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30 Cannon Street
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Dear Mr Clark

ED 5 *Insurance Contracts*

The Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand is pleased to submit its comments on Exposure Draft 5 *Insurance Contracts* (ED 5), which was issued in July 2003.

Although the response focuses on the specific questions raised in the Exposure Draft, comments have also been provided in respect of some issues not specifically addressed by the questions.

Any queries on the content of this submission should be directed in the first instance to:

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Yours faithfully

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Tony van Zijl
CHAIR – FINANCIAL REPORTING STANDARDS BOARD

OVERALL COMMENTS

The FRSB broadly agrees with the proposals in ED 5. Addressing insurance activities rather than insurance entities will result in consistent accounting treatment of all insurance contracts. The FRSB agrees with this approach.

The FRSB understands that the proposed IFRS is a bridge towards a much more significant standard emerging as a result of phase II of the Insurance Project. New Zealand has two industry specific standards broadly covering insurance contract accounting. In our experience, having high-quality principle based standards, built around clearly understood definitions of fair value do work, and the FRSB considers that this results in more useful information being provided for the users of financial statements. The FRSB strongly encourages the IASB to press forward with phase II in order that the project can be completed.

New Zealand has recently released exposure drafts updating local GAAP for the likely changes brought about by the proposed IFRS resulting from ED 5. The proposals in the exposure drafts are broadly consistent with those developed and recently issued by the AASB. Fortunately we are not plagued with the issue that is confronting many European insurers as a result of introducing ED 5, namely having a mismatch arising from different measurement bases for assets and liabilities. The existing New Zealand standard for life insurers requires all assets to be measured at net market values and liabilities at net present value. The existing New Zealand standard for general insurance activities requires investments integral to the entity's insurance activities to be measured at net market value, other assets to be measured in accordance with GAAP (which in New Zealand permits revaluation) and liabilities to be measured at the present value of the expected future payments. To ensure that this continues in the future, in redrafting local GAAP, a requirement that all assets of insurers are valued on the basis they are "held for trading" has been included.

There are some proposals in IASB ED 5 with which the FRSB disagrees or where the FRSB considers further guidance is necessary. The FRSB is satisfied with the level of guidance provided in the proposed standard regarding the accounting of a financial arrangement in accordance with ED 5 or IAS 39: *Financial Instruments: Recognition and Measurement.*

SPECIFIC QUESTIONS

Question 1 – Scope

(a) The Exposure Draft proposes that the IFRS would apply to insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. The IFRS would not apply to accounting by policyholders (paragraphs 2-4 of the draft IFRS and paragraphs BC39-BC52 of the Basis for Conclusions).

The Exposure Draft proposes that the IFRS would not apply to other assets and liabilities of an entity that issues insurance contracts. In particular, it would not apply to:

(i) assets held to back insurance contracts (paragraphs BC9 and BC109-BC114). These assets are covered by existing IFRSs, for example, IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*.

(ii) financial instruments that are not insurance contracts but are issued by an entity that also issues insurance contracts (paragraphs BC115-BC117).

Is this scope appropriate? If not, what changes would you suggest, and why?

(b) The Exposure Draft proposes that weather derivatives should be brought within the scope of IAS 39 unless they meet the proposed definition of an insurance contract (paragraph C3 of Appendix C of the draft IFRS). Would this be appropriate? If not, why not?

1(a) Except as noted below, the FRSB considers the scope of the proposed IFRS to be appropriate.

(i) The FRSB is concerned that many entities which are not insurance entities are not aware of the changed emphasis from insurance activities to insurance contracts. This means that these entities are not aware of the impact of the proposed standard on their activities because their "normal" business is not the issuing of insurance contracts.

For example, in New Zealand, the Accident Compensation Corporation (ACC) offers a self-managing accident insurance option for employers. This allows the employer to act as an agent of ACC, managing workplace injuries for its employees and providing entitlements in relation to work-related personal injuries and illnesses. The employers who participate in this scheme employ 20% - 40% of the workforce in New Zealand. These employers will now be required to account for this policy in accordance with the proposed standard.

(ii) Life insurers in New Zealand measure assets at net market value. General insurers measure investments integral to the entity's insurance activities at net market value and all other assets in accordance with GAAP. Changes in the net market values of assets of both types of entities are recognised in the income statement. In accordance with ED 5, if property, plant and equipment is revalued then the changes in value are recognised in equity (paragraph BC114). Life insurers in New Zealand would prefer to maintain the status quo and measure property, plant and equipment at fair value, with changes recognised in the income statement. In the opinion of these entities, the differentiation between property, plant and equipment and investment properties is arbitrary. Fair value has been applied in New Zealand for several years with no apparent difficulties.

