L I T T L E J O H N   F R A Z E R
C H A R T E R E D   A C C O U N T A N T S
1 Park Place · Canary Wharf · London E14 4HJ
Tel 020 7987 5030 · Fax 020 7987 9707 · DX 42660 Isle of Dogs
www.littlejohnfrazer.com

Email

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Dear Mr Clark,

Response to ED5

We welcome the opportunity to comment on the Exposure Draft of the IASB's proposed IFRS *Insurance Contracts*, the related Basis for Conclusions and draft implementation guidance. Our response below is based primarily in our expertise in relation to general insurance; we do not claim to be experts in relation to the business generally written by Life Insurers. Throughout, except where the distinction is expressly drawn, we have used the term *insurance* to also encompass *reinsurance.*

General Comments

It is unfortunate that the timetable agreed for the implementation of IFRSs generally, and that for the development of the IFRS *Insurance Contracts* cannot apparently be brought into line. The consequential need for a "bridging" standard to apply until superseded by the "full" IFRS is clear, although this imposes on the insurance industry a burden in relation to reporting that other industries do not suffer.

In this context, while we regret that different accounting treatments will be permitted during the interim period prior to the full second phase IFRS, we agree that this is an inevitable consequence of the two phase approach. The potential mismatch between the valuation of insurance liabilities and non-insurance assets is particularly unfortunate.

Arising from this two phase approach, in our view it is inappropriate to require of the insurance industry any significant change in business or accounting processes that may be reversed or changed further in the second phase. Where we believe this ED goes too far in this context, we have made that clear in answering the specific questions below.

Question 1 - Scope

We support the application of the proposed IFRS to contracts rather than entities, as it seems clear that the accounting treatment of a contract should be driven by the nature of that contract not that of the reporting entity, which may be largely unrelated. We also agree that the IFRS should not apply to accounting by policyholders.

It follows that we agree that non-insurance contracts entered into by an insurance entity, including financial instruments and contracts dealing with assets linked to insurance contracts, should be accounted for according to their substance, by reference to whichever other IFRS most closely applies. It also follows that we agree that weather derivatives should be within the scope of the IFRS if they meet the definition of insurance contracts.

Question 2 - Definition of an Insurance Contract

In our view it is desirable that there should be clear and unambiguous criteria for determining, for accounting purposes, whether a particular contract is an insurance contract, and accordingly whether transactions under that contract should be accounted for as insurance transactions.

The definition set out in the proposed IFRS and the related guidance is, in our view, appropriate, although we note that there are contracts that fall both within the definition of insurance contract in this IFRS, and within the definition of financial derivative in IAS 39. In our view this double-coverage creates difficulties requiring pragmatic resolutions that sit uneasily with the general principles underlying the draft IFRS. Examples are discussed in our responses to specific questions below.

Further, we note with particular approval that an insurance contract is defined as being one that effects the transfer of *significant* insurance risk, and that *significant* is defined in a way that is clearly different to that implied or express in many current national GAAPs. The twin requirements of the proposed IFRS, that the “plausible” change in the present value of cash-flows should be “non-trivial”, are sufficiently inclusive as to remove much of the uncertainty which arises from the requirement, present in many current national GAAPs, to exercise judgement across a wide range of possible outcomes in determining whether a contract transfers sufficient insurance risk to be accounted for as an insurance contract.

Question 3 - Embedded Derivatives

Without the proposed exemption from the provisions of IAS 39, there would be contracts that could, on the face of the definitions set out in IAS 39 and this proposed IFRS, be accounted for either as Financial Instruments or Insurance Contracts. This is clearly unsatisfactory. The question appears to be whether such contracts should be exempted from IAS 39 or the proposed IFRS *Insurance Contracts*. In our view, it is inherently illogical to prefer the inclusive “significant insurance risk” test over the more commonsense “predominately financial in nature” test set out in IAS 39. In principle therefore, IAS 39 should take precedence over the proposed IFRS in this respect.

However, we recognise that this principled approach is likely to cause material implementation difficulties for some entities (mainly Life Insurers), and that a pragmatic approach may therefore be necessary for this phase 1. In line with our general introductory comments, we believe that whatever treatment is required in phase 1 in this respect should not be changed in phase 2 if the phase 1 requirement involves any material operational or reporting burden. Accordingly, as adopting the proposed approach does nopt create such a burden, on purely pragmatic grounds the proposed treatment is, in our view, appropriate for phase 1.

