise paragraph 19 of ED-5 requires that a cedant shall apply IAS 36 impairment of assets to its rights under a reinsurance contract. The FFSA acknowledges the need for a robust and solid impairment test of these assets. However the FFSA is concerned that the requirements of implementing IAS 36 might not be appropriate for a consistent measurement of direct liabilities and related assets under a reinsurance contract. This would lead to a fair value measurement of the reinsurance assets inconsistent with the measurement of the direct liabilities.

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<u>Question 8 - Insurance contracts acquired in a business combination or portfolio transfer</u>

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?

<u>FFSA's comments on Q8</u>

The FFSA agrees with the proposals of the Board but notes that the scope of the requirement for an expanded presentation that splits the fair value of acquired contracts into two components is limited to the sole insurance contracts. The FFSA suggest bringing in line the scope of these proposals with the scope of ED5 i.e. insurance contracts and financial instruments with a discretionary participation feature.

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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?

FFSA's comments on Q9

The FFSA sustains the temporary exemption for contracts with a discretionary participation feature until phase II is completed. The FFSA agrees with the Board's proposals that an insurance entity should determine how to account for the unallocated surplus. However, if an insurance entity does not split the unallocated surplus, the latter should be explicitly identified and accounted for as a liability during phase I. Policyholders' contract conditions, regulatory requirements, market conditions and financial situation of the entity should determine the allocation of unallocated surpluses between liabilities and equity.

The FFSA notes that the issuer of a financial instrument with a discretionary participation feature shall continue its existing accounting policies subject to the requirements prescribed by paragraphs 24 and 25 of ED5. The FFSA concludes that this results in the continuation of the all existing policy of accounting for such contracts i.e. in recording items such as premiums, related losses etc… Other comments about financial instruments with a discretionary participation feature are addressed in our comment on Q13.

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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?

FFSA's comments on Q10

The FFSA disagrees with the Board's proposals to begin requiring compulsory fair value assessments of insurance contracts as of 31 December 2006. Phase II project is not foreseen to be completed in the near term and many other issues (revenue recognition, measurement, performance reporting) has not been dealt yet by the Board. Disclose the fair value by the suggested deadline does not therefore appear realistic. Besides fair value assessment requires heavy and important changes in IT systems that are not compatible with a measure that could be reversed if new tentative conclusions were reached by the Board when finalising phase II. Financial instruments with a discretionary participation feature should also be excluded from this requirement.

However the FFSA suggests that the Board offers the possibility to insurance entities to disclose, on a voluntary basis, value based information or marked-to-model measurement of liabilities stemming from contracts issued by insurance entities including information about the key assumptions and the methodology used to calculate those values. If the FFSA is opposed to any compulsory fair value disclosures until Phase II has been finalised by the Board, one shall not preclude insurance entities to give additional information about the measurement of their liabilities towards policyholders or change its accounting policies if requirements of paragraphs 14-17 are satisfied.

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<u>Question 11 – Other disclosures</u>

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

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

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

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

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

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

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

<u>FFSA's comments on Q11</u>

The FFSA welcomes the balanced requirements of other disclosures proposed by the Board. The FFSA supports the principles stated in ED5 and considers the examples given in the implementation guidances as suggestions; it would be useful for the Board to precisely state the indicative nature of the guidances. Additionally the FFSA would like to outline that some of the suggested information for instance claims development should not be disclosed on a retrospective basis from the date of implementation for the meaningfulness and usefulness for the users can be questioned. Also retrospective information will inevitably have significant IT costs.

The FFSA notices that no IFRS requires disclosures about "risk management objectives and policies for mitigating risk". Therefore the FFSA suggests that this type of information should be exclusively stated within the « Management' s Discussion and Analysis »; therefore ED5 paragraph 29 and IG 37 should be suppressed. In the same way, the sensivity analysis should be reclassified in the MD&A, which involves the suppression of ED5, 29 (c) (i) and IG 41 to IG43.

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

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?

FFSA's comments on Q12

The FFSA agrees with the Board's proposals about financial guarantees noting that these proposals allow to distinctly identifying credit insurance underwritten by credit insurers from other financial guarantees. Credit insurance which meets the definition of insurance is therefore included in the scope of ED5.

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Question 13 – Other comments

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

FFSA's comments on Q13

The FFSA would like to comment the following additional items:

1. the mismatch issue which is brought by applying inconsistent valuation principles for assets and liabilities,
2. the consequent need to amend IAS 16 and IAS 40
3. the measurement of financial instruments with a discretionary participation feature,
4. the need to review the fair value of a financial instrument with a surrender option issued by an insurer,
5. the measurement of unit-linked investment contracts,
6. the need for a consistent treatment of deferred acquisition costs.

