Association of British Insurers

51 Gresham Street, London EC2V 7HQ

Direct Tel. 020 7216 7625
E-mail Peter.Vipond@abi.org.uk
Direct Fax. 020 7367 8645

24 October 2002

Ref T/701/003

Paul Ebling Esq
Accounting Standards Board
Holborn Hall
100 Gray's inn Road
London
WC1X 8AL

Dear Mr Ebling

FRED 30 Exposure Draft

I am pleased to enclose the response of the Association of British insurers to the above Exposure Draft.

Yours sincerely

Peter Vipond
Head of Financial Regulation & Taxation

Enclosure

RESPONSE OF THE ASSOCIATION OF BRITISH INSURERS (ABI) TO FRED 30 "FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION RECOGNITION AND MEASUREMENT

1 INTRODUCTION AND OVERVIEW

Specific Insurance Industry Concerns

1.1 This is the response of the Association of British Insurers to FRED 30. The ABI represents some 430 insurance companies accounting for 97% of the business written in the UK by the insurance company sector.

1.2 Given the current state of affairs over the development of IAS32 and 39 and the IASB interim solution for insurance contracts, we consider that the principles in FRED 30 should not apply to insurance contracts or insurance contract related embedded derivatives. Consistent with our representations to the IASB on IAS32 and 39 we firmly believe that, if the ASB is unwilling to completely scope out such contracts and derivatives, then there must as a minimum be a very significant reduction in scope so that only those contract and related derivatives with de minimis insurance risk transfer are covered by any FRS based on FRED3O.

1.3 We must emphasise that the potentially adverse impact of the current requirements of FRED3O is a matter of serious concern to insurers. We consider it imperative for ASB to enter into a comprehensive dialogue with the ABI should it feel minded to reject our comments in this regard.

1.4 We would also draw your attention to the fact that, as part of the EU approval mechanism for IASs, the Technical Committees of EFRAG has identified fundamental concerns over the fitness for purpose of 1AS32 and 39 in relation to insurance contracts. Before these standards can be approved, these concerns must be addressed.

1.5 In the light of these and other concerns, it is likely that IAS32 and 39 will be subject to further amendment. It would therefore be premature for ASB to implement all or part of FRED3O ahead of the 2005 deadline for listed EU groups while the international standards on which it is based are still subject to possible change.

Application of FRED 30 to insurance contracts and related embedded derivatives

1.6 Currently there is uncertainty over how insurance business will be accounted for under IAS standards. Based on the current versions of IAS32 and 39, insurance contracts that principally transfer financial risk and embedded derivatives within insurance contracts (unless tied to the host contract) will be subject to the requirements of those standards.

1.7 There is insufficient guidance in these standards at present however as to which insurance contracts would fall within their scope, and how the liabilities under those contracts should be measured. This is a fundamental concern for all insurers.

1.8 In the absence of the detailed guidance referred to above, supported by appropriate field-testing, it is difficult to see how an FRS based on FRED 30 could be applied to insurance contracts before 2005. This would result in insurers having to prepare financial statements under conditions of great uncertainty as to how the new requirements should be applied.

1.9 For other insurance contracts the accounting requirements to apply from 2005 will be addressed by an as yet undecided interim IASB solution.

1.10 In the longer term, IASB intends to publish an IFRS on accounting for insurance contracts. Its current thinking in this respect is set out in a Draft Statement of Principles (DSOP). This includes a definition of insurance contract that is inconsistent with the definition of insurance contract in IAS 32 that determines which insurance contracts are excluded from IAS 39. Furthermore, the principles set out in the DSOP are still tentative and therefore subject to possible future change.

1 .11 There is a case for arguing that all contracts having the legal form of insurance contracts, and regarded by insurance regulators as such, should be accounted for in the same way. Even if a distinction is made between such contracts according to the amount and type of risk transferred, the accounting treatment should be covered in the proposed insurance IFRS. In the meantime all contracts having the legal form of insurance should be excluded from IASs32 and 39. This would obviate the need to adapt those standards to deal with certain types of insurance contract, while at the same time creating a single point of reference on accounting for insurance contracts.

1.12 IASB has announced its intention to review the application of IAS32 and 39 for insurance related items before 2005 as part of the interim (phase 1) solution. It is therefore inappropriate for FRED 30 to apply the principles in the current version of the revised IAS 39 to some insurance contracts and related embedded derivatives before the results of this review are known.

