CL 34

ED5 – Comments of the Royal Association of Belgian Actuaries

A) General comments

A.1 The questions not dealt with in this document are considered to be clear, requiring no remarks or further explanations. This isn't to mean that we agree with these topics, but we will make comments on phase I and in view of the preparation of the definitive insurance standard.

A.2 More generally, the present document gives our questions, comments and remarks for phase I, taking into account that this intermediate phase will be limited in time. This is why we propose pragmatic (rather than dogmatic) solutions. In the coming months, we will eventually comment on topics to be specified for the phase II.

A.3 Globally, we draw to the attention of the Board that we find the requirements resulting from the ED5 seem to be for many aspects in contradiction with paragraph 1 of the exposure draft, saying that “the objective of the IFRS is to make limited improvements to accounting practices for insurance contracts, …” (we will extend more on these issues in the “specific comments” section).

A.4 The following specific comments describe specificities of the Belgian market (product, profit share, accounting treatments, disclosure, …) involving many efforts of the insurers or other issuers of insurance contracts if they would apply to the prescriptions of the ED5.

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B) Specific comments

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?

1.1 Non application to assets backing insurance liabilities

The consequences of the non application of the ED5 to the assets backing insurance liabilities will introduce a distortion in the balance sheet during the phase I. This distortion will be the source of artificial volatility.

Even in the case of absence of mismatch between assets and liabilities, the different treatment of both sides of the balance sheet will introduce volatility (in equity or P&L).

Furthermore, it does not enhance the transparency and the comparability during the phase I of the balance sheets for the liability side and consequently of the profit and loss accounts.

Even worse, a company with a mismatch between its assets and its liabilities, could possibly disclose accounts that will not show this mismatch.

We propose for this category of assets to ask the insurers to present balanced balance sheets (by applying coherent methods for both sides asset-liabilities) and to give additional information about the fair value of the assets in the disclosure.

1.2 Application of IAS32 to financials instruments with discretionary participation features

Financial instruments with discretionary participation features are excluded from the scope of IAS 39 because of the lack of method for fair value calculation for this kind of contract. At the same time, these contracts fall into the scope of IAS 32 requiring disclosure of fair value. To avoid this contradiction, we propose to exclude these contracts from the scope of IAS32.

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?

Although we concur with the spirit of the definition, we still have some issues with the application of the definition and the related implementation guidance in the sense that we are not convinced that it enables us at this stage to consistently distinguish contracts that are insurance contracts from contracts that are in substance investment contracts and should therefore be accounted for in accordance with IAS39.
We particularly encountered classification problems in our Belgian market when discussing the issues that are described below:

2.1 Surrender indemnities

Paragraph B23 states that "if a contract pays a death benefit exceeding the amount payable on surrender or maturity, the contract is an insurance contract unless the additional death benefit is insignificant."
Many of our products in the Belgian market offer a death benefit that is equal to the account balance upon death of the policyholder. They often include a surrender indemnity that is designed in such a way that there is at least one plausible scenario that the "amount payable" on surrender significantly differs from the amount payable upon death.
These contracts would therefore be classified as insurance contracts.

We would welcome specific guidance that would help us understand if it is the intention of the Board to capture these contracts.

2.2 Pure endowments

Example 1.4 of IG2 explicitly states that pure endowment contracts are not insurance contracts "unless there is a significant probability that the holder will not survive until the specified date".

It is however clear for all the actors of the Belgian life insurance market that these contracts clearly include significant insurance risk and should therefore be classified as insurance contracts.

A pure endowment contract for a given policyholder and a given duration period is the complementary coverage of a term insurance for the same person and the same period of time. We consider that if the second contract includes sufficient risk to be classified as an insurance contract, the first contract also does.
Survival risk is insurance risk, and in the case of pure endowments, the amount payable upon survival is the amount paid on maturity. In this case, we think it is wrong to compare the benefit upon survival to the benefit upon maturity, as survival and maturity are one and the same insured event.

2.3 Experience rating

Paragraph (b) of B18 on items that are not insurance contracts reads as follows: "contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example some financial reinsurance contracts or group contracts (such contracts are non-insurance financial instruments)."
We do not know if this paragraph was intended to capture experience-rating provisions where future premiums are adjusted to reflect incurred losses.
Our understanding is that in many cases, these contracts could qualify as insurance contracts for the following reasons:

- The adjustment of future premiums creates a timing difference between the financial cost of the claims and the adjustments of future losses. This timing difference has an adverse impact on the cash flows of the insurer that is triggered by the insured event (claims incurred).
- For many of these contracts, adjusting future premiums operates risk transfer and this adjustment cannot be performed in case of bankruptcy of the
- policyholder. As bankruptcy is a plausible scenario, these contracts could be qualified as being insurance contracts.

We would welcome more guidance or examples in order to clarify the intention of the Board on the classification or unbundling of contracts with these features.

