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The Actuarial Profession
making financial sense of the future

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Dear Peter

ED5 INSURANCE CONTRACTS

The UK actuarial profession is pleased to submit this response to the request for comment on ED5. We would welcome the opportunity to meet with you to discuss the points raised. We confirm that we are happy for our response to be placed on the public record.

The profession accepts the need for a Phase I to ensure that EU listed insurance companies (and those listed in other territories which have agreed to adopt IFRSs) have a set of accounting standards covering all aspects of their operations in place by 2005. Unfortunately, progress on completing the insurance project has been too slow to enable a comprehensive solution to accounting for insurance liabilities to be in place in time to meet this deadline.

Nevertheless, the proposals of ED5 are not ideal for the purpose, in particular they do permit a company to adopt inconsistent approaches to the valuation of assets and liabilities thereby introducing artificial volatility into the balance sheet and possibly income statement. We comment further on this below in response to questions 1 and 4.

We are also concerned at some of the "tentative conclusions" reached by the Board for the Phase II of the project and comment on these in response to Question 13. The UK life market is overcoming many of the practical barriers that caused the IASB to produce ED5 and prevented a more rapid move to fair values. The market initiative is called Realistic balance sheet and is driven by the Financial Services Authority. It covers the complex area of with-profits (participating) business and the transition is due

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to be completed by 31 December 2004. The results to investors and managers on the new basis are proving to be superior in many ways to previous information on the financial position of the business, If it has not already done so we recommend that the IASB consult on the points that can be learned from this complementary development to the IASB's insurance project.

Our responses to the questions posed are set out below.

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………

Is this scope appropriate? If not, what changes would you suggests 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?

Question I Response:

(a) We understand the proposal as a temporary expedient in view of the practical constraints on this ED to meet the EU's 2005 deadline. To the extent that it determines items in anticipation of phase II, such as the definition of an insurance contract, the option should be left open to modify these items on the basis of practical difficulties experienced. The exclusion of references to assets backing the insurance contracts does not give an immediate concern in the context of UK valuations, because it permits continued use of current UK valuation rules which do allow the valuation rate of interest to flex with the returns achieved on the covering assets. The temporary rules therefore do not create any additional problem in this respect for business written by a UK company. This observation may not be true for liability valuations in other countries, where we are aware of the concerns being articulated by the IAA. These concerns could emerge in the group accounts of a UK holding company with non UK insurance subsidiaries.

Paragraph 14 of the draft IFRS permits modifications of accounting policies if the change makes financial statements more relevant. If asset values have changed due to an increase or decrease in interest rates, then the IFRS should make clear that a change of accounting policy is permitted so that the liability valuation rate may be correspondingly amended and that this policy change does not fall foul of para 16(c) (i). The discount rate does not relate to the company's assets but to general levels of interest rates.

In this context 'correspondingly changed' could be referenced to a change in a gilt rate of an appropriate term (i.e. it may differ for deferred annuities than ten-year term policies) from one financial year end to the next.

We do have concerns about the lack of consistency between the valuation of insurance contracts and liabilities under financial instruments, particularly where the latter relate to contracts issued by insurance companies. We would hope that under Phase II these different liabilities will be treated in a comparable manner. Note also our comment about entry values in response to question 13.

(b) We agree that weather derivatives which do not meet the definition of an insurance contract should be accounted for under IAS39. Some insurance companies use such weather derivatives to hedge their liabilities under contracts of insurance and it might be helpful if guidance could be supplied on hedge accounting in such circumstances.

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 draft 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?

Question 2 Response:

We have a number of concerns with the definition of insurance contract.

- The attempt at drawing a distinction between insurance and gambling leads to anomalies. A pure endowment is thus not within the definition of insurance, although mortality is an important element in setting the premium rate. It is also not clear to us that "survival", in the case of an annuity (which can be considered as a series of pure endowments), can really be called an event that adversely affects the policyholder.

  We remain unconvinced that the concept of insurable interest should drive accounting treatment.

- The definition of insurance risk relies on words like significant, non-trivial and plausible. We believe there is scope for confusion about the precise meanings (and differences between) these various terms. This is particularly the case when they are translated into other languages.

- B21 needs to refer back to B15 to ensure that the insured event does not have only the same (or very similar) impact as persistency risk.

- We would recommend that assessment of the significance of any change in the present value of cashflows should be based on gross, rather than net, cashflows. Otherwise contracts with a profitability of close to zero will all qualify as insurance. This change appears to be more consistent with the examples supplied in the Implementation Guidance.

