AMERICAN COUNCIL OF LIFE INSURERS
FINANCIAL SECURITY FOR LIFE

German Insurance Association

National Association of Independent Insurers

Austrian Insurance

RAA

NAMIC®

The Life Insurance Association of Japan

CL 74

31 October 2003

The Honorable David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street, First Floor
London EC4M6XH United Kingdom

Dear Sir David:

On 31 July 2003, the International Accounting Standards Board released Exposure Draft 5, Insurance Contracts (ED5), for comment. Many insurers and accounting firms have provided comments, either directly or through the Advisory Committee process. For others, this is the first opportunity to make comments.

Since March 2002, several insurance company trade associations have been monitoring the activity of the Board with respect to the Insurance Contracts Project and other related standards. From time to time, some of the trade associations have taken the opportunity to express their views to the Board. The following letter represents those associations' comments on ED5.

We know the Board will receive many comments expressing concerns with the draft. Many of them will provide detailed examples of these concerns. This letter will not attempt to duplicate those details, but, rather, give a high level view of the issues in common to an extremely large and global segment of the insurance industry.

In our analysis, we have identified ten items that we believe will need to be resolved before Phase I can be adopted.

1. **Overall Timing**
2. **Due Process**
3. **Mismatch**
4. **Temporary Exclusion from Criteria in IAS 8**
5. **Disclosures**
6. **Fair Value of Liabilities Disclosure**
7. **Reinsurance**
8. **Catastrophe Provision**
9. **Equalisation Provision**
10. **Mixed Standards: IAS based on "fall-back" approach**

1. Overall Timing

The insurance industry is concerned about the timetable of all the projects of the IASB. The EU community has expressed the need to have final standards, including Phase I of the Insurance Project, as soon as practical to allow companies ample time to prepare financial statements by the 1 January 2005 date. The proposed requirements in ED5, if adopted, will significantly add to the already growing list of changes in IT systems.

The impact on the industry could be further complicated by:

- IAS 39, Financial instruments;
- Performance Reporting related to Phase I;
- IFRS for Phase II, Insurance Contracts, and
- Performance Reporting related to Phase II.

It will be difficult and extremely expensive to implement all these changes in such a short time-frame (one to two years). The insurance industry strongly recommends that the Board avoid causing a situation that would create multiple changes and undue cost and effort for preparers. The targeted implementation schedule would also make it very difficult for users to compare, over time, the performance of the industry. Financial analysts will need time to assess the effects on net income and surplus as entities make the transition to the new standards.

The industry supports the development of a new, high-quality, robust insurance contracts accounting standard. We suggest all major changes be implemented at the same time as the effective date of Phase II. Considering the Board's other projects (revenue recognition and measurement objectives) and the on-going debate about "performance reporting" for financial institutions (banking and insurance industries), it does not seem reasonable to implement all the above-mentioned changes this quickly. The industry strongly suggests limiting the scope of changes in Phase I to the two following:

- Distinguishing between insurance contracts and other financial instruments
- Disclosures

2. Due Process

The effect of the Insurance Contracts Project on the insurance industry will most likely be significant. Consequently, we believe the Board should be deliberate and thorough in the development of a comprehensive insurance standard. The process should include utilizing the resources of the Insurance Advisory Committee, industry roundtable sessions and rigorious field testing of any measurement model before adoption.

In recent meetings and presentation by Board members on the status of the Insurance Project, members have noted that the Board has not made any decisions about the measurement criteria for insurance contracts. While we applaud these comments, previous Board discussions and material contained in the Basis of Conclusions suggest otherwise. For example:

- ED5 proposes a provisional resolution that "the measurement technique of insurance contract be based on the fair value".
    - (BC138) This proposal is intended not only to give useful information to users of an insurer's financial statements, but also to encourage insurers to begin work on fair value systems to avoid the need to provide a long transition period for Phase II.
    - (BC139) Disclosure of the fair value of insurance liabilities and insurance assets will provide relevant and reliable information for users, and this would still be the case even if Phase II does not result in a fair value model.
- ED 5 requires unbundling of deposit components and fair value of embedded derivatives.

Because significant measurement issues remain unresolved including fundamental points such as renewal premiums and non-guaranteed elements, we believe it is inappropriate to include measurement elements in Phase I.

We are particularly concerned that the views expressed in the joint trade letters have not been sufficiently considered by the Board at open IASB meetings. To date, with the exception of responding to our views on disclosures, there has been no response or an opportunity to discuss our expressed views. The insurance industry plays an important social role especially with respect to financial planning and risk management. Thus, we believe that the full participation of industry is essential to the decision process about insurance accounting standards.

