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Dear Wayne

A Commentary on the proposed revisions to IAS32 and IAS39

Following our conversation last week and your kind invitation of 7 February to attend the roundtable discussions on the revisions to IAS32 and IAS39, I am pleased to enclose a short commentary on IAS 32 and IAS 39 regarding the areas of immediate concern to the European actuarial profession. These comments are prepared by a subcommittee of the Insurance Committee of the Groupe Consultatif and, due to time limitations, have not completed full due process within the Groupe. On completion of due process, we will re-submit a formal contribution.

The reason for the late presentation of this commentary is that it is only relatively recently that the insurance industry, and the actuaries advising it, has become aware of the impact that these standards will have on the financial reporting for insurance entities. The insurance industry has limited experience of the practical impact that these standards will have on its business. Consequently, our comments are necessarily based on a theoretical analysis. This said, the consequences discussed below are probable and should be given appropriate consideration.

Further, there are likely to be consequences for insurance business that will not become apparent until the standards are applied in practice. We trust that the Board will wish to be aware of any further concerns as practice develops.

Key principles

The two key actuarial concerns are:

i) that the assets and liabilities arising from a contract should be measured on a consistent basis within a set of financial statements. This is essential to avoid artificial profits and losses being created purely as a result of different measurement bases; and

ii) that the economic impact of all financial guarantees and options should be fully reflected in performance reporting.

If these two conditions are not met, the European actuarial profession believes that financial statements for insurance entities have the potential seriously to mislead existing and potential investors.

On fair value measurement of liabilities under IAS39

The current proposals regarding the measurement of contracts written by insurers that do not contain significant insurance risk (referred to in this note as 'investment contracts') state that investment contracts should be accounted for under IAS39 under either a fair value approach or an effective interest method.

If the fair value measurement basis is adopted for liabilities, then it is possible to adopt a fair value approach for asset valuation as well. In this case, the bases for the assets and liabilities should move consistently as economic conditions fluctuate, thereby avoiding the creation of artificial income or outgo.

However, the measurement of the fair value of the liabilities is complicated by the absence of a deep and liquid market from which to derive a fair value. Accordingly, the determination of the fair value must fall back on discounted cash flow methods. As there are a number of methods that potentially meet the fair value principles, the Groupe Consultatif recommends that further guidance on the application of the fair value approach under IAS39 is developed.

While having some reservations on details, the Groupe Consultatif believes that the general principles relating to the determination of fair values from cash flow projections developed in the Draft Statement of Principles on the accounting for insurance contracts (the 'DSOP') would provide a sound basis for the determination of the fair value of liabilities in IAS39. Accordingly, we believe that the principles currently set out in the DSOP should be incorporated into the revised IAS39.

This addition to IAS39 would not be in conflict with the existing principles in IAS39 as we understand them, would clarify and strengthen the fair value approach and would have the added value of ensuring that broad consistency between the treatment of investment contracts and insurance contracts is achieved.

On the effective interest rate method

The effective interest rate method is predicated on the contract locking into the interest rate structure prevailing at its commencement and holding to that interest rate through to maturity. If the effective interest rate approach is adopted for liabilities under investment contracts, then it would be desirable that the assets are assessed on a held-to-maturity basis as this basis assumes that the asset is locked into the interest rate structure at outset and is measured accordingly. As noted in one of our key concerns, the adoption of any alternative basis would create artificial increases or decreases in the assessment of an entity's equity whenever the interest rate structure changes. This artificial increase or decrease could easily be of a scale to render the balance sheet irrelevant and potentially misleading.

An issue facing entities providing and maintaining investment contracts in a retail market is that many of the contracts are not held through to maturity at the choice of the individual contract-holder despite any original undertaking. The entity will have the obligation at outset to provide the contract through to maturity and will structure its assets accordingly. Nonetheless, the entity will need to realise assets early if the contract is surrendered early.