Question 4 - Temporary exclusion from criteria in IAS 8

This proposal is directly consequential on the two phase approach to the development of the IFRS *Insurance Contracts*. As such, we agree that it is appropriate, subject to our view that it is unwise to “hard-code” into this exclusion the proposed date for the implementation of phase 2, 1 January 2007. It would be better, in our view, to extend the exclusion to the date at which phase 2 is actually implemented, whenever that may be.

In our view the proposals set out in b(i) to (iii) are appropriate, subject to clarification over their applicability to the renewal of existing contracts (which should in our view be treated as new contracts), and the requirement to explain the basis of the loss recognition test actually implemented (ie national GAAP or IAS 37). Although there is some merit in the argument that loss recognition should follow IAS 37 in phase 1, disclosure should be adequate to highlight possible difference in bases between entities, and the benefits of consistency at his phase 1 stage do not outweigh the possible burden of change on the entities concerned. Following the general principles proposed in relation to changes in accounting policies, it may be appropriate to require that any changes in the bases for loss recognition represent convergence with IAS 37.

Question 5 - Changes in Accounting Policies

This proposal is an unavoidable consequence of the two stage process, and in that context we believe that it is appropriate.

Question 6 - Unbundling

In our view, the key aspect of this proposal is that unbundling is only required where, obligations or rights under a contract may not, otherwise, be recognised. The separability of the elemental cash-flows is not only simply not the issue, but also introduces likely differences of interpretation that could lead to inconsistent treatments.

In other words, the proposal is appropriate insofar as it addresses an accounting abuse, rather than a mere preferred treatment. There may be packaged products of a hybrid nature in relation to which the assets and liabilities (including contingencies) are fully recognised as insurance assets and liabilities, ie not on the deposits basis. A general insurance example might be many financial reinsurance contracts. In our view, unbundling should not be required in such cases.

Applying this principle, we agree with the proposed treatment of surrender or maturity values, in that so long as the liabilities arising from such provisions are recognised, the “financial” elements of the package need not be unbundled.

Question 7 - Reinsurance Purchased

In our view, no particular aspects of this area should be singled out for phase 1; the whole subject of reinsurance accounting should be dealt with in a unified fashion at phase 2. In that context, we would respond as follows.

In our view the proposal in para 18(a) is appropriate.

The proposals in para 18(b) and (d) expose issues that will not be properly dealt with until the whole area of reinsurance accounting is addressed in phase 2. One of the key distinctions not made in the proposal is between retrospective and prospective reinsurance. For instance, the proposal at (a) would prevent the use of retrospective reinsurance to <u>explicitly</u> discount insurance liabilities, and the proposal at (b) would prevent the use of retrospective reinsurance to <u>implicitly</u> discount insurance liabilities. In those particular cases, we believe that the proposals are appropriate. However, prospective reinsurance could also apply to insurance liabilities already booked by an insurer where the liabilities concerned represent reserves calculated on the basis of a prudent assessment of the likely outcome of a particular contract or portfolio

In this case, the proposal at (b) would require the liability to be recognised (on the basis of an entity specific fair value in most cases) but the directly matching asset to be recognised only to the extent that payment has been made to the reinsurer (fair value, but not entity-specific). It is far from clear that the proposal in (d) would allow the resultant difference to be recognised on a basis that reflects the reality in this case, as this proposal clearly envisages the assert being “earned” over a period. Such a treatment could be positively misleading accounting in this case.

A better alternative might be to deal with the issues surrounding retrospective reinsurance specifically, perhaps along the general lines of FASB 113.

In our view the proposal at para 18(c) is appropriate, although we would reiterate that we would prefer the matter to be dealt with as part of a full review of reinsurance accounting, as referred to above.

So far as the proposal at para 18(e) is concerned, we do not believe that the suggested inference, that the insurance liabilities are understated, is the only or even the most reasonable one, as this will be wholly dependant on the circumstances in each case. Accordingly, we do not agree with the inclusion of the proposal at (e).

In our view, the proposal at para 19 is appropriate.

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

We agree that the proposals are appropriate.

Question 9 - Discretionary participation features

We make no comment in relation to these proposals, as we do not believe we have the relevant expertise in sufficient measure to do so.