3. Mismatch (ACLI/IAA Joint Research Project and supplemental papers)

The ACLI/IAA joint report presented two significant issues:

- Inconsistent measurement of assets and liabilities will, in many cases, produce "financial noise" that can misrepresent business reality.
- An accounting model that establishes artificial constraints can lead to unrepresentative results.

We concur with these points and strongly recommend that the Board reconsider these issues in Phase I. By not allowing for another asset category for assets held to back insurance liabilities, or relax the constraints on a held-to-maturity portfolio, the Board has effectively dismissed any concerns over an insurer's mismatched balance sheet. Adoption of either of these concepts would alleviate the mismatch during Phase I and could provide a model that could be analyzed during the deliberations on Phase II.

Artificial constraints also tend to cause "financial noise" that the Board should avoid in standard setting. One example is that of a deposit floor. In the Basis for Conclusion, the Board expressed its intent to modify IAS 39 to make clear that the fair value of a financial liability with a demand feature is not less than the amount payable on demand. The imposition of a requirement that the value of an insurance contract cannot be less than the amount payable on demand places a significant constraint on the valuation process and misrepresents the insurance liability.

4. Temporary Exclusion from Criteria in IAS 8

The associations believe that it is appropriate for the Board to exclude the issuers of insurance contracts and holders of reinsurance contracts from the hierarchy in paragraphs 5 and 6 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors to the extent the hierarchy is inconsistent with the goals of Phase I. However, we believe that it is inappropriate for the Board to "sunset" that exemption by ending it in 2007 because:

a) There exists the possibility that measurement guidance for insurance contracts may not be available by the beginning of 2007. The complex issues that remain outstanding and the expectation that sufficient testing of any proposed standard would be undertaken may make this date unattainable.

b) Without an insurance standard the "sunset" provision will not serve anyone's interests. If this exemption is terminated without Phase II guidance in place, it is unclear how insurers will interpret application of the remainder of IAS to insurance contracts. This increases the likelihood that different insurers will make different accounting judgments, thus reducing the comparability and usefulness of insurer financial reports.

c) As pointed out in our discussion of issue 1 above, the "sunset" provision will also present the possibility that insurers will have to change their systems multiple times without adequate justification.

d) It is unclear how the difficulty, expense and confusion of multiple systems changes will contribute to the Board's stated goals of "developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements."

e) The "sunset" provision could put added pressure on the Board to finish Phase II without due consideration. Given the importance of Phase II, it is important that the Board takes the time to do it right.

5. Disclosures

In the joint letter from several of these trade associations dated June 12, 2003, comments were provided on the proposed disclosures. IASB Senior Project Manager Peter Clark's response acknowledged these comments, reflected some of the recommendations in ED5 and asked that consideration be given to the substance of the proposed disclosure requirements and the Implementation Guide.

We believe that sufficient disclosures about insurance contracts should be provided to assist users in understanding the nature of the business. The disclosures should not be overly burdensome to preparers of the financial statements or so complex that readers will not understand them or take the time to read them.

The requirements should not cause insurers to disclose "business secrets" or proprietary information, such as pricing information. We strongly oppose disclosure of this information because it would seriously hinder the competitive condition of insurance companies.

As noted in the joint letter, we are also concerned about disclosures of an insurer's process. It's questionable that this information would provide relevant information to users. The disclosure will tend to be either highly summarized or so complex that readers will find little value in them. Therefore, we recommend deleting the requirement to disclose "the process used to determine the assumptions…" in paragraph 27 c.

The disclosure requirements of paragraph 29, we believe, are too broad and extensive. Greater specificity would be desirable in this case. Since the individual letters of the trade associations on the ED5 contain detailed recommendations, we will not repeat those recommendations here. We do recommend, however, that disclosures about risk management should be stated separately with a focus on the methods used to manage those risks.

6. Fair Value Liability Disclosure

We continue to believe that the fair value disclosure requirement should be removed from Phase I. Until the measurement criteria are known, there is no basis to form a meaningful and consistent disclosure. We do not find as a compelling argument the statement "This proposal is intended…to encourage insurers to begin work on fair value systems… ". Insurers already possess knowledge about discounted cash flow methodologies and no other preparatory work can be done until sufficient guidance is available.

Requiring this disclosure in Phase I:

- Prejudges the decisions about the measurement criteria the Board will make in Phase II, or
- Will require insurers to report liabilities at fair value based upon their notion of fair value only to change to another measurement standard when Phase II is adopted, providing little value to financial statement users and while requiring insurers to incur significant costs.

As mentioned above, Board members and staff have recently expressed an "open mind" about the recognition and measurement criteria to be considered in Phase II. We, therefore, find it inappropriate for the Board to require a fair value disclosure before pen has been put to paper on Phase II. It also seems to be inconsistent with these assurances, and serves as another sign that the Board has already decided on the measurement criteria for insurance liabilities.