1. Mismatch

The mismatch issue has now been illustrated and commented by all parties (insurance industry, actuaries, staff and Board); the Board will find in the following annexes two examples of the significant impact this mismatch could have on financial statements of French insurance companies.

Having recognised that the mismatch issue is not anymore controversial regarding its existence or its significant impact on the equity of insurance groups, the FFSA considers that a great attention should be devoted to this issue since equity is an essential item looked at closely by users of financial statements. Equity has to reflect the economic reality of a company – i.e. very simply, if it is rich or poor – and how financial markets' movements really impact its financial strength. If too many restatements are needed in order for analysts to assess companies, no improvement to the existing situation would be realized, not mentioning the condition that companies provide enough and consistent information to illustrate the consequences of the mismatch issue. Things would even be made worse since undue cost effort will be needed to manage an issue that does not exist today. Analysts use the equity for many computations: Price to book value ratio, solvency calculation (premiums or provisions to equity for example), ROE, gearing… Those ratios are keys for analysts and other readers, as they are very simple. So equity should give the most relevant picture of the company wealth volatility in order to allow a good comparison between two insurance companies that do not have the same structure of contracts. Moreover these simple ratios are used for all industries, not only insurance, in order to conduct cross-sectorial comparisons. If the published equity shows some artificial noise, clearly some discounts will be applied to market valuations for insurance, which will be particularly unfair if nothing economic, except inconsistent accounting principles, justifies this noise.

The FFSA has been proposing different solutions to cope with this mismatch issue (cf. roundtables about IAS 39, 14th March 2003). Having consistent accounting principles to measure both assets and liabilities is necessary because the bulk of the liabilities of insurance entities will remained accounted for under local GAAPs and because there is a clear link between the measurements of assets and financial liabilities with a discretionary participating feature. In order to avoid significantly amending IAS 39, we recommend creating a new temporary category of financial assets backing insurance liabilities (in general) for phase 1. The assets classified as “Held to back insurance liabilities” would be measured at either amortised cost or book value (historical cost) since the FFSA suggests to allow insurance companies to classify univocally all types of assets within this category. Even though the FFSA acknowledges the interest and value of fair values of stocks, she notes that this information which has value for the users is already compulsory required in the notes under European GAAPs’ requirements. On the contrary, not enabling all types of assets to be recorded within this category would leave unresolved some part of the mismatch issue (namely stocks valued at fair value backing insurance liabilities valued at amortised cost).

The FFSA wishes to outline that the assets backing insurance liabilities shall follow several and important requirements of IAS 39, notably:
- initial measurement of financial assets,
- impairment and uncollectibility of financial assets,
- hedging accounting,
- disclosures,
- embedded derivatives to be bifurcated.

The FFSA notes that the suggested solution is consistent with its past proposal of having either all assets & liabilities at fair value or all assets & liabilities accounted for under local GAAPs. Concerning the fair value of a financial instrument with a surrender option issued by an insurer, we refer to the point 4 of Q13.

<u>2. The consequent need to amend IAS 16 and IAS 40</u>

The FFSA has been stressing the mismatch issue on the sole ground of the differences of accounting principles between assets accounted for according to IAS 39 and liabilities accounted for according to local GAAPs. This emphasis was explained by the significant part of assets held to maturity among the assets held to back insurance liabilities (in general).

However, insurance companies invest in property, for investment or operating purposes. Both property buildings back insurance liabilities. One could conclude that if a specific category of assets held to back insurance liabilities, including property, there would not be any other difficulty to account assets. However, these assets can be held either in a general account or in a separate account (although the US legal separate account concept is not valid in France, we use the generic term) in order to back unit-linked contracts. Local GAAPs lead to mark-to-market assets of unit-linked contracts (see below point 5 of Q13); therefore, some investment properties are valued at fair value, other at historical/amortised cost but accounting principles of assets and liabilities for the same category of contract (unit-linked contracts / other contracts) are consistent.

The FFSA draws the attention of the Board to the need to ensure that consistency of accounting principles for ALL assets held to back ALL insurance contracts (in general) requires addressing the issue of the univocal requirement or choice of method to account for property in IAS 16 or IAS 40.

This question can be extended to all other assets backing unit-linked contracts (see below point 5 of Q13).