1.13 Furthermore, it has not been decided how insurance contracts meeting the DSOP definition should be accounted for under the recent EU Regulation requiring the consolidated accounts of listed groups to adopt IFRSs from 2005 given that the insurance IFRS will not now be ready by then. In view of this uncertainty, we believe the EU Commission should allow insurers to follow their existing accounting practices until the insurance IFRS comes into force. Consistent with this, it should not require IASs32/39 to apply to any insurance contracts. This will ensure that insurance contracts continue to be accounted for on a consistent basis for the time being.

1.14 The alternative could open up a gap in accounting practice between contracts satisfying the DSOP definition of insurance contract and those accounted for under IASs 32 and 39. This divergence might continue even after the insurance IFRS is finalised if it adopts different principles from those in IAS 39. An example of this is the valuation basis; the insurance IFRS may require entity specific fair value whereas IAS 39 currently prescribes fair value. Eventually however consideration might need to be given to how, and to what extent, the requirements of the insurance IAS and the requirements of IAS 39 in relation to insurance contracts should be converged.

1.15 Our particular concern is that any steps taken by the IASB or the EU Commission to exempt all insurance contracts from lASs 32 and 39 should not be over-ridden in the UK by the publication of an FRS based on FRED 30 applying those standards to some insurance contracts

Is there any need for FRED 30?

1.16 ASB is proposing to issue an FRS based on IASs 32 and 39 requiring early adoption of some of the provisions of the proposed revised lASs 32 and 39. The FRS will however defer implementation in the UK of some aspects where either ASB disagrees with IAS 39 or where it considers there is a need to await international convergence.

1.17 Moreover, there are some areas where ASB has substituted its own views in place of those in the proposed revised draft of IAS 39. Recycling is an example of this. There seems however little point in issuing an ASB FRS intended to bring about convergence with IASB Standards which incorporates significant variations from those IASB standards. In other areas, for example recognition and derecognition, the ASB proposes delay in the hope that IASB will eventually adopt the ASB viewpoint.

1.18 We are very firmly of the opinion that there is no case to be made for the early implementation of an FRS introducing all or part of the FRED 30 requirements. This would create a significant burden for accounts preparers by requiring changes and restatement to financial statements without leading to full compliance with IASs 32 and 39. Moreover, accounts users might be confused if the changes to LAS 39 that ASB anticipates did not in fact materialise. ASB should therefore find some other way of influencing the debate at the international level than issuing draft FRSs.

1.19 This could be done, for example, by the ASB issuing position papers on which comments would be requested before submission to IASB. This would encourage detailed debate to ensure the post 2005 regime is implemented in a way that reflects the concerns of UK companies but avoids the need for phased implementation that virtually all observers have seen as being as an impractical and confusing way to proceed.

1.20 Our replies to the specific questions raised in FRED 30 are given below.

2 **ANSWERS TO THE SPECIFIC QUESTIONS RAISED IN FRED 30**

ASB (i) We agree that lASs 32 and 39 should be viewed as a single package of requirements and implemented in the UK at a single point in time, but not within the timescale envisaged in FRED 30.

ASB(ii) We believe the single point in time referred to above should be I January 2005 when the EU Regulation requiring adoption of lASs in the consolidated accounts of EU listed groups comes into effect. In the meantime, we believe that the case for “drip feeding” international requirements into the UK framework through a combination of mandatory and non-mandatory requirements and deferral of some of the IAS32/39 requirements to a later date has not been made in a persuasive manner. In the absence of a convincing case for this, we remain convinced that requirements of IAS32 and 39 as eventually confirmed by IASB should be implemented in a comprehensive manner at one time. Indeed the ASB approach will be counter-productive in imposing an unnecessary additional burden on accounts preparers while creating confusion and uncertainty in the minds of accounts users.

ASB(iii) We question the need for a further ASB Exposure Draft after agreement has been reached within the IASB and presumably reflected in the final text of IAS 39. This will be mandatory in Europe, at least at the group level, even if it is only an interim standard. FRS5 should remain in place insofar as it covers issues not dealt with by lASs.

ASB(iv) (a) As noted above we do not believe that it is sensible to introduce elements of the FRED3O requirements before essential additional guidance on how IASs32 and 39 apply to certain insurance contracts has been developed. To implement changes without a comprehensive solution on these issues would be an unhelpful step. Consistent with this view, we see no benefit in implementing measurement requirements of FRED3O for companies such as insurers, where guidance is yet to be developed on how the fair value of liabilities should be determined.

(b) On the assumption that the implementation of FRED3O is delayed, the approach to recycling for the period before 2005 will remain as per the current requirements. It would seem sensible for the ASB to fall into line with whatever is eventually agreed at the international level.

