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FEDERATION OF FINNISH INSURERS COMPANIES
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PRELIMINARY COMMENTS ON IAS 39

The IASB is currently studying the improvement of IAS 39 on Financial Instruments: Recognition and Measurement. The IASB is also developing financial reporting for European insurance companies within the project to establish a Standard on Insurance Contracts. As the current developments will remarkably change the European framework for European insurance companies it is important that field-tests should be run to find out if the final Standard is appropriate and workable. The IASB should then be able to give insurance companies good and field-tested application guidance before 2005.

Here are our preliminary comments.

1.) Definition and classification of insurance contracts

Last October 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."

The Board agreed:

- "to use this definition of insurance contracts throughout IFRSs;
- to change all scope exclusions in IFRSs that refer to "insurers entities" to "insurance contracts" (for example in the scope exclusions contained in IAS 18 *Revenue,* IAS 32 *Financial Instruments: Disclosure and Presentation, IAS 37 Provisions, Contingent Liabilities and Contingent Assets, IAS 38 Intangible Assets* and *IAS 39 Financial Instruments: Recognition and Measurement*)
- to define a reinsurance contract as an insurance contract issued by one insurer (the reinsurer) to indemnify another insurer (the cedant) against losses on an insurance contract issued by the cedant
- to remove from IAS 32 and IAS 39 the scope exclusion for derivatives based on climatic, geological, or other physical variables. Such contracts would then be subject to the IFRS on insurance contracts if payment is contingent on an uncertain future event that adversely affects the contract holder, and subject to IAS 39 in other cases."

We think that the definition of "insurance contract" is not clear: how to determine whether the insurance risk is significant or not? Guidance is needed to distinguish properly between those contracts falling within the scope of IAS 39 and those to which the insurance IFRS will apply. The definition of reinsurance contracts does not reflect all kinds of reinsurance contracts.

According to IASB Update October 2002 the staff will research whether scope exclusions are needed for financial guarantees (including insurance that covers credit risk). We would like to pay attention to the fact that exclusion of credit insurance from the insurance IFRS is not consistent with the above decision concerning climatic derivatives.

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

With reference to IASB Update November 2002 the Board discussed whether it should add future application guidance to IAS 39 to clarify how insurers should apply the requirements of IAS 39 to investment contracts. The Board concluded that no such guidance was needed.

There are many issues which are not specifically addressed by IAS 39 and which the Board has not yet considered. Such are for example amortised cost basis / fair value valuation, renewal options, policyholder behaviour and management, performance linked investment contracts.

3.) Unbundling of investment and insurance components

With reference to IASB Update November 2002 the Board agreed tentatively that an insurer should unbundle deposit-like components from insurance contracts if the cash flows from the insurance component do not affect the cash flows from the deposit-like component.

As Phase II of the insurance IFRS has not been decided yet, the above mentioned unbundling requirement is not appropriate.

4.) Embedded derivatives

According to IASB Update November 2002 IAS 39 requires an entity to separate an embedded derivative from the host contract and account for it separately if certain conditions are met. The Board focused its discussion on “closely related” in the first condition and the related examples in IAS 39 and decided to make some modifications to IAS 39 Improvement Exposure Draft.

As Phase II of the insurance IFRS has not been decided yet, the requirement of unbundling the embedded derivatives from a host contract is not appropriate, particularly for insurance contracts which are accounted for under the local GAAP during Phase I of the insurance IFRS.

5.) Classification and measurement of financial assets backing investment contracts and insurance contracts held by insurance companies

With reference to IASB Update November 2002 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.

This decision would lead to a mismatch between assets and liabilities creating undue volatility in the equity of an insurance company. This decision is not relevant with the substance over form approach, which should lead to recognising assets and liabilities management, which is typical of insurance business. We hope that there will be a way of allowing Held to Maturity Accounting.

6.) Hedge Accounting

The application of IAS 39 concerning hedge accounting would lead to misleading results, because it does not take into consideration the real policy of hedging by insurance companies. Managing assets and liabilities is essential in managing insurance companies. Optimization of Asset Liability Management relies on macrohedging whose accounting is hindered by IAS 32 and 39 and its exposure draft.: the option of accounting for the hedged and the hedging instruments at fair value cannot be computed, because some components must be accounted for according to amortized cost and some insurance contracts in Phase I of the insurance IFRS will be accounted for according to local GAAPs.

7.) Own credit risk

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

If the investment contracts sold by insurance companies were measured at fair value, it would cause confusing results not reflecting the characteristics of the insurance business.

8.) Equalisation provisions

With reference to IASB Update October 2002 the Board agreed that an insurer should not recognise catastrophe provisions relating to possible future claims beyond the end of the contracts included in the closed book or equalisation provisions to cover random fluctuation of claim expenses around the expected value of claims.

Insurance is an industry different from any other in that insurers receive payment for their services in advance, ie payment for the eventuality that a claim falls payable by the insurer in the future. Unlike insurers, companies in other industries usually first deliver the service or product sold and receive payment after delivery. Estimating the amount of future claims for accounting purposes may pose difficulties, because claims are not exchanged on any market where prices for the products would be readily available. Paragraph 37 of the IASB Framework requires that any uncertainties surrounding business "are recognised by the exercise of prudence in the preparation of financial statements".

The volume of claims paid under insurance contracts may fluctuate a great deal from year to year and level off over the long term. Against this background, a 12-month review does not give a true view of an insurer's underwriting performance and financial position. For example, risks like natural catastrophes and terrorist attacks are really difficult to forecast and that is why calculations include inherent uncertainty. An insurance liability should be estimated over a suitably long time-period in order to ensure that a realistic picture is given about the true liability inherent in a book of insurance contracts. Equalisation provision would be an ideal technical tool for offsetting these risks over a longer period of time and help give a true view of the company's underwriting performance. This is also in agreement with Paragraph 23 of the IASB Framework, which reads: "The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future." Recognising equalisation provision as part of technical provisions is also well supported by what is stated in Paragraph 37 of the IASB Framework, that uncertainties are recognised by the exercise of prudence.

In order to qualify for recognition under technical provisions, equalisation provision could be bound by certain requirements, such as a fluctuation range determined on the basis of the risks involved in the business carried on by the company. If the upper limit of the fluctuation range were exceeded, the company would no longer be allowed to accumulate funds under equalisation provision and, correspondingly, if equalisation provision fell below the lower limit of the fluctuation range, the company should start boosting the provision. As it would be part of technical provisions, equalisation provision should not be available for distribution to shareholders. Portfolio transfers from one company to another should be accompanied by equalisation provisions corresponding to the insurance portfolio transferred. Equalisation provision should be disclosed in financial statements and disclosures should give more measurement information on the equalisation provision.

If equalisation provision is accepted as part of insurance liabilities insurers will not be forced to cover their risks with reinsurance. In other words, this is a way to avoid a situation where accounting regulation means artificial purchase of reinsurance cover and premium rate rises.