<u>3. Measurement of financial instruments that contain a discretionary participation feature</u>

3.1. ED5 applies to financial instruments that contain a discretionary participation feature [ED5 § 2(b)].

It rules [ED5 § 25] that, as for insurance contracts, they should be recorded in conformity with existing accounting policies (i.e. local GAAP) subject that:

(i) Unallocated surplus arising from the discretionary participation feature be classified as either a liability or equity;

(ii) Embedded derivatives (within the scope of IAS 39) that they contain be unbundled.

ED5 also states [ED5 § 25] that the local GAAP measurement of the financial instruments with a discretionary participation feature should be compared to the IAS 39 measurement of the fixed element they contain , this latter amount being considered as the floor carrying value on the balance sheet. ED5 relaxes the necessity to compute the amortised cost of the fixed element if the total reported liability in local GAAP is clearly higher.

A draft amendment to IAS 39 [BC 117 (c)] adds 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.

3.2. For the following reasons, we consider that the reference to the IAS 39 measurement should be cancelled in paragraph 25:

(i) First ED5 rules financial instruments with a discretionary participation feature out of the scope of IAS 39. Then, despite this temporary exclusion, it requires a partial IAS 39 measurement, which is contradictory.

(ii) The requirement to compute the IAS 39 measurement of the fixed element would make paragraph 24(a) not applicable for the financial instruments with discretionary participation feature: As of matter of fact, one would be obliged to separate the fixed element from the participation feature as it would be difficult to evidence that the total reported liability in local GAAP is clearly higher than the IAS 39 measurement. This unbundling would certainly lead insurers to make major changes in their EDP systems, which is not the objective followed by the Board [ED5 § 1(b)].

(iii) Difficulties of application and interpretations between insurers would certainly arise as the term "clearly higher" is imprecise.

(iv) Adopting different measurement bases for the same discretionary participation feature depending on the qualification of the contracts (insurance or investment) is not in accordance with the IAS Framework. No reference to a floor carrying amount is made for the liabilities of insurance contracts with a discretionary participation feature: The risk of understating those liabilities is addressed by the loss recognition test [ED5 § 11-13]. We therefore think that it would be much simpler and much more consistent if this loss recognition test also applies to financial instruments with a discretionary participation feature in replacement of the requirement to measure the fixed element according to IAS 39.

(v) The requirement to assess at fair value the option to surrender, as presented by a draft amendment to IAS 39, would be difficult to be implemented during Phase I: The fair value of the option to surrender is correlated to the fair value of the discretionary participation feature, which is to be addressed by the Board for Phase II only. Again, we consider that applying the loss recognition test as set in paragraphs 11-13 would meet the objective followed.

4. The need to review the fair value of a financial instrument with a surrender option issued by an insurer:

In June 2003, the Board confirmed that the measurement of a financial liability with a demand feature is not less than the amount payable on demand. The Board notified that this statement overrides a liability measurement based on expected surrender patterns if the latter amount is less than the amount payable on demand.

In a first analysis, it may appear that insurance entities are concerned by this statement for several reasons:

i) Some of their liabilities, namely non insurance financial instruments without a discretionary participation feature will be accounted for according to IAS 39,
ii) Another significant part of their liabilities, namely financial instruments with a discretionary participation feature, will most probably be governed, once phase II is finalised, by IAS 39,
iii) The Board's conclusion could be seen as an anticipation of what fair value for insurance contracts and financial instruments with a discretionary participation feature with a surrender option could be, whereas the FFSA had understood the debate was still open, notably as a surrender option is different from a demand feature.
iv) The Board's decision seems to contradict its past orientations about what could be fair value of insurance liabilities and constitutes brakes for insurance companies in developing models to implement fair value or entity specific value of insurance liabilities in anticipation of phase II,
v) This decision also appears to contradict existing standards which consider expected surrender patterns or probability weighted average of all cash flow, for instance IAS 19 or IAS 37,
vi) Finally and principally, the Board's decision does not reflect the reality of the economics of the insurance industry. The use of the surrender value as the floor for the fair value of a financial instrument or an insurance contract issued by an insurance entity implicitly implies that all policyholders surrender at every closing date of the financial statements. The insurance industry can certainly demonstrate the stability of the close book of policies and that, even a significant rise of interest rates (200 bp for instance) does not entail a huge surrender rate. The issue is not about recording a gain at inception but rather to record a partial offsetting gain when interest rates increase and value of the assets consequently decrease reflecting the real economic picture of an insurance entity and its equity.