The FRSB considers that all assets backing insurance contracts within the scope of IAS 39 and IAS 40 should be measured at fair value and that changes in value should be recognised in the income statement. Alternative measurement options should, in our view, be eliminated for insurers.

The IASB may wish to consider the measurement of land and buildings that back insurance contracts by widening the scope of IAS 40 to require that land and buildings held for investment be measured at fair value, which is the situation in Australasia. The concern is that the changed emphasis from insurance activities to insurance contracts may result in property, plant and equipment now being measured according to IAS16, which requires revaluations of property, plant and equipment to be recognised in equity and not in the performance statement.

(iii) Paragraph 4(f) specifically excludes from the scope of the proposed IFRS "direct insurance contracts that the entity holds (ie. direct insurance contracts in which the entity is the policyholder)". The draft IFRS does not cover accounting by policyholders of direct insurance contracts. Where such contracts have no insurance risk, they would be accounted for under IAS 39.

The FRSB believes that a direct insurance contract that an insurer holds should be accounted for in a manner which is consistent with a direct insurance contract that an insurer issues. In order to achieve this objective, the proposed standard should specify that contracts with no insurance risk should be accounted for in accordance with IAS 39 where the policyholder is an insurer.

1(b) The FRSB considers the IASB proposals regarding weather derivatives to be appropriate, although use of this type of instrument is extremely rare in our country.

Question 2 – Definition of insurance contract

The draft IFRS defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary' (Appendices A and B of the draft IFRS, paragraphs BC10-BC39 of the Basis for Conclusions and IG Example 1 in the proposed Implementation Guidance).

Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?

Except as noted below, the FRSB considers the definition of insurance contract and the related guidance to be appropriate.

Question 3 – Embedded derivatives

(a) IAS 39 *Financial Instruments: Recognition and Measurement* requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to derivatives embedded in an insurance contract, unless the embedded derivative:

(i) meets the definition of an insurance contract within the scope of the draft IFRS; or

(ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

However, an insurer would still be required to separate, and measure at fair value:

(i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and

(ii) an option to surrender a financial instrument that is not an insurance contract.

(paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the proposed Implementation Guidance)

Are the exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that many regard as predominantly financial (such as the guaranteed annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). Is it appropriate to exempt these embedded derivatives from fair value measurement in phase I? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase I?

(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs IG54-IG58 of the draft Implementation Guidance). Are these proposed disclosures adequate? If not, what changes would you suggest, and why?

(d) Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?

3(a) The FRSB considers the proposed exemptions from the requirements in IAS 39 to be appropriate, given that this draft IFRS is only phase I of the Insurance Project.

3(b) The FRSB considers the proposed exemptions from the requirements in IAS 39 to be appropriate given that this draft IFRS is only phase I of the Insurance Project.

3(c) The FRSB considers that the proposed disclosures in paragraph 29(e) and paragraph IG54-IG58 of the draft Implementation Guidance are adequate.

3(d) The FRSB considers that no other embedded derivatives should be exempted from the requirements in IAS 39.

Question 4 – Temporary exclusion from criteria in IAS 8

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects of its existing accounting policies for:

(i) insurance contracts (including reinsurance contracts) that it issues; and

(ii) reinsurance contracts that it holds.
(paragraph 9 of the draft IFRS and paragraphs BC52-BC58 of the Basis for Conclusions).

Is it appropriate to grant this exemption from the criteria in paragraphs 5 and 6 of [draft] IAS 8? If not, what changes would you suggest and why?

(b) Despite the temporary exemption from the criteria in draft IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:

(i) eliminate catastrophe and equalisation provisions.

(ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies.

(iii) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC59-BC75 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you propose, and why?

4(a) The FRSB considers the exemptions from the criteria in paragraphs 5 and 6 of [draft] IAS 8 appropriate, given that this draft IFRS is only phase I of the Insurance Project.

However, the FRSB is concerned that by putting a sunset clause date, 1 January 2007, in paragraph 9 of the draft IFRS, it would create a potential vacuum period if phase II of the Insurance Project is not completed by 1 January 2007. The FRSB recommends replacing "For accounting periods beginning on or before 1 January 2007" with "Until the effective date of an IFRS issued as part of phase II of the IASB Insurance Project".