A fair value disclosure without sufficient measurement guidance will not improve the quality of information for financial statement users. The Board has acknowledged that neither ED5 nor any existing IFRS gives insurers guidance as to how to calculate fair value for insurance liabilities. A fair value measurement of insurance contracts requires guidance about how contracts should be grouped, the discount rate and the estimates about claims. Insurers will invariably use different approaches and assumptions to compute the fair value of their liabilities. Therefore, without guidance there will be little or no comparability between the disclosures of different insurers.

We recommend that the fair value disclosure be removed from Phase I especially since the proposed requirement would not become effective until 2006.

7. Reinsurance

The accounting guidance for reinsurance suffers from many of the same problems as other functional elements in ED 5 because the IASB is attempting to implement a model that is only partially complete. The proposed accounting guidance will result in a mismatch of insurance assets and liabilities arising from reinsurance transactions because it requires measurement of liabilities at cost and assets, generally, at fair value. This situation will result in financial reports that are not useful to users and will likely cause dislocations in the insurance and reinsurance markets.

<u>*Prohibition of offsetting insurance assets against direct insurance liabilities [Paragraph 10(c) & (d) and BC 69].*</u>

In general, this treatment is reasonable since the IASB policy on de-recognition requires that insurance liabilities only be derecognized when the liability is extinguished. This position is consistent with U.S. GAAP, which has adopted a similar principle in paragraph 14 of Statement of Financial Accounting Standards (SFAS) No. 113.

Prohibition of changing the measurement of its insurance liabilities upon purchase of reinsurance [Paragraph 18].

ED5 states that an insurer should not change its measurement basis for insurance liabilities when it buys reinsurance and the ceding entity should use the premium paid to measure its rights under a reinsurance contract at inception, so that it does not report a gain at inception.

It appears as though the guidance for this section is directed primarily toward what is known under U.S. GAAP as a retroactive reinsurance contract. Retroactive reinsurance involves reinsurance agreements that cover losses, which occurred prior to the effective date of the contract. In general, we agree with the conclusions in the draft to the extent they apply to retroactive reinsurance since they are consistent with U.S. GAAP. SFAS No. 113 prohibits the immediate recognition of gain by a ceding entity as a result of a retroactive reinsurance transaction.

We also note that the exposure draft creates an exception to this rule in paragraph 10(c) that allows the recognition of income to the extent that deferred acquisition costs are released. We agree with this exception in Phase I because many prospective reinsurance contracts, particularly quota share contracts, involve a ceding commission that would result in a gain under current GAAP in most jurisdictions.

Requirement that the ceding entity shall apply IAS 36 to its rights under a reinsurance contract [Paragraph 19]

This requirement is a significant problem with respect to reinsurance accounting guidance in ED5. Paragraph 19 of the exposure draft requires that the ceding entity apply IAS 36 *Impairment of Assets* to its rights under a reinsurance contract. IAS 36 requires that receivables be measured at the higher of the asset's net selling price or value in use. Because there is no active market in reinsurance recoverable balances, net selling price is not an option and value in use would be the default measurement criteria. IAS 36 paragraph 26 states that the value in use is measured by discounting estimating future cash flows until the ultimate disposal of the asset.

The treatment would result in a significant mismatch of assets and liabilities recorded by the ceding entity in Phase I This result could have a significant negative financial impact on insurers that cede long-tailed liability risks such as products liability, workers compensation and other liability exposures. Since ceding entities will record the insurance liabilities at ultimate (i.e. undiscounted expected losses) and will be required to record the reinsurance recoverable on a discounted basis, prudent use of reinsurance to manage overall insurance risk will result in a significant and immediate financial penalty. Such a penalty will result in less use of reinsurance and may have a significant disruptive effect on the insurance and reinsurance markets. Moreover, this treatment essentially requires implementation of Phase II measurement criteria in Phase I. We strongly urge the IASB to delete this requirement in Phase I of the insurance standard.

8. Catastrophe Provision

The elimination of the catastrophe provision in ED5 is premature since the measurement criteria will not be addressed until Phase II. Insurers in some jurisdictions establish a liability that serves to equalize loss-claims over time. By nature, insurers offer products which balance out the required risk-premium over years. Those products would subsequently disappear if catastrophe provisions are eliminated. For example, the loss needed to cover a 100-year-flood is distributed over the statistical frequency of such a flood (which should be close to 100 years). This enables the insurer to distribute premiums collected for that time period and charge small premium amounts enabling many clients to purchase the product.

Banning the provision without giving due consideration to its effect, could adversely impact an insurer's ability to issue coverage or individual's ability to purchase it. We therefore ask the IASB to defer its decision about catastrophe provisions until Phase II.