The FFSA would like to see the Board reconsider the use of the surrender value as the floor for the fair value of a financial instrument or an insurance contract issued by an insurance entity.

5. Unit account policies

1. Unit-linked contracts without any minimum guarantee of unit values in the event of death would probably be considered as not exposing the insurer to insurance risk and not meeting the definition of an insurance contract. In addition, the linkage of the contract value with the unit return does not qualify as a discretionary feature: As a matter of fact, the amount and the timing of the payments are not at the discretion of the insurer. Therefore these contracts are excluded from the scope of ED5. IAS 39 applies to them.

2. French unit-linked contracts can not be economically considered as "held for trading" as insurers intend to held them until the policy maturity (at best) or until policyholders surrender them (at worse).

3. Draft revised IAS 39 § 89A requires that "*after initial recognition, an entity shall measure all financial liabilities, other than liabilities designated as held for trading and derivatives that are liabilities, at amortised cost using the effective interest method.*" This requirement opens the question as to how apply the amortised cost to the unit-linked contracts.

4. French unit-linked contracts may be viewed as a hybrid instrument that combines a debt instrument and an embedded derivative, i.e. the equity-linked return available on surrender or maturity. Based on this approach, and by reference to draft revised § A6 of IAS 39 Application Guidance, "*in the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as for units of an open-ended mutual fund or for some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that is payable at the balance sheet date if the holder were to exercise its right to put the instrument back to the issuer*".

5. Then, as the amortised cost equals the redemption value by application of preceding § A6, transaction costs directly attributable to the acquisition of the unit-linked contracts should be expensed and not amortised.

6. This treatment does not reflect the situation of the contracts. It also could cause some inconsistency and costly effort during phase I:

   (i) The economic reality is that all contracts are not surrendered immediately after the balance sheet date. So the carrying value of the contracts at the balance sheet (i.e. the amortised cost) could possibly be less than their redemption value.

   - Taking into account the expected lapses of a book of contracts instead of the individual contractual right to surrender is already considered by the draft revised definition of the effective interest method, which reads as follows : "*the determination of the effective interest rate is based on the estimated stream of cash receipts rather than the contractual stream of cash receipts for the purposes of recognising interest income for a group of assets that are subject to prepayment risk, provided it is possible to make a reasonable estimate of the timing and amounts of prepayments in the group…*". One may conclude that the redemption value is not a floor value in any case.

   - Stating the unit-linked contracts at less than their redemption value on the balance sheet depends on the adoption of the books of contracts as the unit of account: measurement of contracts should focus on books of contracts that are subject to substantially the same risk rather than on individual contracts. This question has already been raised. However, it will be addressed for phase II only.

   As a matter of fact, the issue of amortising the transaction costs of the unit-linked contracts and thus of valuing those contracts at less than their redemption value is not yet satisfactorily addressed by IAS standards.

   (ii) During phase I, deferring acquisition costs would be allowed for insurance contracts as local GAAP would apply, including for those unit-linked contracts that guarantee a minimum payment in case of death. These latter contracts indeed qualify as insurance contracts (see § 2.2. of ED5 Implementation Guidance).
   However, deferring acquisition costs (i.e. using the amortised cost method) would not be allowed to non guaranteed unit-linked contracts.

During phase I, adopting for such unit-linked contracts two different approaches that could be challenged in phase II when shifting to a fair-value measurement, would be inconsistent and may result in irrelevant costs for adapting EDP systems.

As for the option offered by the IAS 39 to a fair value measurement of insurance liabilities, it will be very complex to implement for unit account policies. It indeed supposes to consider future cash flows which are incertain because of the option offered to underwriters to obtain cash value (completely or partially)of their contracts, and of the option offered also to underwriters to arbiter from one support to another in the case of the contracts "multi supports". In addition, if the current orientation is to limit at inception the recognition of future margins, the projection of future cash flows, of which one knows nothing for the moment, technically will probably leads to the taking into account as of the these future margins, which moreover are linked up with the value of assets market, particularly volatile.

The FFSA invites the Board to clarify, thanks to a thorough investigation in close cooperation with the industry, all aspects of the measurement of the unit-linked contracts. If this cannot be done within the limited timeframe before Phase I is to be implemented, the FFSA believes that unit-linked contracts should continue to be accounted for under existing accounting policies during Phase I. Deposit-like accounting should be adopted only for revenue recognition.

