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Comments by the European Insurance Industry on IAS 39 and Insurance IFRS Project Phase I

The IASB is currently undertaking extensive studies on the improvement of IAS 39 on Financial Instruments: Recognition and Measurement. At the same time, it is shaping the reporting environment of European insurance companies within the project to establish a Standard on Insurance Contracts. The current developments will substantially change the framework in which the European insurance industry works. European insurers would therefore like to give their comments on this important matter and, at the same time, would like to encourage the IASB to facilitate an open and in-depth discussion and analysis. Furthermore, it is essential that – before the revised IAS 39 comes into force – field-tests, i.e. simulations of norms on real portfolios, be run in order to assess whether the solutions are appropriate and workable. The insurance industry will not be able to implement IAS 39 in 2005 unless IASB has published the **exposure draft for Phase I** as well as **appropriate** and **field-tested application guidance** well before then, i.e. **end of 2003 at the latest**. However, given the shortage of time available to complete this work, we have reservations over whether this will be possible. If such a deadline was impossible to meet, insurance companies should be allowed to use local GAAP for all insurance-specific contracts during Phase I.

After its preliminary comments sent to the IASB on 17 January 2003 CEA hereby wishes to provide more detailed comments, especially with regard to the Roundtable Discussion of the week beginning 10 March 2003.

It is not within the scope of this paper to address the issues arising under Phase II, where CEA members have reservations about the proposals and potential inconsistencies with IAS 39. In any case, CEA sees a **level-playing field** as the core long-term objective of any effort to review accounting standards and hereby reaffirms its endorsement of such an objective.

Contents

1 Definition and classification of insurance contracts

At its meeting on **23-25 October 2002**, the Board tentatively agreed that the definition of insurance contracts within IAS 32 and IAS 39 would be changed to: "a contract under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary."

At its meeting of **22-23 January 2003**, the Board agreed to ask its staff to develop proposals to grant a temporary exemption from IAS 32 and IAS 39 during phase I to participation features that comprise a contractual right held by the investor to receive additional payments or other benefits.

Finally, at its meeting of **19-21 February 2003**, the Board provided clarifications on some aspects of the definition of insurance contracts tentatively agreed in its meeting of 23-25 October 2002.

1.1 CEA General Comments

Appropriate guidance is needed:

- on the application of this definition, e.g. what determines whether the insurance risk is significant or not?
- The identification of the insurance and investment elements for the purpose of unbundling (for our comments on the treatments of the unbundled components, please refer to section 2.2);
- on the identification of embedded derivatives within contracts with participation features (for our comments on the treatment of embedded derivatives, please refer to section 2.3);
- on the definition of participation features and consequently the separation of participation features

Furthermore, it is the view of the European insurance industry that embedded derivatives and unbundling issues should be postponed until phase II.

1.2 CEA comments on Reinsurance

The definition of reinsurance contracts does not reflect all kinds of reinsurance contracts. Indeed, the present definition of a reinsurance contract (see paragraph 51) raises the following comments:

- A reinsurer is not necessarily in a position to know whether the original contracts issued by its cedant qualify under the definition of "insurance contracts" in the cedant's accounts or not;
- In some cases, the contracts issued by the cedant could not meet the definition of "insurance contracts" because the insurance component is not sufficient. At the same time, the contract issued by the reinsurer would meet the definition because it would only concern the insurance component ; in these cases, it is uncertain, under the present definition, whether the reinsurer is assuming direct business or reinsurance and thus what the consequences are regarding disclosures to be made by line of business, noticeably direct business versus reinsurance business;
- Finally a reinsurance contract such as a "stop-loss" contract does not relate to one single "insurance contract issued by the cedant" but should nevertheless be classified as a "reinsurance contract".

Accordingly, it is suggested that the definition of Insurance – as tentatively agreed by the Board – be amended by adding the following sentence:

> "In relation to contracts of reinsurance the words "insurer" and "policyholder" should be construed as references to the reinsurer and ceding company respectively".

Furthermore, regarding timing risk, paragraph 53 clearly indicates that financial reinsurance (reinsurance contracts that do not transfer significant risk) should be accounted for under IAS 39. Nevertheless, it does not indicate whether insurance risk results from the presence of timing and underwriting risk or only one of the two. We understand that the criteria used by the DSOP insurance risk definition (see paragraph A21: significant change in the present value of cash-flows) implicitly relates to a contract which would include only one of the two risks. We believe that this question deserves more detailed consideration and that timing risk by itself should count. This does not seem to be the case at present because, where the liability is certain (rather than uncertain) the contract falls outside the current definition even if the timing of payment is uncertain.

