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Ref.: **Comment letter by the Allianz Group on ED 5 Insurance Contracts**

Dear Sir David,
Ladies and Gentlemen,

The Allianz Group appreciates the opportunity to comment on ED 5 Insurance Contracts Phase I. The Allianz Group was the first German insurance company and amongst the first European insurers preparing its consolidated accounts in accordance with IAS/IFRS since 1998. Under IAS/IFRS there currently exists no pronouncement which provides technical accounting guidance concerning insurance contracts. As such, and envisioned in the IASB Framework, the Allianz Group has thus far embodied and applied the accounting principles generally accepted in the United States of America (US GAAP) for its insurance assets and liabilities. We would like to emphasise our full support of the IASB's objective to develop a single IFRS for insurance contracts.

We believe the main value of the development of an IFRS for insurance contracts is to permit an insurer to appropriately reflect its long term business model and its management of economic risks. An insurer's business model is based on the management of risk over time and within a portfolio. Until more definite criteria for reporting the substance of the insurance business model will be developed in Phase II of the project, interim solutions are necessary during Phase I. The Allianz Group therefore appreciates the IASB's decision to split the Insurance Contracts Project into two phases and to design ED 5 as a transitional phase. We also appreciate the underlying spirit of ED 5 to be in many respects a continuation of existing accounting policies (ED 5.16). Albeit limited, the improvements to accounting practices (ED 5.1) that ED 5 will introduce should however not lead to an unbalanced model through punctual modifications or requirements that are premature. The following items are of the most concern to us:

- **Fair value disclosures**

The IASB has not yet developed a measurement concept for fair valuing insurance liabilities and intends to develop this in Phase II. To pass on the responsibility for the development of such a concept to companies would neither serve the aim of comparability of accounts nor reliability of disclosures for users of financial statements (ED 5.1 b, BC 138). We note the IASB's intention to encourage insurers to begin work on fair value systems, whilst at the same time acknowledging that the Board's decision to adopt a fair value model is tentative only and will not become definite until the due process for Phase II is complete (BC 139). A change to a fair value system that is still hypothetical appears to contravene the principles of responsible rulemaking as it would necessitate a considerable cost in time and money for a company which should be based on more conceptually founded and definite grounds. It would also be contrary to ED 5's aim not to require major changes that may need to be reversed when the Board completes the second phase of its project (ED 5.1 a). A change to a potentially different fair value concept developed by the IASB would be unduly expensive. Moreover, such a fundamental change in the measurement model of insurance contracts would simply not be feasible within the set timeframe. Contrary to the IASB's intention, not to require comparative fair value disclosures by the end of 2005, *de facto*, for internal quality control purposes, insurance companies would have to calculate such values by 2005, which is effectively not feasible, in particular for a large international financial services Group such as Allianz with more than 1200 subsidiaries in 70 different jurisdictions each with individual products.

We estimate that after the IASB has concluded on a workable concept for the measurement of insurance liabilities in Phase II, preparers will need at least two years time for the implementation of the fair value disclosure requirement. This timeframe would be necessary for the development of IT systems, for education and field-testing.

We believe that with the integration of fair value disclosures within ED 5, Phase I cannot be regarded any more as a „transition“.

- **Tentative conclusions on Phase II**

While we recognise that the Boards’ conclusions for Phase II (BC 6-8) are tentative only, we are concerned with the current directions. We consider the proposals yet as inconsistent.

The IASB proposes that, at inception of a contract, a gain may not be recognised. Even if this decision should in principle be endorsed, it leaves many questions open. In particular, since the proposals state simultaneously that acquisition costs should be expensed immediately, while a risk adjustment should be included when discounting expected future cash flow. Calculating the discounted value of future cash flows inevitably leads to a positive discounted value at inception. Irrespective of whether this balance is set to zero by discretionary selection of assumptions or by means of setting up a provision, the question as to how this balance should be distributed over the residual term remains unanswered.

Furthermore, the proposal that the estimated fair value of an insurance liability shall not be less, but may be more than the entity would charge to accept new contracts with identical contractual terms and remaining maturity would be unrealistic for the majority of insurance contracts. Comparable new contracts do simply not exist as each single contract has to be regarded as “individual” as a result of its specific terms and conditions in the contract.