6. The need for a consistent treatment of deferred acquisition costs

IAS 39 and ED5 do not account for transaction costs on a similar basis. Leaving the matter unchanged would lead to inconsistent accounting for a same item – acquisition costs – whatever the underlying contract is (insurance contract, financial instrument with a discretionary participating feature, financial instrument without a discretionary participating feature). Notwithstanding this inconsistency, the FFSA notes that insurance companies has not been addressing the IT-treatment of the split of their acquisition costs between lines of business in a way suggested by the Board. The difference of accounting would create significant, temporary and useless changes in IT-systems before phase II is finalised. The FFSA suggests to bring in line the accounting method of acquisitions costs of an insurance entity in line with local GAAPs during phase I.

Also the FFSA asks the Board to clarify the definition of transaction costs under IAS 39. In July 2003, 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 FFSA understands that both internal and external costs are eligible to be characterized as “incremental”. Regarding acquisition costs for a financial liability for instance arisen from participating and non participating contracts subject to accounting according to IAS 39, the FFSA would like to see complete accounting neutrality between acquisition costs generated by internal salaried workforce and external tied agents for instance. The acquisition costs linked to marketing networks that are variable costs should be qualified as incremental costs.

* * *

Set up in 1937, the Fédération Française des Sociétés d'Assurances (FFSA) represents the views of the French insurance companies. In 2003, the FFSA has 299 member enterprises conducting insurance, investment and reinsurance business. These companies belong to one of two trade organizations, depending on their legal form:
• the Fédération française des sociétés anonymes d'assurance (FFSAA): corporations
• the Fédération française des sociétés d'assurance mutuelle (FFSAM): mutual societies.

FFSA member companies represent 91% of the French insurance and reinsurance market.

The FFSA currently has 299 members, 282 of which are active. The 17 others, correspondent members, are recently established players. Overall, the FFSA includes:
– 181 French corporations
– 66 mutual insurance societies
– 52 branch offices of foreign companies.

In 2002, premium income accounted for by companies underwriting in France totalled EUR 131.7 billions. Assets managed by French insurance companies totalled EUR 880.1 billions (carrying value).

* * *

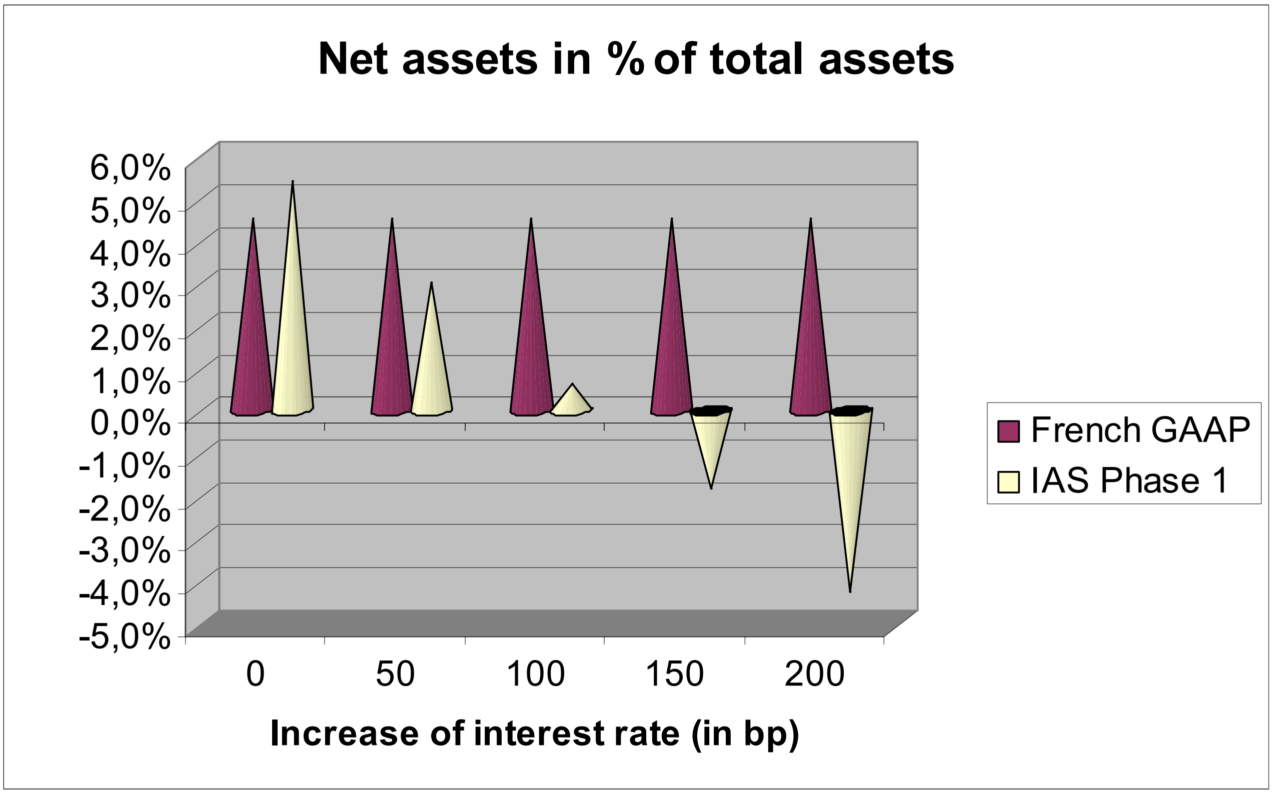
The two following instances illustrate the impact of the mismatch of valuation of assets and liabilities.