4(b) The FRSB considers the proposals in paragraphs 10-13 of the draft IFRS to be appropriate.

However, the FRSB notes the reference, in paragraph 12(b), to the application of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to insurance liabilities where the loss recognition test under existing accounting policies does not meet the minimum requirements of paragraph 11 of ED 5. The FRSB recommends that the IASB develop some additional guidance on the application of IAS 37 to insurance liabilities as insurance entities consider that loss recognition is critical to proper insurance accounting.

Question 5 – Changes in accounting policies

> The draft IFRS:
>
> (a) proposes requirements that an insurer must satisfy if it changes its accounting policies for insurance contracts (paragraphs 14-17 of the draft IFRS and paragraphs BC76-BC88 of the Basis for Conclusions).
>
> (b) proposes that, when an insurer changes its accounting policies for insurance liabilities, it can reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss (paragraph 35 of the draft IFRS).
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> Are these proposals appropriate? If not, what changes would you propose and why?

The FRSB considers the proposals in both 5(a) and 5(b) to be appropriate.

Question 6 – Unbundling

> The draft IFRS proposes that an insurer should unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet (paragraphs 7 and 8 of the draft IFRS, paragraphs BC30-37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).
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> (a) Is unbundling appropriate and feasible in these cases? If not, what changes would you propose and why?
>
> (b) Should unbundling be required in any other cases? If so, when and why?
>
> (c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

6(a) The FRSB acknowledges that there are certain hybrid products where it may not be possible to separate the risk and the deposit components because of undue cost or effort. In such circumstances, the FRSB believes that there should be an allowance in the draft IFRS to recognise both the premium income and claims expense associated with these hybrid products in the statement of financial performance. The FRSB recommends the addition of the following to the end of paragraph 7:

"For products where the separation of premiums and claims into components is not possible because of undue cost or effort or the components cannot be reliably measured, premiums shall be recognised as revenues and claims shall be recognised as expenses."

6(b) The FRSB considers the proposal to unbundle deposit components of some insurance contracts to be appropriate. The FRSB agrees that there are no other cases where unbundling should be required.

6(c) The FRSB considers that the proposals in ED 5 are clear. However, there may be cases where unbundling is impracticable (refer to 6(a) above).

Question 7 – Reinsurance purchased

> The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18 and 19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).
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> Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?

The FRSB considers these proposals to be appropriate.

Question 8 – Insurance contracts acquired in a business combination or portfolio transfer

> IAS 22 Business Combinations requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 Business Combinations proposes to continue that long-standing requirement. The proposals in this draft IFRS would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, they would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:
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> (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and
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> (b) an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset would be excluded from the scope of IAS 36 Impairment of Assets and IAS 38 Intangible Assets. Its subsequent measurement would need to be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 would apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights and obligations acquired.
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> The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer (paragraphs 20-23 of the draft IFRS and paragraphs BC93-BC101 of the Basis for Conclusions).
>
> Are these proposals appropriate? If not, what changes would you suggest and why?

The FRSB considers these proposals to be appropriate.

Question 9 – Discretionary participation features

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.

Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?

The FRSB considers these proposals to be appropriate.

Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

The proposals would require an insurer to disclose the fair value of its insurance assets and insurance liabilities from 31 December 2006 (paragraphs 30 and 33 of the draft IFRS, paragraphs BC138-BC140 of the Basis for Conclusions and paragraph IG60 of the proposed Implementation Guidance).

Is it appropriate to require this disclosure? If so, when should it be required for the first time? If not, what changes would you suggest and why?

The FRSB considers this disclosure to be appropriate, subject to further guidance being issued by the IASB on determining the fair value of insurance assets and liabilities. Similar to paragraph 9, paragraph 33 includes a sunset clause date, 31 December 2006. The FRSB is concerned that by putting a sunset clause date, it would create a potential vacuum period if phase II of the Insurance Project is not completed by 1 January 2007. The FRSB recommend replacing “for dates before 31 December 2006” with “Until the effective date of an IFRS issued as part of phase II of the IASB Insurance Project.”