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

There is currently a wide range of differing views as to the appropriate bases for determining the fair value of insurance assets and liabilities. The two phase approach recognises that this is a key area of insurance accounting and that these differences must be resolved before phase 2 can be implemented. It is possible that the implementation date might, despite the best efforts of the Board, be delayed because of persisting differences in this area.

The requirement to disclose fair value will impose on some reporting entities the obligation to make significant changes to operational systems and reporting processes, based on what remain a very fluid set of expectations as to what the eventual requirements will be in phase 2. We believe that the proposal is therefore inconsistent with our overall view that material changes should not be made in phase 1 if they may be reversed or further changed in phase 2. Further, we believe that it is likely that such disclosures may embody material variations between the bases used by different entities, and not therefore provide the relevant and reliable reporting that is the aim of the Board in this respect.

Accordingly, in our view the proposal is not appropriate.

The stated aim of the Board is that phase 2 will include requirements in respect of fair value reporting. That much is clear to all entities concerned. It may well be appropriate, for accounting periods ending 31 December 2006, to encourage (on a best practice basis) entities to disclose information relating to their business in a way which will contribute to the reader's understanding of the value (in the entity's own terms, ie not necessarily "fair value") of the assets and liabilities concerned. This will therefore include disclosure of the bases used in arriving at the values disclosed. Such a proposal would lead entities towards the reporting capability likely to be required under phase 2, without second guessing the detail of the as yet undetermined phase 2 requirements.

Question 11 - Other disclosures

In our view, the disclosure requirements set out in para 27, 29(a), 29(c)(ii) and (iii) are appropriate.

The requirement is para 29(b) requires clarification. In practice, almost all substantive terms of every insurance contract can have a material effect on the amount, timing and uncertainty of cash-flows arising from those contracts. In our view, it would be reasonable to require entities to explain in general terms the effect of the key substantive terms in the types of policies they issue, and the proposal should be clarified to achieve this.

The terms of para 29(c)(i) appear to us to be tantamount to a requirement to disclose the prospective results of stress-testing the entity's business model. This is commercially highly sensitive information, and is accordingly a regulatory issue, not a public reporting matter. In our view it would be reasonable to require entities to disclose the key variables that do affect profit or loss, and equity, but not the quantitative link between those variables and the results. Even this requirement is open to very significant variation in its application, as variables tend to be both causal and themselves results of other causes. In our view it will not be possible in practice to define to what depth the disclosure should be in this respect. Different entities may reasonably argue that they manage the variables concerned at a greater or lesser level of detail, and inconsistency between entities' disclosures will therefore simply have to be tolerated. A requirement to disclose, in relation to accounted for results (ie retrospectively), the key factors and uncertainties affecting those results, would in our view be reasonable.

Without necessarily endorsing any particlar Implementation Guidance, in our view the approach described in (b) is appropriate. It is important that the status of the Implementation Guidance is clearly stated.

The transitional relief described in (c) is reasonable.

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

The proposal appears to create a specific exemption from the general principles of applicability of IAS 39, As is clearly set out in the example in IG1 1.15, if the risk transferred in guaranteeing the non-financial asset is in relation to more than just the market price (eg the condition of the asset), then the contract would appear to be an insurance contract rather than a financial derivative.

In our view, the principles should stand on their merits if possible. However, as discussed above in relation to embedded derivatives, the question in this case is whether contracts that could reasonably fall within either IAS 39 or the IFRS *Insurance Contracts* should actually be dealt with under the one or the other. In the former case, the more inclusive definition of an insurance contract in the proposed IFRS was favoured over the commonsense (predominate character) definition of a financial contract in IAS 39. We do not find the arguments of the Board compelling for adopting the opposite approach in the case of financial guarantees.

Question 13 - Other Comments

We have no other comments except to emphasis that we feel there are considerable difficulties in producing a practical solution to Phase II. Producing a standard that properly addresses the issues that are likely to arise in fair valuing insurance contracts and ensuring the resulting answers are intelligible to the readers of the accounts is likely to be a time consuming process. Although Phase I is an interim solution and should not be tolerated for longer than necessary it is important that the Phase II standard is robust and therefore should not be hurried. It will be important to field test any propsed Phase II standard to ensure it produces a workable solution.

Should you wish to discuss the contents of this letter please contact Neil Coulson or David Roberts on 020-7987-5030.

Yours faithfully,

Littlejohn Frazer