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Dear Sir David

Skandia Insurance Company Ltd welcomes this opportunity to comment on the IASB exposure draft ED 5 Insurance contracts ("ED 5").

We appreciate and support the IASB work towards a single international accounting standard for insurance business. However, we would like to comment on an issue of immediate concern to us, and other life insurance companies, the accounting for long-term savings contracts. Some of these contracts might not qualify as insurance contracts under ED 5 ("investment contracts"). Since Skandia writes mainly unit-linked contracts, our comments have been drafted with a unit-linked investment contract specifically in mind.

The comments relate to **Question 13 – Other comments**. We hope that this will be helpful to the IASB when it finalises the amendments to IAS 39 or the guidance to ED 5, regarding the fair value approach

Our principal concerns are that:

- the application of a 'deposit floor', as stated in ED 5 Basis of Conclusions paragraph 117 e), to the measurement of investment contracts under the fair value model would typically mean that an insurer would report a significant loss in the first year of issuing an investment contract. We believe that this paragraph should be deleted since we think that reporting performance based on this excessively prudent basis would be misleading for users of our accounts; and

- although the amortised cost model would produce more meaningful results than fair value if the deposit floor is retained, the application of the amortised cost model is highly complex and subjective, because IAS 39 was not designed to account for the type of investment contracts typically issued by life insurers.

Please note in the appendix, the significant differences in profit profiles between US GAAP and IAS 39 Fair Value approach.

We would welcome the opportunity to discuss these issues further with you. As you will appreciate, we have not commented on all the practical issues encountered in this letter, rather, we have focused on some of our more immediate concerns. If you would like further written input from us on these topics, please do not hesitate to get in touch with me.

Yours sincerely,

Jan Erik Back

1. The economics of the contract.

A typical long-term savings contract in a unit-linked company is entered into by the policyholder with the purpose of long-term saving, often for retirement. Most contracts also include features like death benefits, although for some contracts, the amounts might be trivial. A typical unit-linked contract does not include any guarantees. The policyholder takes the investment risk. The contracts may also include surrender features and to some extent also surrender penalties. However, since the typical lifetime of such contracts is 20 years, there is no need for a full surrender penalty to protect the shareholders' investment.

The normal cash flow from the contract includes significant initial transaction costs in order to acquire the contract. These transaction costs can exceed the initial premiums and fees paid by policyholders, but they are more than covered during the lifetime of the contract by later years' charges. The transaction costs paid are a prerequisite for acquiring the contract over the life of which the issuer will earn its profit.

2. Amortised cost

We believe that the amortised cost model in IAS 39 was primarily designed to account for contracts that involve deposits and borrowings on which interest is paid or received. Investment contracts issued by insurers typically contain other features that are not currently addressed in IAS 39 (eg significant transaction costs, annual management charges, renewal and surrender options). Although the revised IAS 39 (when issued) will provide some clarification of the treatment of these features under the amortised cost model, and does allow the implicit deferral of some transaction costs, its application will, in practice, be extremely complex and open to different interpretation. For example, it is not clear what is the 'maturity value' of the host contract and how the servicing component should be dealt with.

The adoption of the amortised cost model would result in significant conversion costs for Skandia. It is unfortunate that the calculation basis is so complex since a comparable result could be achieved under the fair value model using our existing systems if there was no requirement to apply a 'deposit floor'. We also believe that it would be unfortunate if we were required to adopt (and adapt) a methodology that is designed primarily for 'deposit' type contracts when we believe that a 'fair value' approach would be more appropriate for our equity-linked contracts.

2. Fair value

Fair value accounting for Skandia's unit-linked investment contracts would produce profit profiles that do not fairly reflect the economics of the contracts (see appendix for illustration of profit profiles). A significant loss would be reported in the first year of a contract because it would not be possible either to defer any transaction costs, nor to recognize the 'fair value' of our right to receive future annual management charges, since internally generated intangible assets cannot be recognized under IAS 38, and the fair value of an investment contract liability cannot be less than the surrender value of the contract.

We are also concerned that if we were to adopt the amortised cost methodology, that we might be required to revise this approach during Phase II of the Insurance Contracts Project. Some of our contracts that qualify as insurance contracts are very similar to our "investment contracts" except that they also contain significant insurance risk.

3. Conclusion

When IASB ultimately finalises the amendments to IAS 39, paragraph BC 117e) in ED 5 should be deleted. The paragraph should not be included in the final standards or implementation guidance.

The deposit floor goes beyond the principles of impairment testing used in other standards. Other industries can establish assets for costs already incurred, subject to normal impairment testing. This can be illustrated by reference to IAS 11 *Construction contracts* and IAS 18 *Revenue* as follows.

An insurer typically earns fees on its unit-linked investment contracts over the term of the contracts. These fees are designed to recover both transaction costs and maintenance costs (including administration and investment management costs), and to provide a profit for the insurer. Both the transaction costs and maintenance costs associated with these investment contracts tend to be significantly higher than the similar costs for deposit type investment contracts. The additional costs arise because the servicing element is a significant component of these investment contracts. We believe that the servicing element could be accounted for separately from the financial instrument.

The measurement of the servicing element, comprising the transaction costs and all fees earned (and any maintenance costs) would then fall within the scope of IAS 18 *Revenue*. The measurement of the financial instrument, which comprises a deposit component and an equity-linked embedded derivative, would fall within the scope of IAS39.

Although IAS 18 does not specifically deal with the recognition of costs, paragraph 21 of IAS18 states that the requirements of IAS 11 *Construction Contracts* are also generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services. IAS 11 requires contract revenue and contract costs to be recognised as revenue and expenses by reference to the stage of completion of the contract.

Paragraph 21 of IAS 11 requires costs that relate directly to a contract and which are incurred in securing the contract to be included as part of the contract costs. We believe that this could be applied to investment contracts as well.

Paragraph 27 of IAS 11 permits costs incurred that relate to future contract activity to be recognised as an asset. We believe that this would allow costs incurred in securing an investment contract (ie transaction costs) to be deferred and spread over the estimated life of the contract.

We do not envisage that this requires any changes to be made to existing standards. IAS 11 does not prescribe a basis that must be used to determine the stage of completion of a contract. The overriding principle is to produce a financial statement that measures the true value of the contracts.

We suggest that fees should be recognised when earned, and that transaction costs should be matched with fees earned and estimates of future fees to be earned, in a similar manner to the approach required by USGAAP and that maintenance costs should be recognised when incurred. This would enable profits to emerge on a basis that more closely represents the economics of the contracts. Please note in the appendix, the significant differences in profit profiles between US GAAP and IAS 39 Fair value approach. US GAAP allows for a DAC to be measured against future profits (fees). We appreciate that US GAAP might not be the perfect standard, but it does take into account some of the features of these contracts.

We also believe that a consistent approach could be adopted for unit-linked contracts containing significant insurance risk in Phase II of the Insurance Contracts Project.

Appendix – A Sample product

To illustrate the comments in this letter, we modelled one typical unit-linked regular premium product, with no guarantees. Profit profiles have been calculated under three accounting methods:

- Embedded value reporting

- US GAAP

- IAS 39 Fair value, according to current proposal in ED 5 Paragraph 117 e)

The profiles are projected for 10 years only for illustration. Over the lifetime, the total profits are, of course, the same.