1.3 CEA comments on Credit Insurance

The Staff have suggested that credit insurance be excluded from insurance contracts because it covers the credit risk, even if the event triggering the payment adversely affects the policyholder.

Firstly, as demonstrated in detail in Annex I, credit insurers are exposed to credit risks in an insurance way. Therefore, they resort to exclusive insurance techniques to manage their risks. These techniques are different from the ones used by issuing banks of a documentary credit.

Thus the exposure to credit risks being different, the way to manage credit risks being different and the credit risks handled by credit insurers not commonly traded in capital markets, it is the view of the insurance industry that there is room for a different accounting set of rules for guarantees with a financial risk and guarantees with an insurance risks

In addition and as recognised by the Staff itself, though credit insurance does not fit the definition of financial risk found in the DSOP on insurance contracts[1], it does fulfil the criteria contained in the DSOP definition of insurance risk defined as:

> '...an event affecting the policyholder or other beneficiary may cause a significant change in the present value of the insurer's net cash flows from the contract.'[2]

This has been the rationale behind the treatment of weather derivatives, whereby contracts where a payment occurs only if a particular level of the underlying climatic, geological or other physical variables adversely affects the contract holder are insurance contracts.

Therefore, CEA struggles to find any justification for credit insurance to be treated under IAS 39 if it is acknowledged that it meets the definition of insurance. The insurance industry's purpose is not to exclude credit insurance from any standard, but to allow it to be treated under the most adequate standard – i.e. the one specifically designed for insurance contracts.

The risk to adopt only one set of rules would be to harmonise the products when it is clear from a client standpoint that the two are different and that the needs they meet are different. The fact that the markets have never seen these products as identical is a good illustration of this point.

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[1] Paragraph 1.28

[2] Paragraph 1.50

2 Measurement of contracts sold by insurance companies and classified as investment contracts

2.1 General application guidance and classification of insurance contracts

At its meeting on **12-14 November**, the Board concluded that no further application guidance on IAS 39 was needed.

CEA comments

CEA welcomes the Board's decision in its meeting of 21 February to treat performance-linked investment contracts and insurance contracts with performance linked features in the same way for Phase I.

However, as far as Phase II is concerned, the industry believes that more guidance is needed, as many issues not specifically addressed by IAS 39 have yet to be considered by the Board – notably:

i. amortised cost basis valuation / fair value
ii. renewal options
iii. policyholder behaviour and management
iv. separate account business with minimal guarantee

2.2 Treatment of unbundled investment and insurance components

At its meeting of **21 February 2003**, the Board confirmed its decision to unbundle deposit-like components from insurance contracts only if the cash flows from the insurance component do not affect the cash flows from deposit-like components and provided some clarifications.

CEA comments

CEA welcomes the Board's decision and clarifications. However, this still leaves scope for some insurance contracts to be subject to unbundling. Therefore, CEA would like to point out:

- Firstly, that this is in contradiction with the proposal of the DSOP, which came out against unbundling altogether.
- Furthermore, that any requirement to unbundle is inappropriate until the outcome of Phase II is finalised.

Indeed, for a significant number of contracts, unbundling will require a huge effort in respect of capturing the basic data and changing the systems and will add to complexity in financial reports. Furthermore, being the result of an artificial fragmentation of the product's cash-flows not contemplated at outset, the very reliability, usefulness and thus credibility of such a process' output is put into jeopardy.

In addition, there is great uncertainty as to how unbundling would apply to the different components of certain contracts falling within the scope of IAS 39. Please refer to Annex II for concrete examples of such situations.

Considering the important open questions and the little time for preparing the changes, we believe that there should be an exemption for insurers from applying IAS 39 and IAS 18 for long term savings contracts falling outside the definition of insurance contracts from 2005. Preferably, IAS 39 should be amended in order to handle the accounting for long-term savings contracts. This work should be undertaken in close co-operation with Phase II of the Insurance Project, in order to obtain a clear, robust and consistent accounting model for long-term saving contracts. Insurance companies that issue contracts falling under IAS 39 should be allowed the same time for preparing the changes as companies issuing insurance contracts or other industries.

2.3 Treatment of embedded derivatives

Under IAS 39, embedded derivatives must be bifurcated and accounted for separately from a host contract if certain conditions are met. In November 2002, the Board agreed to make some modifications to IAS 39 Improvement Exposure Draft.