IAS39, to date, has not reflected these behavioural issues described above for liabilities. If a comparison is made with the treatment of held-to-maturity assets, the surrender of a liability measured on the effective interest rate method in advance of its maturity date could be regarded as invalidating the adoption of the 'effective interest rate' method for all such contracts and require the restatement of all such liabilities on to a fair value basis.

However, this would seem inappropriate as the decision of the contact-holder is beyond the control of the entity providing the contract and the entity itself still intends to honour its obligations through to maturity for the remaining contracts. This reasoning seems to be reflected in IAS39 as no such portfolio-wide revaluation of liabilities is required if one contract-holder surrenders early.

Given that the treatment of the liabilities is established, the focus of concern shifts to the assets held to ensure the entity fulfils its obligations under its contracts. The surrender of the contract will normally give rise to a payment to the contract-holder of some amount. The amount reflects the fact that the contract-holder has made an initial investment into the contract and that investment has a value to which the contract-holder still has some right despite surrendering the contract. This amount will need to be financed and the obvious step is to realise the assets held previously to ensure that the entity fulfils its obligations. However, under the current IAS39, there is little scope to realise an asset held-to-maturity early without requiring all assets to be revalued on to a fair value basis. As a result, the early surrender of a contract by a contract holder would lead to all held to maturity assets being assessed on a fair value basis while the liabilities would be assessed on an effective interest rate method. This would result in the situation envisaged in the opening paragraph whereby the assets and liabilities arising from one contract are measured on different bases. As noted, this would make the financial statements meaningless for users.

Of the options open to solving this problem, the Groupe Consultatif believes that the only practical solution that will be acceptable to both the preparers and the users of financial statements will be to extend the current relaxations on the circumstances in which the held-to-maturity assets are required to be revalued to fair value. We propose that the relaxations should be extended to include the realisation of assets previously held to ensure the fulfilment of contracts that have now been surrendered at the sole instigation of the contract holder.

The Groupe Consultatif recognises that the proposed relaxation is different in nature from previous relaxations in that previous relaxations refer to specific infrequent external events outside the control of the entity concerned. Further, we recognise that the proposal will affect the accounting of entities other than those providing long-term investment contracts and the wording of the relaxations should be precise in its application. Nonetheless, we believe that the relaxation is acceptable and appropriate because the circumstances are outside the control of the entity issuing the investment contract and reflects the economic reality of the retail market. Further, the relaxation is auditable and, because the association of assets and liabilities to a contract is capable of documentation at outset, should provide little scope for abuse. Moreover, the benefits in terms of usefulness to the readers of the accounts would be substantial.

While this commentary is focused on the impact of IAS32 and IAS39, it is worth noting that similar artificial mismatching is likely to arise during Phase 1 of the IFRS relating to insurance contract accounting. In this period, insurance contract liabilities will usually be assessed using local GAAP bases that reflect amortised cost principles while assets will be valued under IAS39. The possibility of balance sheets in this period being misleading is significant.

On the valuation of financial options and guarantees

Under the current proposals, when the liability for an investment contract that grants financial options and guarantees is measured on a fair value approach, the full economic value of the option or guarantee will be recognised. However, this is not the case when such a contract is measured on an effective interest method. Under the effective interest rate method, a financial option or guarantee in a contract is only valued if, firstly, it would meet the definition of a derivative if it were viewed on a stand alone basis, and, secondly, it is not clearly and closely related to the host contract.

The European actuarial profession sees no theoretical reason to exclude from measurement an option or a guarantee on these grounds. There is no doubt that options and guarantees are valuable even when closely associated with the core benefits of a contract. For example, the technical interest rate on a standard European endowment can represent an onerous guarantee in low interest environments despite being core to the structure of the contract. The non-recognition of many financial options and guarantees under IAS39 as a result of the 'clearly and closely related' test for embedded derivatives could lead to material obligations being excluded from the balance sheet.

We recognise that this technique is widely applied for insurance business under US GAAP but we feel, nonetheless, that this is an instance where US practice is deficient and convergence would be best served by the development of a better recognition standard to which US GAAP could converge.

