CL 124

31 October 2002

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Sirs

EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 32 FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

We welcome the opportunity to comment upon the Board's proposals to make improvements to the existing standards. Whilst acknowledging the efforts made to improve these standards our major concerns relate to issues that are relevant to our business that have not been fully addressed in either the existing standards or in the proposed changes. These are the specific concerns that we have as a European insurer in applying the proposed standards for the first time in 2005.

The Board has already recognised the particular issues relating to insurance companies and has dedicated a great deal of resource into the project seeking to provide a coherent methodology for accounting for insurance contracts. The project has already included a high level of debate on the most fundamental question of defining an insurance contract and subsequent questions on the measurement basis. Our view of the former subject is that the definition currently included in the Draft Statement of Principles ("DSOP") represents a considerable improvement to that contained in IAS 32. We do however have doubts as to whether the adoption of the revised definition will resolve the issues surrounding many of the contracts that are written by insurers; in particular the long term insurance contracts that fail to meet the definition of an insurance contract.

The major issues to be resolved are addressed in the DSOP and are relevant to contracts that will fall either side of any divide of contracts written by insurers. We are fully supportive of the Board's efforts to resolve the financial reporting issues relating to insurance contracts. We are concerned that the same issues may need to be resolved within an accelerated timeframe in seeking to account for those contracts falling outside the scope of the insurance contract project and hence into the scope of IAS 39.

The principal issues that we have identified are as follows:-

- Accounting for "investment contracts" which share features of profit participation with contracts falling within the scope of the insurance contract project,
- The treatment of renewal rights attaching to long term contracts written by insurance companies,
- Accounting for acquisition costs,
- The treatment of unallocated surpluses, and
- Accounting for embedded derivatives within insurance contracts.

We shall now deal with each of these issues in turn.

Profit Participation Contracts

We have heard it often said that the categorisation of contracts written by insurance companies that fail to meet the definition of an insurance contract, will in many instances cause them to fall within the scope of IAS39 and hence into a treatment consistent with investment contracts written by other financial institutions.

The absence of any detailed guidance for the treatment of such contracts (other than the option to account for such contracts either at amortised cost or at fair value) suggests that there are features of such contracts that are characteristic of a more specific class of financial instrument. In the UK, there are likely to be contracts written by insurers that will be classified as insurance contracts and as investment contracts that share most important features, in particular profit participation characteristics. It would be unfortunate if the accounting treatment for those falling either side of the divide were ultimately accounted for in a different manner.

This may prompt calls for the bifurcation of such contracts into their component parts but we would argue that such a treatment would be inconsistent with the manner in which the writer of such contracts manages the business. In addition, a vital linkage between the components could be lost under such an approach. The insurance contract element often has a direct relationship with the investment contract by providing indemnity (in case of insurance claim) against a shortfall of a real (or notional) investment balance. Conversely, in the UK, there may also be a linkage between the investment contracts (including those with no insurance element) and the insurance contracts in that the investment contracts may participate in the results of the insurance contract portfolio as well as in the investment performance of the entity. We are not convinced that it will be feasible to determine a basis of accounting for either component of this mixed portfolio in isolation.

It could be that, when considering the accounting treatment of participating contracts in Phase 2 of the insurance contracts standard, the Board may conclude that the treatment of all profit participation contracts will need to be brought into the scope of a consistent standard or guidance. As the Board has not yet reached a conclusion on this section of the DSOP, we believe that it would be appropriate to include all the affected contracts within the scope of the Phase 1 solution.

The following three issues relate primarily to specific issues concerning participating contracts.

Renewal Rights

A particular feature for some long term insurance contracts is the renewal rights of the policyholder. The writers of the DSOP spent a considerable amount of time considering the basis of recognition of cash flows arising from the exercise (or forfeiture) of such renewal rights. The DSOP considers the issues in the context of accounting for insurance contracts, but the same arguments will need to be considered when considering the basis of measurement of non-insurance contracts written by insurance companies. It would again seem to illogical to potentially adopt a different measurement system when accounting for renewal rights of insurance contracts and for renewal rights for contracts falling just outside the definition of insurance contracts. We believe that guidance on this area needs to be provided by IASB in order to avoid the potential for diverse accounting treatments under IAS 39.

Acquisition costs

Within the Phase 1 of the insurance contracts project it is proposed that existing practices of deferring acquisition costs are permitted to continue; at least until such time as the final standard is produced. There is continuing debate as to whether the deferral of such costs is permitted under the Framework with proponents giving examples of existing standards where similar treatment is permitted.

For those contracts scoped out of Phase 1 of the insurance contract standard, there will be a need for guidance as to whether the deferral of acquisition costs may be permitted to continue. If the practice is outlawed under guidance on the treatment under IAS 39 there is a danger that contracts that have been priced to provide an expected value to the provider, will show losses at the outset of contract.

We are not convinced that this presentation is faithful to the principles set out in proposed amendments to paragraph 5 of IAS 8.

This issue is closely linked to the issue of recognition of cash flows associated with renewal options as noted above.

The treatment of unallocated surplus

A particular feature of insurance accounting in the UK is the treatment of unallocated surplus. Under European law, insurance companies are permitted to recognise as a liability:-

> "*all funds the allocation of which either to policy holders or to shareholders has not been determined by the end of the financial year."*

Such funds are recognised under the heading of the Fund for Future Appropriations ("FFA"). The accounting treatment for such items as currently fall under this category is being discussed in Phase 1 of the Insurance Contracts project. The use in the UK of this item is largely derived from the legal structure of Life Insurance Companies but a more general principle is of relevance here and will impact on entities in other territories. By way of example, European law also permits the use of a liability category of "Provision for bonuses and rebates" which is defined as: -

> *"amounts intended for policy holders or contract beneficiaries by way of bonuses and rebates … to the extent that such amounts have not been credited to policy holders or contract beneficiaries …"*

Additionally, similar issues may arise for companies in other jurisdictions currently carrying their investments at cost, when their investments are valued at fair value under IAS 39. This is in the context of constructive or legal restrictions upon the use to which any realised investment gains may be applied,

The DSOP seeks to address the treatment of the FFA (and to a lesser extent the related items identified above) in the context of the contingent obligations to current (and possibly future) generations of policyholder. These issues are currently unresolved.

The same issues arise in respect of obligations to holders of participating contracts that fall outside the scope of any definition of insurance contracts and into IAS 39.

Embedded Derivatives in Insurance Contracts

We acknowledge the need to ensure that liabilities in respect of embedded derivatives are recognised but we are concerned about the practical issues of bifurcation of such items.

We note the recommendations within the DSOP that such liabilities are an integral part of the host contract and as such that they should not be separately valued. If the IASB accepts the current proposals in the DSOP (Principle 1.6 – possibly by including an assumption that entity specific value equates for the purpose of paragraph 23(c) of [draft] IAS 39 to fair value) then there will no requirement to value such items separately. The issue may therefore only be relevant for the duration of Phase 1 of the Insurance Contract project.

We believe that the Board should consider whether the current bases of valuing such insurance contracts takes into account the embedded derivative in calculating the overall liability of the hybrid contract. If the Board is satisfied that this is the case, then we believe that in Phase 1 of the project insurers should not be required to apply paragraph 23 of [draft] IAS39.

We do not propose to respond specifically on each of the questions on [draft] IAS 32/39 to which comments were invited but we are satisfied that the response of the Association of British Insurers to the UK Accounting Standards Board reflects the views of the Group.

I trust that you may find this response of assistance but should you have any queries, please do not hesitate to contact me.

Yours faithfully,

Doug Logan
Director, Group Technical Accounting