ASB(v) (a) Again, we advocate delay in implementation of changes to rules on hedging. Para 67 of appendix Ill of FRED3O argues the need for a definitive standard on hedge accounting. ASB however is contemplating the introduction of piecemeal changes to requirements under FRED23 and FRED3O with the possibility that further changes may be necessary. This is counter-productive and of no obvious benefit to users of financial statements.

(b) See answer to ASB(iv) above

ASB(vi) (a) Again we are not in favour of changes prior to 2005. We also believe that the issue of which entities should apply IAS39 measurement techniques is more complicated than whether or not they should apply to entities other than listed entities.

A recent DTI consultative document identifies a number of categories that need to be considered in relation to whether or not LAS reporting requirements should apply. The issue of applicability of IAS39 measurement requirements should be considered at a similar level of granularity.

For insurers, who currently follow fair value accounting rules, we are not convinced of the need for early implementation of IAS39 measurement and hedge accounting provisions in any circumstances and believe that the requirements for 2005 onwards should be viewed as part of a comprehensive package of requirements in respect of all insurance contracts and related derivatives.

(b) We are not opposed in principle to the ASB's view that insurance undertakings should be included within the scope of requirements of FRS 13. The concern though is that the disclosures required by a successor to FRSI 3 should be not only capable of being prepared but more importantly provide relevant and reliable information to users of financial statements in a readily understandable way. When the proposals for FRSI 3 were first developed the ABI made representations that the requirements of FRED 13 were inappropriate for insurance entities. This was accepted by the ASB for the reasons given in para 18 of Appendix VII of FRS13. Similar concerns will apply to the proposed adoption of FRED3O particularly in the absence of a comprehensive solution for insurance contract liabilities. We consider the requirements of FRED3O would provide accounts users with a misleading picture of the risk profile of an. insurer. The intention to adopt these provisions for 2004 reporting is unfortunate. A better solution would be to work with IASB and the ABI to refine the requirements for insurers and establish more detailed guidance that is appropriate in the context of the UK insurance industry's products and regulatory regime where assets are held within ring fenced long-term funds and are not necessarily attributable to shareholders. The FRED3O disclosures would be particularly misleading where the intention is primarily to disclose the risks attaching to shareholders and also because they fail to take account of the matching (eg of currency and maturity) of assets and liabilities inherent in the management of long term insurance business. In saying this we presume that the FRSI 3 disclosures are primarily intended to assist shareholder users of the accounts. We would accept however that the discursive disclosures should include references to long term insurance business.

In the UK the assets of the long-term fund are "ring fenced". Although shareholders may have an indirect interest in a proportion of these assets, transfers from this fund to shareholders are only permitted under FSA rules after an actuarial valuation of surplus has been performed. Moreover, in relation to unit-linked life insurance business the policyholder bears most of the risks associated with fluctuations in the value of the underlying investments.

There is already a precedent in FRS I on cash flow statements for drawing a distinction between the shareholder and long term insurance elements of an insurer's business. Insurers are required to produce cash flow statements in relation to shareholder cash flows; FRS I recognises that the cash flows of the long term business are ring-fenced. It therefore requires the cash flows of the long-term funds to be included in the cash flow statement only to the extent of cash transferred and available to meet the obligations of the company or group as a whole.

It should also be borne in mind that UK insurers are already required to provide a considerable amount of detailed information on financial instruments (including derivatives) in their supervisory returns to the FSA. These returns, which cover the whole of the insurer's business and are on the public record, assist the FSA in carrying out its main function, which is to protect policyholders. The disclosures required in the FSA returns are more appropriate for assessing the solvency position of, and risk factors attaching to, an insurer than the numerical disclosures proposed in FRS 13. They are also designed to assist the supervisor in monitoring compliance with the legal requirements applicable to insurers governing the currency matching of assets and liabilities, location of assets and the purposes for which derivative instruments may be used.

(c) Yes.

IAS 32(i) It is not necessary to refer specifically to the situation where accelerating dividend payments will compel redemption. Paragraph 22 covers this point in stating that a preferred share that does not establish such a contractual obligation explicitly may establish it indirectly through its terms and conditions. Where an entity's obligation to settle in cash depends on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, the instrument should be treated as a liability unless the likelihood of cash settlement is considered remote. In general terms we are concerned that the current drafting of FRED3O should adequately articulate that it is the substance of the transaction that should drive the accounting treatment. Also the deletion of the concept of economic compulsion seems unhelpful - it would be better if it were reinstated with more detailed guidance.

IAS 32(ii) In the interests of consistency and comparability, it is desirable far options to be removed as far as possible. However, given that the sum of the fair values of the liability and equity components when measured on a stand-alone basis may be greater or less than the fair value of an instrument combining both elements, the value of the equity component derived under the new proposals will not necessarily be the fair value. We would prefer therefore the relative fair value method permitted in the current version of IAS 32. Furthermore, there appears to be enough ambiguity in the current drafting to facilitate arbitrage opportunities for companies in applying the rules. To prevent this it would be appropriate to provide further guidance to augment the guidance in paras 29c to 29g.