CEA comments

CEA welcomes the Board's clarifications of its meeting of 19-21 February 2003 regarding guaranteed annuity options and guaranteed minimum death benefits. However, CEA believes that until Phase **I**, the requirement for embedded derivative bifurcation is not appropriate, particularly for insurance contracts, which will be accounted for under local GAAPs during Phase I.

2.4 Transaction costs

The IASB has recognised that the transaction costs for some long-term contracts are proportionately much larger than for most other financial instruments. In addition, the revised definition of transaction cost under the proposed Exposure Draft of improvements to IAS 39 excludes all internal costs, including transaction commissions paid to employees.

CEA comments

IASB has not yet considered the implications for contracts sold by insurance companies:

- The external / internal costs distinction would lead to misleading treatment, whether the contracts are sold through external agents or internal networks. Indeed, companies distribute their products either through:

    i. external networks of financial advisers and/or agents
    ii. internal sales force
    iii. a mix of the two

  The treatment of the distribution costs should not depend on the means of distribution, as the current proposed system suggests.
- This distinction for investment contracts is in contradiction with the accounting treatment of acquisition costs as defined in most GAAPs and which would be in force during Phase I for insurance contracts.
- IAS 39 does not include any provision on acquisition costs with respect to the renewals of contracts.

The insurance industry believes that this is an issue, which should be dealt with under Phase II.

2.5 Own credit risk

Paragraph 100 of IAS 39 requires including the creditworthiness of the debtor when valuing a financial instrument at fair value.

CEA comments

Under the hypothesis that investment contracts sold by insurance companies would be measured at fair value, this would cause confusing and counter-intuitive results not reflecting the characteristics of the insurance business.

It is CEA's view that the offsetting effect of a guarantee scheme should be taken into account in the calculation of credit risk if credit risk is taken into consideration when calculating liabilities. CEA notes a disparity of treatments on the one hand between insurance and investment contracts, on the other hand between insurance companies and banks. It is CEA's view that, being underpinned by the same rationale, there should be more consistency in the approaches to credit risk.

In any case, it is the European insurance industry's view that this is an issue that should be dealt with under Phase II.

3 Classification and measurement of financial investments held by insurance companies

The Board has agreed that it should not create a new category of financial assets (financial assets held to back insurance liabilities) that could be held at amortised cost.

CEA comments

This decision would lead to a mismatch between assets and liabilities creating undue volatility in shareholders' equity or insurance.

This decision is, furthermore, not compatible with the substance over form approach, which should lead to recognising assets and liabilities management – one of the unique features of insurance business.

Several solutions have been proposed (to create a new specific asset and category or to recognise the need for "Shadow accounting" for instance). However, the industry senses that finding ways of allowing Held To Maturity accounting according to Asset Liability Management constraints could be a relevant, practical and convenient solution. It would answer the industry's concerns without requiring excessive amendments to IAS 39.

Finally, it is the insurance industry's view that a satisfactory solution must be found before the end of phase I to ensure a consistent management of assets and liabilities.

4 Hedge accounting

CEA comments:

Like banks, insurance companies see the treatment of hedge accounting by IAS 39 as extremely problematic.

Firstly, the application of IAS 39 to hedge accounting would lead to misleading results, as it does not take into consideration the real policy of hedging by insurance companies, especially with regard to:

- Hedging of Held-To-Maturity investments.
- Portfolio hedging

Indeed, the existing rules widely contradict companies' risk management objectives, which intend to hedge net risk exposures. The proposed changes do not address these weaknesses. Accounting should follow prudent business practices – not the other way round.

Furthermore, managing assets and liabilities is the essence of managing insurance companies. Optimisation of Asset Liability Management relies on macro-hedging whose accounting is hindered by IAS 32-39 and its exposure draft: the option of accounting for the hedged and the hedging instruments at fair value – although interesting in a pure academic approach – cannot be computed since some components must be accounted for according to amortised cost.

Annex I - Why Credit Insurance are Insurance Contracts

The Insurance Industry believes Credit Insurance meets the definition of an insurance contract:

- Credit insurance contracts provide corporate entities global coverage of their receivables together with services such as debt collection. The contracts normally include a wide range of cover, depending on the specific circumstances. Credit insurance is often required by financing banks as an added coverage.
- The insured is exposed to losses on its receivables due to the failures of its debtors both at inception and over the life of the contract. The Credit Insurer provides payment if a debtor fails to pay when payment is due, which is an identifiable insurable event. At least one of the following is uncertain at the inception of a contract:

    - whether a future event specified in the contract will occur,
    - when the specified future event will occur, or
    - how much the insurer will need to pay if the specified future event occurs?

