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SPANISH ACCOUNTING AND AUDITING INSTITUTE (ICAC)

COMMENTS ON ED 5 INSURANCE CONTRACTS

In general, the ED-5 is considered as a transitional rule applicable during phase I, on which further work needs to be carried out on a consensual basis in order to give accounting solutions to the different operations done by insurance and reinsurance undertakings, that will be applicable in phase II. A solution that will necessarily have to seek equivalence between the correct input of the different operations in the accountings and the intention and goal of the operations carried out by such undertakings on issuing, coverage and liquidation fo the compromises assumed.

Concerning the different questions raised in the ED-5, we'd like to underline:

Question 1 – Scope

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.*

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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?

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?

We share the idea of focusing the delimitation of the scope of the standard, according to the principle that establishes "the contract must be understood considering the underlying reality rather than the formal features", to the nature of the contracts, and, therefore, extending the accounting regime for insurance contracts to those operations compliant with the definition of Insurance Contract foreseen in ED-5, regardless they are issued or not by insurance undertakings. As long as phase II doesn't come into force, we consider necessary on a transitory basis the non-strict application of IAS 39 for asset held to back insurance contracts, as long as during phase I it won't extent the fair value to those liabilities derived from insurance contracts, the different accounting regime applicable to such liabilities and to the financial assets hedging the, may raise a big decree of volatility to the asset of insurance undertakings, according to the oscillations of either interest rates or prices not encompassed with liabilities variations in the same direction.

Therefore, Spanish supervisory authority for insurance undertakings considers that, on a transitory basis during phase I, IASB should make more flexible the requirements demanded for the maintenance of assets in the held to maturity's portfolio, so that, thus, asset held to back insurance contracts may be valued at cost; or allow on a transitory basis a new category of assets inside IAS 39, named as asset held to back insurance contracts, that can be valued at acquisition cost. In both cases, problems linked to the volatility created by the mismatching of assets and liabilities would be removed.

Question 2 – Definition of insurance contract

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> 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?

Insurance contract is defined by ED-5, for accounting purposes only, as the one by 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'

However according to the legal delimitation of these contracts in insurance market, and we think that in most of Europe as well, a difference is made among the three parties intervening in the contract with the insurer, the policyholder, the insured person (to whom, him or his goods, the risk affects), and the beneficiary (who will get paid the sum). So , even if all three of them may be the same person, they may not, but in every case the one that will have to support/sustain the damage will be the insured person, not the policyholder nor the beneficiary.

According to the aforementioned, we propose the following definition for insurance contract: ¨ insurance contract is defined as the one by which one party (insurer) accepts the risk ceded by the other party (policyholder), compensating the beneficiary in case an uncertain adverse event affects the insured ¨.

On the other hand we don't share the opinion stating that pure endowment contracts, as they appear in IG 1.4, won't be considered as insurance contracts. Such contracts rely on financial-actuarial calculations, and as the insurance operations that they are, they incorporate an insurable risk borne by the insurer, in line with the definition, thus not being any reason for their exclusion.

Furthermore, in line with the aforementioned, we consider that at a global level the definition of insurance contracts and its delimitation from other financial products is coherent, although such coherence results bigger from a theoretical point of view than from a practical one, as there aren't concrete specified criteria to delimit what stands for Significant risk and Non-Significant risk thus setting an unclear and subjective threshold hardly applicable in practice. In addition to that, it

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may imply that identical products would have a different accounting treatment due to the different level of risk assumed, thus raising regulatory arbitrage. An example of such philosophy may be the delimitation of credit insurance from the rest of financial guarantees, where an objective condition(that the debtor won't comply with his obligations, causing an economic loss to the policyholder), allows splitting between insurance contracts and the rest of the financial guarantees.

Therefore, we consider that the standard must combine both qualitative and quantitative elements to define what's understood by insurance contract in a manner that subjective criteria of those elaborating the financial information to be disclosed won't distort the annual accounts.

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:

(a) meets the definition of an insurance contract within the scope of the draft IFRS; or

(b) 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

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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?

We agree with the general statement of separating embedded derivatives included in insurance contracts, in the line of IAS 39, and in the same way, to except the separation of the surrender option on a fixed amount. However, the separation of implicit derivatives in order to value them at fair value, while the liabilities derived from the insurance contract during phase I is done at cost, builds up on the volatility of assets-liabilities, qualified as non-desired, so that we consider that such separation shouldn't be carried out until phase II comes into force.

a) 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

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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?