9. Equalisation provision

Likewise, we believe the elimination of the equalisation provision is premature. According to paragraph 10 of ED 5 an insurer shall not recognise any equalisation provisions as a liability. Currently certain jurisdictions allow equalisation provisions for the following reasons:

Even where an enterprise has a portfolio of insured risks for which premiums and costs are matched in each accounting period on an actuarial basis, at least arithmetically, the actual level of costs for claims will fluctuate more or less around the expected value of claims. This is a result of the nature of the insurance business. In many countries this factor is taken into account by the use of a "claims equalisation provision".

The occurrence of insured events and the payments made for claims represent a stochastic process taking place over time. This stochastic process does not come to an end at any one balance sheet date.

The outcome cannot be definitively realised at any one balance sheet date. It is more the case that the process of equalisation takes place between past and future periods. This process must somehow be reflected in the financial statements. This is the purpose of the claims equalisation provision. Without the allocations to and from the claims equalisation provision, which take account of the volatility of insured risks, it is not possible to depict fairly the equalisation process taking place in the insurance business. In particular, the fluctuating outcome that would result from a single period presentation of this (volatile) process, depending to a large extent on events of chance, would not provide useful information to assess the enterprise's ability to generate profits on a sustained basis.

In addition, external users of financial statements (mainly investors) also consider short-term issues when making their investment decisions, thus taking account of the volatility of the business. For this reason, the outcome of risks (i.e. the result from underwriting activities) should be shown for each class of insurance before and after the changes in the claims equalisation provision.

Due to its special character, the amount of any claims equalisation provision and the change in the provision during the year should be disclosed separately for each reportable primary segment as part of segment reporting.

The claims equalisation provision should, in principle, be increased each year by the premiums not used where the actual cost of claims is lower than the expected cost of claims (below average claims).

The upper limit for the claims equalisation provision should be based on actuarial principles. Risk premiums brought forward from earlier periods should be transferred to it, if the costs of claims are higher than the expected level of claims (above average claims). Consideration should also be taken where appropriate of any changes in the assumptions used to determine the expected annual cost.

The basis for the calculation and for transfers to and from the claims equalisation provision should be disclosed in the notes to the financial statements.

These points are in line with EU Directives, in particular Articles 30 and 62 of the EU Insurance Accounts Directive.

Compliance with tentative recommendations for a future EU prudential supervisory system[1]: "20. The current use of equalisation provisions may change, as it is likely that these will be classified as own capital by the IASB. The Commission Services however believe that insurance companies still should have the possibility to build up untaxed reserves as restricted capital in a future EU solvency system, and that these reserves could be counted against the solvency capital requirements. The Commission Services believe that this issue should be addressed at a later stage of the project when the general structure of the capital requirements and the links to financial reporting has been laid down."

Therefore, we recommend that Phase I should default to national GAAP. Consideration of an equalisation provision should be addressed in Phase II.

10. Mixed Standards: IAS based on "fall-back" approach

Because some European insurers are currently preparing financial statements based upon IFRS and all EU public companies will be using international standards effective 1 January 2005, the Phase I requirement to apply "local" GAAP for insurance contracts may create reporting inconsistencies. For example, some insurers may be following US-GAAP requirements while others may be applying different standards. Recognizing that this may be a local issue, any guidance the Board could offer where there are choices in standards would be appreciated.

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[1] European Commission, Internal Market DG, Financial Institutions, Insurance: Note prepared by the Commission Services; Subject: Design of a future prudential supervisory system in the EU – Recommendations by the Commissions Services"; MARKT/2509/03, 3 March 2003

Because Phase I guidance will establish disclosure requirements related to insurance contracts, does this imply that they supersede any local GAAP disclosures? Additional guidance related to the preparation, presentation or disclosure would also be helpful.

Summary

The associations strongly recommend that the Phase I guidance be limited to distinguishing between insurance contracts and other financial instruments and appropriate disclosures. Elements of the document that are of a measurement nature, for example, unbundling, and fair value disclosures for insurance liabilities should be removed and considered under Phase II of the Project.

In addition, we believe the Board should give serious consideration to the industry concerns about the mismatch in measurement of assets and liabilities. Relaxing the "held-to-maturity" designation or permitting, as an interim solution, a separate class of assets backing insurance liabilities would be viable alternatives.

Finally, because of the significant of the Insurance Contracts Project to the industry, it is extremely important to engage the industry in meaningful dialogue and testing before finalizing a standard for insurance contracts.

Respectfully submitted:

American Council of Life Insurers
Austrian Insurance Association
German Insurance Association
Life Insurance Association of Japan
National Association of Independent Insurers
National Association of Mutual Insurance Companies
Reinsurance Association of America

Cc: Peter Clark