- While banks manage their financial guarantees on a single risk basis, credit insurers offer global coverage over a specified period with revolving amounts covered, as well as discretionary limits up to agreed amounts under which they often do not know the names on the covered risk.
- The credit insurer covers the total of the receivables portfolio of its clients. Pricing is based on mutualisation of the risks of the whole portfolio, which is typical of insurance contracts and statistical methods. Deductibles are determined below which no losses will be reimbursed.
- Unlike single coverage, the number of possible events (claims) and their amount is not known at inception.
- Credit insurance contracts are not commonly traded on financial markets unlike financial instruments such as credit default swaps. The majority of the credit insurance risks are on small and medium sized companies and credit guarantees are not traded in capital markets. Coverage for risks undertaken by Credit Insurers is performed through transfer to the reinsurance market and makes large use of statistical methods to assess future risk.
- Credit Insurers are entitled to seek recoveries from the insured buyers (subrogation of the insured rights).

Looking at excerpts from the IASB Update of September 2002, we would like to take advantage of IASB's wording to illustrate the above mentioned points:

Excerpt 1:

"The Board tentatively agreed that an insurance contract should be defined as "a contract under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary."

A key feature of an insurance contract is the impossibility for the policyholder to gain control of the risk for which he buys a cover. Within a credit-insurance contract, default is outside the control of the insured, and so is fortuitous and adversely affects the policyholder. Credit insurance is always conditional. It is noteworthy to note that US GAAP recognise the conditionality of insurance contracts.

Excerpt 2:

"Insurance risk is risk other than financial risk. Financial risk is the risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable."

The Credit Insurer provides payment if a debtor fails to pay when payment is due, which is an identifiable insurable event. There is not a single reason for explaining the failure of the debtor. It is however usually beyond the above listed financial reasons for which the debtor usually covers himself. Mismanagement and sudden decreases of turnover are for instance reasons explaining the failure of a debtor.

Excerpt 3:

"Insurance risk is significant if, and only if, there is a reasonable possibility that an event affecting the policyholder or other beneficiary will cause a significant change in the present value of the insurer's net cash flows arising from that contract. In considering whether insurance risk is significant, it is necessary to consider both the probability of the event and the magnitude of its effect."

Since a credit insurer covers the total portfolio of the receivables of the clients of the insured, the probability of a default is everything but negligible and the magnitude of its effect outlined by the multiple that total covered receivables represent compared with the collected premium.

Some developments on the specificity of the credit insurance compared to the documentary credit

As most insurance contracts, credit insurance policies may be regarded as financial instruments because they create contractual rights or obligations that will result in the flow of cash or other financial instruments contracts (DSOP on Insurance Contracts § 1.27).

Yet, credit insurance contracts do not meet the definition of a financial risk as stated by the DSOP on insurance contracts § 1.28 : Financial risk is the risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable.

Instead, credit insurance contract create insurance risks because «an event affecting the policyholder or other beneficiary may cause a significant change in the present value of the insurer’s net cash flows from the contract » (DSOP on insurance contracts § 1.50). Therefore measurement should always occur under the DSOP (DSOP on insurance contracts § 1.57)

Thus, although having «credit » in its name, credit insurance has more to do insurance risks than with « credit » making. It significantly differs from Factoring or Documentary Credit.

Some argue that credit insurance is simply another way of describing a financial guarantee (DSOP on insurance contracts § 1.64). They believe that the way credit insurers manage credit risk is not different from the way that bank manage credit risk in a portfolio of financial guarantees. The exposure to credit risk being the same, they advise that all forms of financial guarantee should be appropriately covered by a standard on financial instruments, as credit risk is a risk commonly traded in capital markets.

We believe this position:-

- is antinomic with that of DSOP on insurance contracts § 1.43 : « **Nevertherless, this DSOP defines insurance contracts by references to the type of risk, rather than by reference to the tradability of the instrument** »,
- does not explain how credit insurance contracts, which are contracts regulated by State insurance regulatory authorities, will be commonly tradable in capital markets,
- does not consider the possibility, credit insurance contracts not being tradable, that all forms of financial guarantee be included in the scope of the DSOP on insurance contracts.