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 a derivative embedded in an insurance contract, unless the embedded derivatives

Are the proposed 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 transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent 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 of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in phase *1?*

(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?

Question 3 Response:

In principle, we strongly support the need to value all derivative features at fair value. However, we believe that in Phase I an exemption should have been given to all options embedded in an insurance contract (or with-profits investment contract) but see our response to question 4 regarding guaranteed annuity options. We are also unclear as to the intention regarding unit linked and index linked contracts, where the embedded option represents the vast bulk of the contract — in contradiction to the normal definition of an option.

Question 4— Temporary exclusion from criteria in IAS 8

(a) Paragraphs 5 and 6 of [the May 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

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 BC58-BC75 of the Basis for Conclusions).

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

<u>Question 4 Response</u>:

We do not see the need for the 'sunset clause"; this could introduce unnecessary uncertainty into the accounting regime if Phase IIls not completed on time. Otherwise, we agree to these proposals subject to registering concerns that

- some local GAAP rules may permit a loss recognition test which becomes inappropriate when assets are measured at market value (see comments on mismatching above).

- some local GAAP rules would not recognise potential losses under guaranteed annuity options which, in our view, would be unacceptable.

<u>Question 5— Changes in accounting policies</u>

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 recognized in profit or loss (paragraph 35 of the draft IFRS).

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

<u>Question 5 Response</u>:

The proposals appear to be reasonable, although we would prefer to see paragraph 16 amended to ensure consistency with BC 77 and make it clear that partial improvements are acceptable.

<u>Question 6 - Unbundling</u>

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-BC37 of the Basis for Conclusions and paragraphs IG5 and IG6 of the proposed Implementation Guidance).

(a) Is unbundling appropriate and feasible in these cases? If not, what changes should be made to the description of the criteria?

(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?

Question 6 Response:

These proposals seem to be acceptable.

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).

Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?

Question 7 Response:

We believe that in Phase I the prohibition on generating "up front" profits in paragraph 18(d) should be restricted to retroactive covers. We are also concerned that the application of an IAS 36 impairment test to rights and obligations under a reinsurance contract will require a present value calculation and produce a result inconsistent with the measurement approach adopted for the gross liability. We recognise that this problem could be resolved by discounting the gross liability but we assume from other comments made in ED5 that such a forced change is not the intention of Phase 1.

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:

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

Question 8 Response:

These proposals seem to be reasonable.

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?

Question 9 Response:

We believe that it is inappropriate to permit the inclusion, within equity, of any element of “free assets” for which regulatory approval would be required to transfer them to shareholders. We also believe that it is appropriate to exempt investment contracts with participating features form the disclosure requirements of IAS32

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

These 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 paragraphs IG60 and IG61 of the draft 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?

Question 10 Response:

We do not believe it is reasonable to impose this requirement from 31 December 2006. As set out below, we have concerns with the way the Board appears to be interpreting "fair value" and until clarity of definition is achieved it is appropriate to defer this requirement. This comment applies with equal force to with-profits investment contracts, where disclosure seems to be required from December 2005 (but see comment in response to question 9 above).

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 draft 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

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

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

<u>Question 11 Response</u>:

We believe that the disclosure as described in the ED itself is reasonable. However, the type of disclosure as set out in the Draft Implementation Guidance goes well beyond what is feasible and what will prove valuable to the users of accounts. We are, however, content with the transitional relief in (c).

<u>Question 12 - Financial guarantees by the transferor of a non-financial asset or liability</u>

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 …….

Is it appropriate that IAS 39 should apply to a financial guarantee give in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

<u>Question 12 Response</u>:

We agree with the proposals.

<u>Question 13 - Other comments</u>

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

<u>Question 13 Response</u>:

We would like to raise a number of concerns regarding the tentative conclusions reached by the Board on Phase II. These are directly relevant for Phase I through the need to disclose fair values and assess whether a change in accounting practice is acceptable.

- The Board has adopted an “entry” value approach to fair value. This is inconsistent with the normal “exit” value (which we would support) and which is reproduced in Appendix A of ED5. We note with concern that the entry value approach will apply to investment contracts in Phase I.

- The use of market value margins is, in our view, to be avoided on both practical and theoretical grounds. In practice they could be used to smooth results, which presumably is not what the Board intends.

- We cannot see the relevance of the existence of policyholder guarantee schemes when assessing the appropriate allowance for “own credit risk”.

We are sending a copy of this letter to Allan Cook at the ASB.

Yours sincerely

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