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Bundesanstalt für
Finanzdienstleistungsaufsicht

BaFin

Appendix I

EXPOSURE DRAFT 5 – *INSURANCE CONTRACTS*

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 BC40-BC51 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?

Response:

a) The decision to address insurance contracts rather than entities is appropriate. Similar contracts should be accounted for similarily, regardless of which entity issued them.

(i) Paragraph (a) (i) obliged insurers to account assets held to back insurance liabilities using existing IFRSs, in particular IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*. This leads to a mismatch between the measurement of insurance assets and insurance liabilities. In practice most of the assets fall into the category “available for sale” and are measured at fair value whereas the insurance liabilities, applying local GAAP, have to be valued at amortized cost. I believe that consistent valuation of assets and liabilities must be allowed on a fair value basis as well as at amortized costs. This objective can be achieved by the creation of a new category "assets held to back insurance liabilities" or by relaxation of the IAS 39 criteria with regard to the tainting of financial assets as held-to-maturity.

(ii) The proposal is appropriate.

b) It is appropriate that weather derivatives that do not meet the definition of an insurance contract have to be brought within the scope of IAS 39.
In order to facilitate this decision, it seems to be helpful if the IASB introduces the use of a hedge effectiveness test to determine if weather derivatives should be classified as insurance contracts or financial instruments. Under the hedge effectiveness proposal (i.e. the proposal considered by the NAIC) if a weather derivative contract is considered to be highly effective (i.e. it es expected to have an adverse effect) the contract is essentially the same as an insurance contract and should be included within the Insurance Contract IFRS. Weather derivative contracts that are considered ineffective (i.e. not expected to adversely affect the policyholder) would then be classified as a financial instrument.

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?

Response:

Basically I agree with the proposed definition of insurance contract as set out in ED 5. In particular I welcome that insurance against credit risk is now included in the definition.

Nevertheless I suggest to replace "significant" in the insurance contract definition by "any". The problem of "significant" is its subjectivity. The use of "any" would lead to more objectivity and as a result to more comparability.

Alternatively "significant" could be substituted by "not insignificant". "The latter is somewhere between "any" and "significant". "Not insignificant" would be less strict and more in line with the related guidance in Appendix B of the draft IFRS and the examples in the draft 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 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 draft Implementation Guidance)

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 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?

Response:

(a) Principally derivatives should be reflected at fair value whether or not they are embedded in a host contract. Otherwise a consistent treatment for all derivatives would be impossible. Nevertheless I think particularly with regard to the close relationship of the components within insurance contracts that it is adequate to exempt from separate valuation embedded derivatives that meet the definition of insurance contracts.

(b) It is appropriate to exempt derivatives such as guaranteed life-contingent annuity options or guaranteed minimum death benefits - as described in paragraph BC 123 of the Basis for Conclusion – from separated fair value measurement.

(c) The disclosure requirements for such options as described in question 3 (b) (paragraph 29 (e) of the draft IFRS and paragraphs IG 54–IG 58 of the draft Implementation Guidance are adequate.

(d) No other embedded derivatives have been identified.

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 BC58-BC75 of the Basis for Conclusions).

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

Response:

(a) The exemption from the requirements of paragraph 5 and 6 of (the May 2002 Exposure Draft of improvements to) IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* appears appropriate.

The sunset clause reinstating hierarchy of IAS 8 in 2007 should be reconsidered. There are concerns that the sunset creates too much pressure on Phase II and may lead to undesirable results due to the lack of time.

(b) Doubts that equalization provisions do not meet the frameworks definition of liabilities are not unwarranted. Hence the intention to eliminate equalization provisions is understandable. Nevertheless I can not support this proposal. It is my conviction that the recognition of equalization provisions adequately reflects insurance business. Waiving equalization provisions means to eliminate an important aspect of insurance business which is balance over time. Insurance business is not completed at the balance sheet date. Its horizon is long-term.

The proposal requiring a loss recognition test if such a test does not already exist under an insurer's current accounting policy is adequate.

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).

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

Response:

The proposal that entities may use non-uniform accounting policies for insurance liabilities within a group is only acceptable against the background of ED 5 being an interim solution. In general non uniform accounting policies within a group should not be permitted since financial statements of that kind can neither be relevant nor reliable.

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-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 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?

Response:

(a) I agree with the proposal provided insurance and deposit components have to be unbundled if and only if accounting for the complete products draws an incomplete picture of the obligations the insurer really has.

Insurance contracts are designed and calculated as bundles of closely related benefits. Unbundling of such products would be artificial and would not necessarily improve information.

(b) There are no other cases where unbundling should be required.

(c) By and large it is clear when unbundling would be required.

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?

Response:

Dealing with certain accounting aspects for reinsurance contracts in phase I is not appropriate. Reinsurance accounting should first be addressed in Phase II. This procedure would not only allow to make sure that every detail of reinsurance accounting is consistent with the approach for direct business, it would also avoid unnecessary system changes just for Phase I.

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:

(a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and

(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.

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?

Response:

These proposals are acceptable.

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?

Response:

I regard the proposed treatment of insurance contracts containing a discretionary participation feature in phase I as appropriate. However I can not agree with what is said in paragraph 24 of this Exposure Draft. The decision whether the unallocated surplus has to be recognized as a liability or equity can not be arbitrary. If the issuers of such insurance contracts are forced either by market practice or own practice in the past to distribute a certain part of the surplus, this unallocated surplus should be recognized as a liability and not as equity.

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 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?

Response:

Past discussions about fair value for insurance liabilities have shown that in the absence of markets for insurance liabilities the determination of fair value is a highly complex subject. The debate has made plain that in the face of the large number of different insurance products world wide the development of reliable mathematical fair value models is extremely difficult. As yet fair value models that are accepted world wide do not exist.

Against this background the Boards proposal to require the disclosure of fair values of insurance liabilities in phase I is unreasonable. As long as IASB itself has not determined how to define fair values of insurance liabilities the requirement to disclose fair values should be given up.

Instead of requiring the disclosure of uncoordinated incomparable fair values of insurance liabilities the Board had better encourage the insurance industry to give more information about values used internally for example in capital allocation or risk measurement models including the key assumptions and the methodology the quantification within these models is based on.

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 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, BC134 and BC135).

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

Response:

Disclosure should concentrate on what is material. The requirements should be precise and limited to the major issues. They should focus on the risks the entity is subjected to. An overload of information should be avoided, not only to prevent disinformation by excess of information but also in order not to place unnecessary burden on the industry.

I doubt whether the proposals meet these premises. A review of the proposed requirements appears necessary. In particular one should ask whether less but high quality information would be the better solution. I believe that the German Accounting Standard No. 5-20 (GAS 5-20) *Risk Reporting by Insurance Enterprises* proposes a useful minimum set of appropriate requirements for disclosures about risk reporting by Insurance Enterprises.

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 (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.

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?

Response:

It is appropriate to apply IAS 39 to a financial guarantee given by the transferor in connection with the transfer of non-financial assets or liabilities. However insurance against credit risk is outside the scope of IAS 39. This kind of insurance is captured by the definition of insurance contracts given in this exposure draft.

Question 13 – Other comments

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

Response:

There are no other comments.