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?

a) Why is separation required for surrender options for which the surrender value varies in response to the change in equity price or index but not for a surrender option with a fixed surrender value ?
The board excluded an option to surrender an insurance contract at a fixed amount from the scope of IAS 39-23 because the separation of these options would require significant system changes beyond the scope of phase I (BC 36-37). Would this not be the case for separation of surrender options with an equity or index linked surrender value ?

We agree with the argument in BC 118 (a) : why require separation of embedded derivatives if the host contract is an insurance contract ? Separating these derivatives would require extensive and costly system changes that might not be needed for phase II if insurance contracts are measured at fair value.

d) Two possibilities :

1. Exclude surrender options included in insurance contracts with an equity price or index linked surrender option. (reason : see answer to question 3a)
2. Exclude all embedded derivatives for which the host contract is an insurance contract (reason : see answer to question 3a)

Question 4 : Temporary exclusion from criteria in IAS 8 – Loss recognition

(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?

We believe that more clarification on the loss recognition test is advisable.

We understand that it is the Board's intention to limit system modification that would be reversed under Phase II. Therefore we believe more clarification on the practical implication of the test according to IAS 37 would be advisable.

We would welcome guidance on:

- How to take into account risk and uncertainty. IAS 37 stipulates that : 1) IAS 37 36 : "The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date". and that 2) IAS 37 42 "The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision". Our understanding of IAS 37 is therefore that the loss recognition test as required by the ED 5 should not only be based on "best estimate assumptions", but should also take into account "market value margins".
- the level of aggregation or the unit of account
- how losses and profits can compensate over time

The European Directive (92/96/EEC, article 17 for Life; 73/239/EEG, article 15 for Non-Life) stipulates that technical provisions should be sufficient to cover future obligations. We assume that if national legislation is in accordance with this European Directive, no Loss Recognition test under IAS 37 is required.

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?

Questions / remarks / suggestions:

- Paragraph 24 (a) specifies that the *fixed element* of a contract with discretionary participation features can be reported separately from the discretionary participation feature. The problem is however, that it is not obvious what is meant by the notion 'fixed element'. If we consider the contract at inception, the fixed element is the contractually guaranteed capital of the contract. However, at any point of time in a later stage of the contract, retrospective guarantees also include accumulated profit sharing distributed in the past.

  We would appreciate the board to include more guidance on the definition of "fixed element".

- Common practice in the Belgian market:

  1. A distinction can be made between the profit sharing related to the global account and to the segregated accounts. In the case of the *global account* the contracts only have to mention the existence of profit sharing (which is in fact a legal requirement). *Segregated accounts* (funds) have a profit sharing rule stipulated in the conditions of the contract and which is based on the performance of its underlying assets. As it is the insurer who decides upon the timing as well as upon the amount of the realization of the capital gains there is still some discretion involved.

     We consider that both types of contracts fall within the scope of ED5 during phase I.

  2. Some *life* insurance companies in Belgium have unallocated funds, the so-called "fund for future allocation". This is a fund of distributable profits of
  3. which the destination is not yet defined at the end of the year. The beneficiaries of these funds can either be the shareholders or the policyholders.

     We agree that these kind of funds have to be classified either as a liability or as equity during phase I.

- Financial instruments with discretionary participation features are excluded from the scope of IAS 39, but not from the scope of IAS 32. The disclosure requirements with respect to these contracts are very demanding, even though there is still a lot of uncertainty about their valuation.

  We propose to exclude these instruments from the scope of IAS 32 during phase I.

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

We understand that the Board tries to push for an effective progress of an insurance standard by fixing the date of 31 December 2006 for the requirement of disclosure at fair value.

For our part, we believe it to be more important in the intermediate phase I to disclose relevant and clear information about the contracts.

As mentioned in the comment 1.2, we believe that it is better to apply coherent methods for the valuation of both sides of the insurance part of the balance sheet. Furthermore, there is until now no clearly defined method to value insurance liabilities. We have to dispose of a precise definition of method for fair value valuation to fix a deadline for it.

Question 11 – Other disclosure

(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?

This is clearly contradictory with paragraph 1 of the exposure draft saying that "the objective of the IFRS is to make limited improvements to accounting practices for insurance contracts, …".

If the insurers will have to disclose all information required by the ED, the following consequences will appear :

- The insurers will have to make a lot of efforts (and certainly more than "limited") to give all this information.
- The third party interested by this information (clients, analysts, …) will have more difficulties to find a specific information.
- The aim of transparency will, consequently, be lost.
- Finally, the confidence in the information delivered by the insurers will be lost too.

To give an example, the requirement of the sensitivity test and movement analysis will require a great deal of development for many companies.

In addition, there is an indication of the level of detail required for this information. At the product level, many groups are distributing thousands of products and for many of them there are different versions of the product differing in risk, coverage, ….