We also recognise that contracts other than investment contracts will be affected by a change in this standard. The non-recognition of some guarantees and options may be acceptable due to the less significant nature of the long-term guarantees in such other contracts. This would make the necessary calculations unduly expensive relative to the potential importance of the information to the user of the accounts. Nonetheless, we believe that the scale and materiality of guarantees to long-term investment contracts make it important that all non-trivial financial options and guarantees are recognised.

The acceptance of the full valuation of the options and guarantees under IAS39 has the added benefit that the scope for accounting arbitrage between insurance contracts and investment contracts is limited. It would also render the classification of a contract as an insurance contract or as an investment contract far less important.

On the convergence of IAS39 and the proposed IFRS for insurance contracts

If the Groupe Consultatif's proposals were to be accepted, IAS39 and the proposed IFRS for insurance contracts would be very similar except for the inclusion in IAS39 of the 'effective interest rate' method. We recognise that the effective interest rate method is a key element in the compromise that enabled many preparers to accept IAS39 and, accordingly, we see this method as remaining in the standard for the foreseeable future. This will inevitably lead to significant accounting arbitrage opportunities, whether by careful product design or through reinsurance.

A radical approach would be to accept such arbitrage as inevitable until the underlying issue of the two measurement bases is resolved and, instead, to seek to regulate the situation. This could be achieved very simply, provided that the earlier Groupe Consultatif's proposals are accepted, by bringing insurance contracts under the scope of IAS39. This has the advantage that the need to differentiate between insurance and investment contracts falls away as the accounting for both is based on the same principles. It also avoids any perception that the insurance industry is subject to a more restrictive accounting regime than other financial institutions.

Some might criticise this approach as reducing the transparency that fair value measurement would bring to reporting insurance contracts. We would comment that the only difference in earnings between a fair value measurement approach and one based on the effective interest rate method incorporating the fair value of all options and guarantees is that the latter will not recognise the unrealised gains and losses arising from the mismatching of the basic assets and liabilities as a result of fluctuations in interest rates and other economic factors in the reporting period. While some commentators would regard such unrealised income as useful information for users of accounts, others will regard such fluctuations as masking the underlying progress of the business. Many analysts will attempt to remove such fluctuations before seeking to assess the likely future performance of the entity and, if a fair value approach is required, the identification of short-term fluctuations separate from the longer term performance is likely to be a disclosure requirement.

On balance, we believe the lack of information on unrealised mismatch fluctuations would be acceptable if the simplicity of a unified recognition and measurement approach can be achieved.

On the timing of the introduction of the changes

The proposed inclusion of insurance contracts under IAS 39 raises the issue of the timing of the application of the standard to insurance contracts. Currently, the proposed IFRS for insurance companies will be phased in over a number of years, perhaps by 2007 or 2008. This will allow insurers time to adapt their systems to the new valuation approach. The Groupe Consultatif's proposals, particularly relating to the valuation of options and guarantees, will need similar timescales to implement. In order to achieve this, we suggest that the structure of the Phase 1 approach is retained in that insurance contracts are defined and exempt from the hierarchy in IAS8. However, under these proposals, there is no separate Phase 1 standard. Instead the insurance definition is included in IAS32 and IAS39 and the application of the standard to insurance contracts is made effective at the chosen date in 2007 or 2008.

Miscellaneous

There are a number of further areas, such as the treatment of future premiums and participation rights, where guidance on the application of IAS39 principles would reduce the scope for different interpretations. We believe that these issues apply to investment contracts regardless of the financial institution by which they were written. The lack of clarity on the application of the principles may well lead to different interpretations being adopted for contracts that are economically the same. Further guidance on application will reduce the scope for inconsistent reporting.

The Groupe Consultatif and the national actuarial associations in Europe are willing and well placed to assist the IASB staff in preparing this and other relevant guidance and would be pleased to do so.

Yours sincerely,

Chairman
Insurance Committee