Example 1:

The first example is a simple computation of the impact of an increase in interest rates on the net equity of a life insurance company. Only the effect on the value of the bond portfolio has been assessed. The breakdown of assets is the following:
- Shares & assets held to cover equity: 15%,
- Cash and others: 5%,
- Bonds: 80% (8% with a residual maturity of 4.5 years, 57% with a residual maturity of 7.5 years, 16% with a residual maturity of 8.5 years).

Equity represents 4.5% of the insurance life reserves; slightly above the required 4.0% by prudential regulation (5.4% after taking into account unrealised capital gains on shares). Interest income covers contractual minimum guarantees. According to IAS accounting-Phase I as exposed in ED-5, unrealised capital losses of the bond portfolio consequent to the increase of interest rates have to be booked into equity because the insurance industry does not see how to account for the bond portfolio as held to maturity because of its too stringent tainting rule. As hypotheses, there is no possibility to create or adjust a deferred participating liability, deferred acquisition cost or deferred taxes.

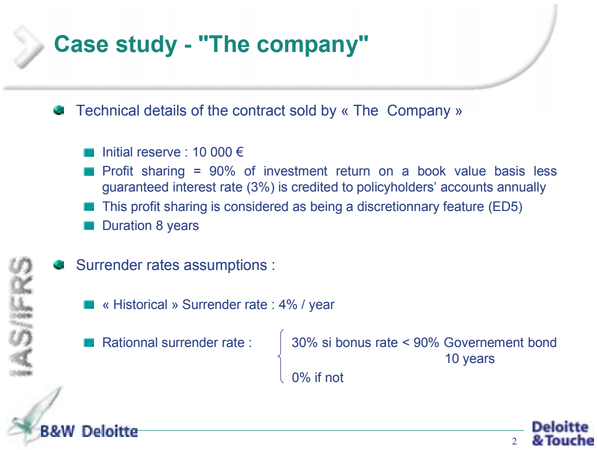
According to the following chart, one can easily pinpoint that a mere 100 basis point increase in the interest rate is sufficient to see equity reduced to c. nil whereas there has not been any additional increase in the surrender rate of policyholders i.e. there has been no need to sell any of the bonds (leaving aside adjustment of the asset & liability matching because of new policies for instance).

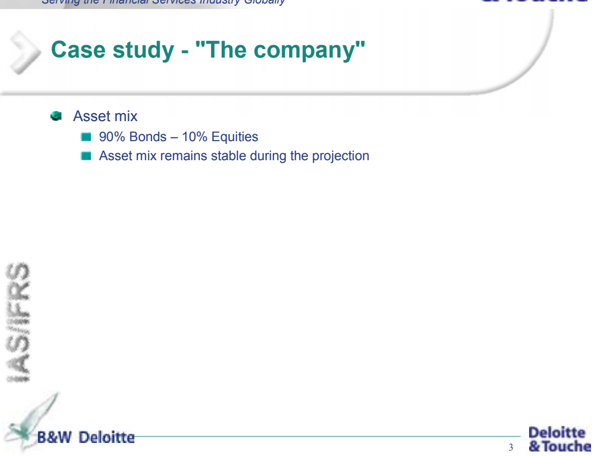


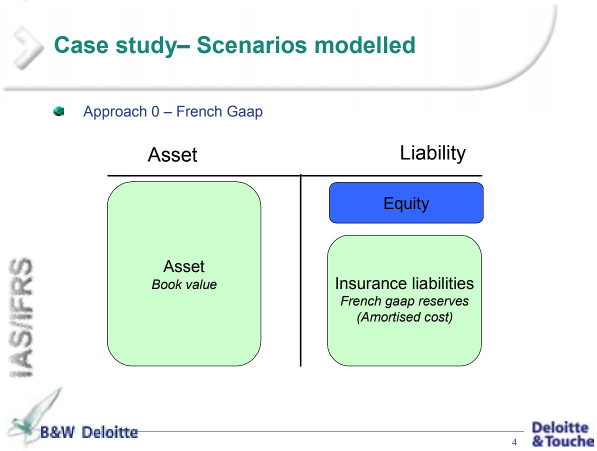
Example 2:

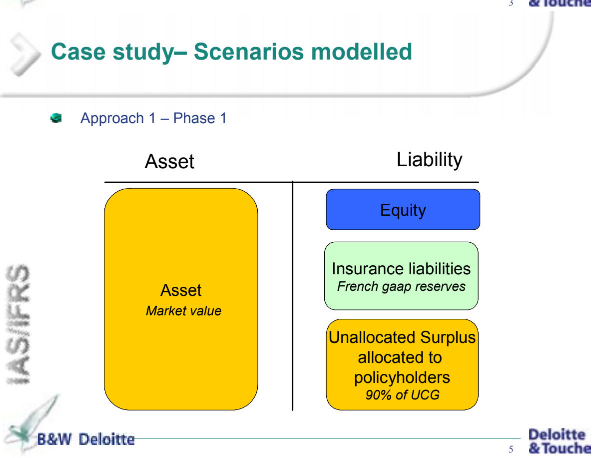
The FFSA has been authorised to present the simulations made independently by Deloitte & Touche-France. The example clearly illustrates two points:

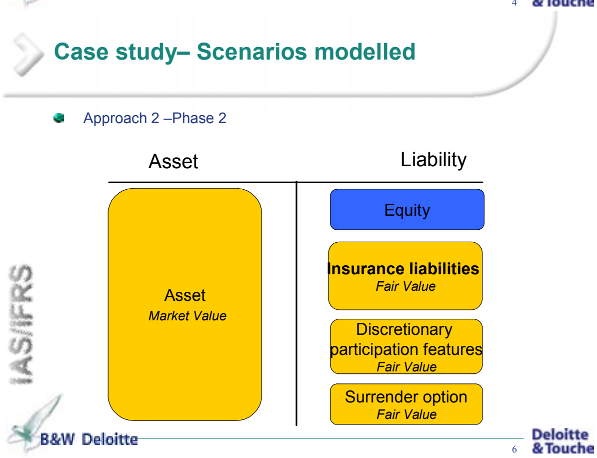
- The significant impact on net equity in Phase I as also stated in the previous example. If nothing is changed re. the question of the mismatch issue, one can not rule out that insurance companies will be presenting net negative equity whereas they are still solvent both on a prudential ground but also and primarily on an economic point of view.
- The Phase II simulation as computed by this auditor suggests that the accounting for of insurance companies will be closer than the current starting point i.e. Phase I will not only distort the economic appraisal of the financial strength of an insurance company but also creates undue changes that will be partly and differently inverted in Phase II. Besides the undue cost and efforts, one has to mention that both users and policyholders may draw conclusions from the financial statements that could impede the development and the financing of insurance companies.









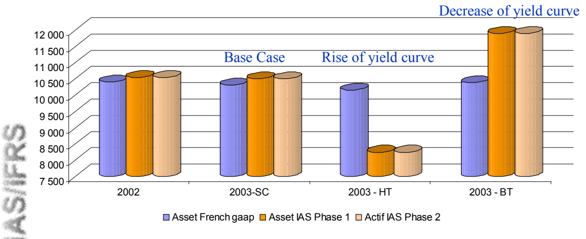


Case study - economic scenarios

- 3 economic scenarios have been modelled :
  - Base case - stability
  - Case HT : Upward shift of 4% of yield curve
  - Case BT : Downward shift of 2% of yield curve