* * *

We take the view that guarantees with a financial risk are different from guarantees with an insurance risks because the exposure to credit risks as well as the way to manage it are different. This could be seen through the comparison between credit insurance contracts and documentary credits.

1. It should first be noted that a basic documentary credit is restricted to a service activity and bears no financial risk (revocable and notified documentary credit). In those cases, banks are only asked to check the documents and the compliance with the import / export rules of their States and especially the currency transfer rules. In developing countries, the monopoly of banks in the enforcement of currency transfer rules accounts for them performing these controls on behalf of the State. It also explains why documentary credits are mostly set up with countries outside OECD whereas credit insurance is mostly used within continental Europe for domestic coverage (see credit insurance market below):

   A basic documentary credit is nevertheless a quadripartite agreement initiated by a « buyer » who asks his bank (the «issuing bank ») to pay against valid documents the « notifying bank » where the « seller » has his account.

   In basic documentary credits, banks only book a service fee and bear no commitments in their off-balance sheet.

2. Banks have gradually added two different financial guarantee to the basic documentary credit, in so far as:
   - in a non revocable documentary credit, the issuing bank issues a *Liability on acceptances* by which it guarantees it will pay the seller if the documents are valid ; the issuing bank bears therefore a risk on its client, the buyer
   - in a confirmed documentary credit, the notifying bank endorses the *Liability on acceptances* and guarantees payment to its client, the seller, if the documents are valid ; the notifying bank bears therefore a risk on the issuing bank

	Revocable documentary credit	Non revocable documentary credit	
		notified	confirmed
Issuing bank	no risk	risk on its client	risk on its client
Notifying bank	no risk	no risk	risk on issuing bank

3. Documentary credit has almost nothing in common with credit insurance.

   The first difference lies in the issuance process: a documentary credit is issued by the buyer where a credit insurance policy is underwritten by the seller. This means that a seller could only be protected for his whole turnover if, and only if, each of his clients was to issue a non revocable documentary credit for each transaction made with the seller.

   Documentary credit is therefore more a mean to make a buyer solvent than a mean to offer coverage for the seller.

   This is not only a semantic way of putting things as it leads to a great difference in the way to manage credit risk. Documentary credits are single risks transactions; credit insurance are whole turnover policies. The assessment of the risk (single risk vs. portfolio risks) and the acceptable price for the customer (a customer is always ready to pay more on a single transaction than on a portfolio where he feels the guarantor always makes too much money on the good risks) are different (in a full documentary credit the buyer pays to be made solvent and the seller pays the guarantee on the issuing bank).

   This difference is increased by the discretionary limit mechanism within the credit insurance policy. The discretionary limit mechanism allows the client of a credit insurer to avoid having to seek prior approval to benefit from coverage for transactions under the discretionary limit. Thus, it is a real whole turnover coverage.

   This means that for day to day transactions, a credit insurer does not know the risks he is bearing (this is why, in compliance with IAS 10, the credit insurer has no commitments in his off-balance sheet as they are only contingent). This is indeed a very different situation from the one of the issuing bank of a documentary credit which knows all the more so its risks as its exposures are on its own clients. This actually means that for a bank, documentary credit is only another way to make credit to its clients, the difference being that the documentary credit is secured by the property of the goods (which belong to the person having the documents in hand)

This discretionary limit mechanism has another consequence to the visible participation to the guarantee. In documentary credit, banks are part of the transaction: it is they who assess the validity of the documents. In a credit insurance contract, the buyer does not know until the loss occurs that the seller has a credit insurance policy.

But how is this feasible? How can credit insurers run their business not knowing precisely the risks? What different techniques do they use to enable this?

4. Credit insurers are not the only ones to face this challenge, as it is the fate of every insurer of this world. For example, property insurers know for sure that on a statistical basis fire and flood will occur, but they do not know when and where and they do not monitor the risks of each house on an individual basis.

   The same applies to credit insurance. Therefore, in order to manage their risks and avoid moral hazard, credit insurers have re-used in their line of business the tools developed in other insurance fields. These tools are specific to the management of insurance risks and are rarely seen or accepted by the client in a guarantee with financial risks which denotes from a client standpoint that the needs for a guarantee with financial risks or with insurance risks are different.