Question 11 – Other disclosures

(a) The Exposure Draft proposes requirements for disclosures about the amounts in the insurer's financial statements that arise from insurance contracts and the estimated amount, timing and uncertainty of future cash flows from insurance contracts (paragraphs 26-29 of the draft IFRS, paragraphs BC124-BC137 and BC141 of the Basis for Conclusions and paragraphs IG7-IG59 of the proposed Implementation Guidance).

Should any of these proposals be amended or deleted? Should any further disclosures be required? Please give reasons for any changes you suggest.

To a large extent, the proposed disclosures are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements. If you propose changes to the disclosures proposed for insurance contracts, please explain what specific attributes of insurance contracts justify differences from similar disclosures that IFRSs already require for other items.

(b) The proposed disclosures are framed as high level requirements, supplemented by Implementation Guidance that explains how an insurer might satisfy the high level requirements.

Is this approach appropriate? If not, what changes would you suggest, and why?

(c) As a transitional relief, an insurer would not need to disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed IFRS (paragraphs 34 and BC134 and BC135).

Should any changes be made to this transitional relief? If so, what changes and why?

Except as discussed below, the FRSB considers the proposed disclosures and approach to be appropriate.

Paragraph 29(c)(iii) requires disclosure of actual claims compared with previous estimates (claims development). The FRSB is concerned that there may be practical difficulties in preparing claims development information for disclosure purposes.

Under the life insurance regime, it is confusing to require disclosure of "claims development information" as payment patterns on death do not provide any information about future trends. Mortality tables and lapse rates provide more useful information.

Under the general insurance regime, claims development provides useful information about claims and settlement patterns. However, the draft IFRS does not specify what level of detail is required. The FRSB recommends that the draft IFRS should specify how the claims development information should be disclosed, that is, whether the information should be disclosed by class of business, long-tail or short-tail business, and what disclosures are required of life insurers.

The required disclosures of claims development that occurred earlier than five years before the end of the first financial year in which an insurer applies the proposed IFRS would also result in added auditing costs for the insurer. The FRSB recommends that paragraph 34 be amended to allow accumulation claims development information from the first financial year in which an insurer applies the draft IFRS.

Question 12 – Financial guarantees by the transferor of a non-financial asset or liability

> The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS 39 *Financial Instruments: Recognition and Measurement* to a financial guarantee that it gives to the transferee in connection with the transfer of non-financial assets or liabilities (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or liabilities.
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> Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

The FRSB considers the approach to be appropriate.

Question 13 – Other comments

> Do you have any other comments on the draft IFRS and draft Implementation Guidance?

Information about insurance risk

Paragraph 29(c)(i) of the draft IFRS requires disclosure of information about insurance risk, in particular, the sensitivity of reported profit or loss and equity to changes in variables that have a material effect on them. The FRSB believes that it is important to disclose benchmarks to assist comparability across entities. The FRSB recommends the following disclosures as a benchmark in addition to the amount of insurance liabilities recorded on the balance sheet:

- The valuation of insurance liabilities at a central estimate, and
- The amount required to secure at the greater of a 75% sufficiency and half of the coefficient of variation of the outstanding claims liability.

These recommended disclosures are consistent with the proposals of the Australian Accounting Standards Board. The FRSB believes that they provide benchmarks to aid comparability with the sensitivity analysis disclosures.

Discounting of deferred taxation

Life insurers are concerned that IAS-12 does not permit the discounting of deferred tax, which is currently permitted for life insurers under local GAAP.

This issue was considered by the FRSB at its meeting in September and will be reconsidered at the November meeting as part of the Income Tax project. The FRSB has noted that an amendment to IAS 12 to permit the discounting of deferred tax would be more appropriately considered as part of the Income Tax Convergence Project being undertaken by the IASB and the FASB rather than the Insurance Contracts Project.

However, we do raise this as a significant issue for the IASB to address.

Actuarial Information

A key feature in New Zealand GAAP is that where an actuarial report has been obtained, disclosure of some of the key elements of that report should appear in the financial statements. The following specific disclosures are required:

a) if other than the reporting date, the effective date of the calculation or assessment in the actuarial report;
b) the name and qualifications of the actuary
c) the basis for the determination of the outstanding claims liability
d) whether the actuary is satisfied as to the nature, sufficiency and accuracy of the data used to determine the outstanding liabilities
e) the key assumptions used by the actuary and
f) any qualifications contained in the actuarial report.

The FRSB believes that these disclosures provide useful information and recommends that the IASB considers widening the disclosure proposed in ED 5, particularly considering that ED 5 is essentially a disclosure standard.