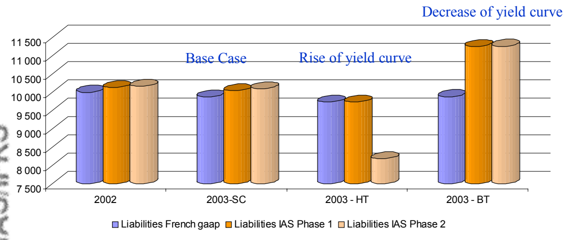
Case study

Asset Value



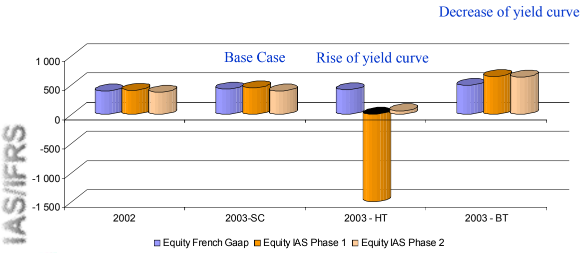
Case study

Value of insurance liabilities



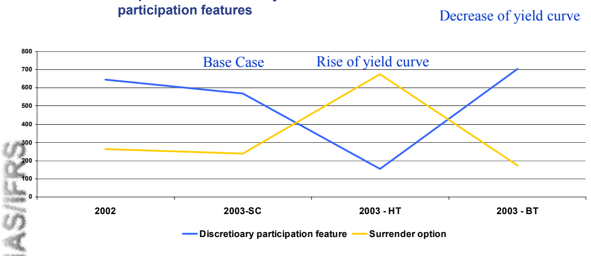
Case study

Equity



Case study

Surrender Option & Discretionnary participation features



Case study – French Gaap Balance sheet Year 1

Base Case - Year 1

Asset		Liability	
Equities	1 040	Capital	401
Bonds	9 361	Capitalisation Reserve	0
Cash	0	PRE	0
		Reserve	10 000
Total	10 401	Total	10 401

Case study – French Gaap Balance sheet Year 2

Base Case - Year 2

Asset		Liability	
Equities	988	Capital	432
Bonds	9 320	Capitalisation Reserve	5
Cash	0	PRE	0
		Reserve	9 871
Total	10 308	Total	10 308

Rise of yield curve - Year 2

Asset		Liability	
Equities	983	Capital	419
Bonds	9 167	Capitalisation Reserve	0
Cash	0	PRE	0
		Reserve	9 730
Total	10 149	Total	10 149

Decrease in yield curve - Year 2

Asset		Liability	
Equities	991	Capital	433
Bonds	9 384	Capitalisation Reserve	64
Cash	0	PRE	0
		Reserve	9 878
Total	10 376	Total	10 376

Case study – IAS Phase 1 Balance sheet Year 2

Base Case - Year 1

Asset		Liability	
Equities	1 092	Equity	415
Bonds	9 446	Value of liabilities	10 000
Cash	0	US of policyholders	123
Total	10 538	Total	10 538

Case study – IAS Phase 1 Balance sheet Year 2

Base Case - Year 2

Asset		Liability	
Equities	1 081	Equity	456
Bonds	9 417	Value of liabilities	9 871
Cash	0	US of policyholders	170
Total	10 497	Total	10 497

Rise of yield curve - Year 2

Asset		Liability	
Equities	990	Equity	-1 493
Bonds	7 247	Value of liabilities	9 730
Cash	0	US of policyholders	0
Total	8 237	Total	8 237

Decrease in yield curve - Year 2

Asset		Liability	
Equities	1 142	Equity	650
Bonds	10 757	Value of liabilities	9 878
Cash	0	US of policyholders	1 371
Total	11 899	Total	11 899

IAS/IFRS

B&W Deloitte

Deloitte & Touche

Case study – IAS Phase 2 Balance sheet Year 2

Base Case - Year 1

Asset		Liability	
Equities	1 092	Equity	381
Bonds	9 446	Value of liabilities	9 248
Cash	0	Discretionary part. feature	613
		Surrender option	296
Total	10 538	Total	10 538

IAS/IFRS

B&W Deloitte

Deloitte & Touche

Case study – IAS Phase 2 Balance sheet Year 2

Base Case - Year 2

Asset		Liability	
Equities	1 081	Equity	397
Bonds	9 417	Value of liabilities	9 271
Cash	0	Discretionary part. feature	556
		Surrender option	273
Total	10 497	Total	10 497

Rise of yield curve - Year 2

Asset		Liability	
Equities	990	Equity	62
Bonds	7 247	Value of liabilities	7 346
Cash	0	Discretionary part. feature	156
		Surrender option	674
Total	8 237	Total	8 237

Decrease in yield curve - Year 2

Asset		Liability	
Equities	1 142	Equity	642
Bonds	10 757	Value of liabilities	10 372
Cash	0	Discretionary part. feature	712
		Surrender option	173
Total	11 899	Total	11 899

IAS/IFRS

B&W Deloitte

Deloitte & Touche