   These tools comprise the following:

   - deductibles : by individual loss or aggregates
   - percentage of coverage : a percentage of each loss remains the responsibility of the insured
   - subrogation for the totality of the receivable whatever the percentage of coverage
   - conditionality of the guarantee (where most guarantee with financial risks are unconditional)
   - reinstatement premiums
   - cancellation of the policy after any one loss, premiums being payable
   - maximum liability: the aggregate amount of claims paid by the insurer during a financial year may not, in any event, exceed a specified amount generally expressed as a multiple of the annual premium.

   Because of the maximum liability clause, not only does a credit insurer not know his risks, but he needs not to. This stems from the fact that the maximum liability is always inferior to the theoretical amount of the credit insurers' commitments. Therefore, if the credit insurer knew his risks and was to report the list of them, he would have to stop the inventory once reached the maximum liability, leaving aside a substantial part of them. How should he therefore choose the ones to report: by alphabetical orders, by declining amounts… This enhances the fact that credit insurers do not have the same credit exposure as the issuing bank of a documentary credit and therefore do not monitor or manage the risks in the same way.

   Yet, because the policyholder bears a part of the risks, which can be greater than their margin (which means that the loss is a real loss for the policyholder; it is not the sole price of a missed opportunity), credit insurers have to provide them with guidance. Therefore, policyholders may ask for opinion on third party debtor and benefit from proprietary information, i.e. exclusive non public and up-to-date information collected from policyholders (who must declare their overdues and credit extensions in order to be covered), from their suppliers, sources of finance, chambers of commerce, trade fairs and professional association. This exclusive non public and up-to-date information is a competitive advantage for selling credit insurance as well as the collection services (the negotiating power when representing several creditors of the same debtor is greater than the one a single creditor acting alone would have). But information and collection services are not the insurance coverage.

Because of the discretionary limit mechanism, policyholders rarely update or cancel their first opinion request, which was most of the time based on a maximum level of anticipated sales. Based on past enquiries, actual exposure is only on average at any one time 30% of the opinion requests in force. This again is a hint to the fact that neither policyholders nor credit insurers manage the contracts with the opinion requests.

As a conclusion, credit insurers are exposed to credit risks in an insurance way. Therefore, they resort to exclusive insurance techniques to manage their risks. These techniques are different from the ones used by issuing banks of a documentary credit.

Thus the exposure to credit risks being different, the way to manage credit risks being different and the credit risks handled by credit insurers not commonly traded in capital markets, it is the view of the Insurance Industry that there is room for a different accounting set of rules for guarantees with a financial risk and guarantees with an insurance risks.

The risk to adopt only one set of rules would be to harmonise the products when it is clear from a client standpoint that the two are different and that the needs they meet are different. The fact that the markets have never seen these products as identical is a good illustration of this point.

Annex II - Application of IAS 39 on long term savings contracts; effects of unbundling.

There is a proposal that contracts falling under IAS 39 should be unbundled into as many as 4 components: investment component, service component, embedded derivatives and possibly insurance component, potentially valued at different and inconsistent basis.

Example of product features for Unit Linked business:

- Front end load of X per cent of first premium or Bid Offer spread of X per cent.
- Premium based fees of X per cent during some years.
- Annual management charge of X.
- Fund management charge of X per cent.
- Mortality cover.
- Surrender fees.
- Initial commission paid to internal or external brokers, salesforce etc.
- Administrative costs

When IAS 39 was written, IASB did not cover the special features of long term savings contracts. Many crucial questions remain unresolved, leading to practical implications that make it more or less uncertain how to apply IAS 39 on a Unit linked contract by the year 2005.

Issues

The proposed accounting treatment for 2005 seems to be:

- **Insurance** under local GAAP
- **Investment / deposit component** under IAS 39. But how do you account for the liability under fair value or amortised cost? Should the fund be on or off the Balance Sheet?
- **The fund management charge** under IAS 39 or IAS 18?
- **Management charge** under IAS 18 ?
- **Treatment of acquisition costs** under IAS 39 or IAS 18? Amortisation of external and/or internal costs?
- Deferral of **bid/offer spread**? Deferral of **premium based fees** and front **end loads**? The IASB staff paper approach, “Unit price method” for bid/offer spreads makes the recognition of profit very back ended.

These uncertainties make it difficult to estimate the total impact of an IAS conversion. When compared to current accounting methodologies, IAS 39 as it stands now shows the most adverse profit pattern in the first year on both a fair value approach as well as amortised cost. This is unfortunately far from a prospective model taking into account future cash-flows from the contracts.