IAS 32(iii) Paragraph 29C does not address the situation where for example a warrant is not exercised and does not therefore lead to the issue of the entity's own equity instruments. Is it correct under these circumstances to retain the premium received in equity? Equally, it may be inappropriate to deduct any payment for a purchased option on the entity's own shares from equity if the option is not subsequently exercised.

IAS 32(iv) We have no strong views. On the one hand it is useful to consolidate requirements covering the same issue in a single standard. Set against this however is the fact that IAS 39 is already very lengthy and complex. On balance we would prefer two separate standards to ensure that issues of disclosure and presentation on the one hand, and recognition and measurement on the other, do not get mixed up.

IAS 39(i) We have no objection to this exclusion.

IAS 39(ii) Yes.

IAS 39(iii) In general terms the approach to de-recognition strikes an uneasy balance between following a substance over form approach and recourse to proposals based on legal structure. We are not convinced that these proposals have been fully considered and, as currently drafted, they may lead to arbitrage opportunities in product design to achieve desired accounting objectives. We suggest that further work in this area is required before proposals are implemented.

IAS 39(iv) Paragraph 89B requires any financial instrument designated on initial recognition as held for trading to retain this classification while it is still held. This is appropriate as measurement at fair value with changes in fair value taken to the profit and loss account should be the default position. Without this restriction there might be a temptation to reclassify these as held to maturity investments when there are unrealised losses and back to held for trading if unrealised profits subsequently emerge.

While in some limited circumstances it might be appropriate at initial recognition to designate financial instruments as held to maturity with valuation at amortised cost, paragraph 90 is correct in requiring them to be reclassified as held for trading where there has been a change of intention.

IAS 39(v) We are not convinced that the proposal in paragraph 100D has been fully thought through. For example, it would appear that the benefits of poor credit standing on the market value of company's debt obligations could be credited to the profit and loss account. In drafting the DSOP for insurance contracts the IASB has considered this issue and rejected that approach.

The requirements on how to determine fair value are appropriate in a general context. In relation to insurance contracts however we believe that entity specific value is more appropriate. This allows information regarding future cash flows available only to the insurer to be taken into account, but the valuation to be derived is an estimate of the value which the market would place on the asset or liability in question were it in possession of that information.

IAS 39(vi) We agree. We also agree with the methodology for measuring such impairment.

IAS 39(vii) We believe that any reversal of impairment losses on available for sale financial instruments that have been recognised in the profit and loss account should also be recognised in the profit and lose account. This is inconsistent with other lASs for example IAS 2, IAS 8, IAS 16 and IAS 37. In the case of insurers the point is of little importance as profits and losses whether realised or not will generally be taken to the profit and loss account. However, it is conceivable that for certain types of business an available for sale classification for investments may be appropriate during the period of the IASB interim solution.

IAS 39(viii) There is an inconsistency in the requirement of paragraph I 53(b) for gains and losses on items classified as available for sale, that would otherwise be recognised directly in equity, to go to the profit and loss account instead if they have been hedged, in order to achieve consistency with the treatment of gains and losses on the associated fair value hedging instruments. This will not affect UK insurers however if they designate all their portfolio investments as held for trading so as to enable their existing practice of taking all the gains and losses on these through the profit and loss account to continue.

IAS 39(ix) The requirement of paragraph 160 to reclassify gains or losses recognised directly in equity into the profit and loss account in the same period during which the asset acquired or liability incurred affects profit or loss will be somewhat cumbersome in practice. We prefer the original wording of this paragraph which required the amount removed from equity to enter into the initial measurement of the asset or liability in question This also enables accounts users to gain a better appreciation of the effectiveness of the hedge.

LAS 39(x) The work involved and cost of recognising financial assets under the revised IAS 39 that were previously derecognised under the previous derecognisation provisions may be very substantial. This is an area where an undue cost or effort exemption would be appropriate. Failing this, we prefer the grandfathering with disclosure approach proposed by the ASB. There appears to be no limit however in paragraph 171 B to how far back it would be necessary to go to reclassify assets and liabilities that had previously been derecognised. Would this cover all assets that still meet the recognition criteria of the new LAS 39? If so, this could create major practical difficulties where a large number of such assets spanning a considerable period of time are required to be recognised. This would extend to any note disclosure requirements even if there were no requirement to make the required restatements in the financial statements themselves.

Ref T/701/OO3
24 October 2002