The draft of IAS 8 .5 and .6 establishes:

"IAS 8.5 - *In the absence of a particular Standard or an Interpretation of a Standard that specifically applies to an item in the financial statements, management shall use its judgement in developing and applying an accounting policy that results in information that is:*

(a) relevant to the decision-making needs of users; and
(b) reliable in that the financial statements:
(i) represent faithfully the results and financial position of the entity;
(ii) reflect the economic substance of transactions and other events, and not merely the legal ***form;***

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(iii) are neutral, ie free from bias;
(iv) are prudent; and
(v) are complete in all material respects.

IAS 8.6 - In making the judgement described in paragraph 5, management shall consider the following sources in descending order:

(a) the requirements and guidance in Standards, and Interpretations of Standards, dealing with similar and related issues, and Appendices and Implementation Guidance issued in respect of those Standards;
(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses set out in the Framework for the Preparation and Presentation of Financial Statements; and
(c) pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature, and accepted industry practices, to the extent, but only to the extent, that these are consistent with (a) and (b) of this paragraph."

We agree with the exception settled concerning paragraphs 5 and 6 of IAS 8, although such exception should refer not to a fixed date, as it currently does (1st January, 2007), but to the moment where phase II comes into force. By doing so, an undesired but still possible delay wouldn't mean the loss of such exemption.

b) 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?

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No specific comment on this issue. We'd like to clarify that the exception to the changes in the accounting policies during phase I doesn't affect just insurance undertakings but also to all others under the scope of such standard. In particular, we are referring to credit entities that give financial guarantees that, according to the delimitation of insurance contract, must be registered according to ED-5, so that during phase I they'll be allowed to apply IAS 39 until phase II comes into force.

c) 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?

We agree with the unbundling as a principle, although its strict application to many insurance operations would have a negative effect on the operation as a whole. The design, planning and management of insurance products is done as a whole, so splitting certain elements of such contracts in respect to other or others would cause a loss in the overall vision of the operation, thus implying a loss of information in the annual accounts.

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The implementation guidance only includes an example on unbundling referred to financial reinsurance. We doubt on whether it could extend to any insurance operation where the financial and insurance risk components were clearly delimited, or if whenever an insurance contract is considered to lack of a significant risk it shall be accounted as a whole according to IAS 39.

We consider that, whenever possible, unbundling shall apply, and whenever not possible the delimitation of insurance and financial risk, at least during phase I the whole operation should be treated as an insurance contract.

d) 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?

In general, we agree with the accounting regime foreseen for reinsurance, although we consider that, in relation with paragraph 18.d), it should be postponed until phase II, once the regime for valuation of liabilities derived from insurance contracts is concreted, the deferral of incomes raising in the accountings with the register of the provisions for ceded reinsurance and the cessions of premiums where the provisions are not financially discountable.

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

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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?

No specific comments on this proposal.

e) 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?

We agree on leaving to phase II the decision on whether distribution of profits is an expense or part of the entity's own funds. No other comments.

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f) 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?

In general we agree on the proposal, but we'd like to comment that we consider fair value of liabilities derived from insurance contracts should be included in the annual report from phase II of the project, i.e., when the regime for valuation of technical provisions is sufficiently clarified. Thus, we consider that the reference to the end of 2006 as the date from which on such information shall be disclosed should be modified, to adapt it to the date phase II comes into force.

g) 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

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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?

In general we see as quite ambitious the disclosure of information foreseen in the proposal, so it's one of the subjects where additional details and examples need to be provided by IASB.

As an example of the aforementioned, there are different measures of sensibility, so in order to make information comparable unique parameters of measure should be settled.

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On the other hand, even if the requested info brings a general overview of risk in all its sides, for small undertakings providing such information may be too costly compared to the utility that such information may provide to its users.

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?

We agree with the proposal included in the draft, that splits between financial guarantees as such and credit insurance, and in that sense we recognize the efforts carried out by IASB to delimit both types of guarantees and classify credit insurance as an insurance contract.

Question 13 – Other comments

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

1.- We consider that deferred acquisition costs already recognized in relation to the contracts classified as investment contracts must be maintained within the current accounting regime during phase I, thus exempting IAS 39 in that sense.

Furthermore, deferred acquisition costs of insurance contracts must be, in our opinion, kept as assets.

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2.- ED-5 states the need of applying loss recognition test during phase I for liabilities derived from insurance contracts, and we think that guidance on application of it would be welcome.

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