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Försäkrings
Förbundet

Swedish
Insurance Federation

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Sir David Tweedie
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Dear Sir David

Comments on "Exposure draft of proposed amendments to IAS 32 and IAS 39" (EXD)

The Swedish Insurance Federation is the trade association for insurance companies. Its member companies account between them for more than 95 per cent of the insurance business in Sweden.

We have recently concluded discussions within the Federation regarding the impact of EXD32 &39 on the financial statements of an insurance company.
Most of our comments below relate to EXD39 measurement considerations and EXD32 separation of liability and equity elements.

<u>Application of IAS 39 on long term savings contracts, measurement</u>

It seems like a lot of the business issued by the life insurance companies in Europe will not meet the definition of insurance business for financial reporting purposes as set out in the Insurance project. These contracts will be classified as financial instruments and fall under IAS 39, although legally defined as insurance contracts. According to the proposed amendment to IAS 39, financial liabilities should be valued at amortised cost or fair value. IASB propose no additional guidance on how to compute fair value or amortised cost for these contracts

It is obvious that when IAS 39 was written, IASB did not cover the special features of long term savings contracts. There are many crucial questions that remain unresolved, leading to practical implications that make it more or less uncertain how to apply IAS 39 on long term savings contracts by the year 2005. For example:

- Profit profiles of similar insurance and investment contracts will appear markedly different.
- In practice, according to IAS 39, how should we account for fair value or amortised cost of financial liabilities in the savings contracts? There is no liquid market against which to determine fair value but reporting according to the embedded value method (used in transactions and widely published as supplementary accounting information throughout

Europe, Canada and Australia) is not allowed. On the other hand amortised cost does not really reflect the economic nature of an insurance contract.

- The treatment of acquisition costs is not clear according to IAS 39. Deferred acquisition costs (DAC) is an important part of many national GAAPs based on the EU directives. Any uncertainty on this will have significant practical consequences. For example, the proposed amendment to IAS 39 would require internal transaction costs to be expensed immediately. This would mean that companies using internal sales forces would be systematically disadvantaged compared to companies that use external sales forces. Obviously this could have a significant impact on how the insurance industry operates.
- If one can neither recognise future premiums according to a fair value approach, nor recognise DAC according to matching and deferral approach, significant initial losses will occur. Such an accounting method would not reflect the economic reality of long-term life insurance contracts. Indeed, this would put the reporting on long-term insurance business back 20 years, negating the progress made through deferral-and-matching and into fair value approximations that now have wide support and, in the UK at least, established guidance. The Draft Statement of Principles produced over the past couple of years by the IASB secretariat represented a further, positive, step forward along this path but has been sidelined by ignoring fine principles and instead following the rules in IAS39.
- What are the consequences of applying IAS 18 on the service component? For example, how should acquisition costs be treated under IAS 18?
- There are important issues regarding IAS 39 contracts that will not be dealt with until Phase II of the project: Unit of accounts and the issue on Separate accounts. The question on whether funds like Unit linked should be accounted for as financial assets and financial liabilities, separate accounts or off balance sheet is important and should be solved before conversion to IAS.

Considering the important open questions and the little time for preparing the changes, we believe that there should be an exemption for insurers on 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. By doing so we will obtain a clear and robust accounting model for long term savings contracts and consistency will be promoted. Insurance companies that issue contracts falling under IAS 39 must be allowed the same time for preparing the changes as companies issuing insurance contracts or other industries. Also there would be sufficient time to carefully evaluate the open questions.

<u>Separation of debt and equity in performance linking contracts</u>

In Sweden, many life insurance companies are mutual or run on a mutual basis which means that surpluses generated must be returned to the policyholders in the form of bonuses. The policyholders have no choice or influence over the investment of their funds.
The majority of the business consists of two major groups of products, all of which are long-term savings oriented insurance products:

- Traditional individual business
- Corporate pensions

While all of these contracts have guaranteed values, they have an account value which is credited (or debited) with accumulated amounts that represent an allocation of actual investment, mortality and expense experience. The allocation is based on the operation of a defined formula, which is required to be filed with Swedish insurance regulators. In principle, the payout at death, maturity, surrender or through annuitization is the guaranteed amount plus an amount calculated using the account value (if any). This determination of account value considers the estimated fair value of total assets. Experience allocated to the account value can be positive or negative, but policyholders are always entitled to guaranteed contract values.

The Bonus reserve in the balance sheet consists of allocated and unallocated accumulated surpluses. There is no requirement that surpluses be passed through to policyholders in the period they emerge nor is there a requirement that these profits be distributed or allocated to current policyholders. Due to the fact that the individual policyholder's right to the bonus reserve is not guaranteed and can be withdrawn, the reserve is classified as equity according to Swedish GAAP. Bonus reserves are the dominant source of risk capital in many of the mutual companies since there are no shareholders contributing with risk capital.

Considering these circumstances we believe that the question of classification of surplus as either debt or equity must be carefully evaluated. We believe that there is a need for an option to classify the bonus reserve as equity.

If you would like further input from us on these topics, please do not hesitate to get in touch with me.

Yours sincerely

Arne Sandström