We question the precise purpose of these tentative conclusions since we believe that they would lead to accounting changes that would be superficial in nature, whilst triggering complex and expensive system adjustments for insurers. The Allianz Group is currently analysing the impact of the Board’s proposals on various insurance contracts (life, health, casualty, reinsurance). Based on the results, we would like to further substantiate our views to you. We are also collaborating with the CFO Forum to establish a harmonised valuation model for insurance liabilities.

- **Other disclosures**

We consider the 56 paragraphs of disclosure principles in the Implementation Guidance as contravening ED 5‘s aim „...not to impose costs that exceed the benefits...“ (ED 5.1). In fact, in our view the proposals are unproportionally excessive in comparison with disclosure requirements for non-insurers. We therefore do not share the view that the disclosure requirements would be analogous to those in existing IAS (question 11). We recommend to consider in particular the risk-related disclosure proposals together with the IASB’s project on Financial Risk Disclosures. The requirements proposed in ED 5 would exceed disclosure requirements under SEC rules (see our response to question 11). Furthermore, whilst the SEC and the German Accounting Standards Board regulate risk reporting inside the MD&A or the *Lagebericht*, the IASBs‘ proposals would have to be disclosed in the notes to the financial statements, which has a different quality, in particular with respect to audit. It should be noted that, statements on future developments and uncertainties are hypothetical and, therefore, in our view belong in the MD&A (OFR). Notes serve to explain the amounts reported in the financial statements. Although ED 5‘s objective is to improve transparency and comparability of financial statements through additional disclosures, we feel that this aim cannot be justified by requiring commercially sensitive disclosures for insurer‘s.

From the ED 5 and related documents it is not clear whether the „specific disclosures to meet the objectives of the high level principles“ (BC para 124) are mandatory or voluntary to comply with, as they are partly considered as „requirements“ (BC para. 126). We understand from subsequent discussions that the Board did not intend the principles in the Implementation Guidance to be mandatory or an exhaustive requirement. As a SEC registrant however, we might come into a situation where we have to comply with every detail in the Implementation Guidance. We therefore ask the Board to clarify explicitely in the IFRS that the Implementation Guidance is not mandatory to comply with. For the purpose of comparability of financial statements however, we recommend to propose a balanced level of disclosure and a converged approach with US GAAP.

- **Misrepresentation of net income and equity**

Asset liability management is an important function of the management of an insurance company's economic risks, (in particular interest rate risks). The IASB's proposals would not permit the accounting model to reflect an insurer's economic risk management model. Instead, the proposals would create a misrepresentation of both equity and net income as a result of the different accounting measurement for assets and liabilities during Phase I. This is due to assets being measured in accordance with the rules in IAS 39 and insurance contract liabilities being measured on an amortised cost basis. To solve this misrepresentation of the economic position in the accounts we propose introducing for the interim period a separate asset class within IAS 39 ”fixed maturity assets backing insurance liabilities”. These assets should be valued consistent with the measurement of liabilities at amortised cost (see our response to question 1).

Feedback from independent financial analysts support our concern that volatility in the balance sheet and the income statement is undesirable for analysts and investors. Reported volatility in either equity or net income appears to alarm capital market operators, especially where these are not insurance sector specialists, and possibly raise insurers' cost of capital.

We estimate that the impact on the insurer's reported equity is of the order of 10 % if interest rates change by 1%.

- **Interaction with the project Performance Reporting**

With the IASB's Insurance Contracts Project in process, the Allianz Group is very much concerned that the implementation issues concerning the Insurance Contracts Project, coupled with the proposed changes to the income statement format in the Performance Reporting project, will prove to be extremely burdensome on preparers of insurance company financial statements, and equally confusing to users of those financial statements, thereby potentially sacrificing quality. In fact, the current proposals would imply significant changes to the financial statements of insurance companies firstly in 2005 (IFRS for Insurance Contracts Phase I), secondly in 2006 (Performance Reporting IFRS) and, thirdly in 2007 (IFRS for Insurance Contracts Phase II). The

Allianz Group recommends that the IASB delays the Performance Reporting IFRS proposed effective date, until the IFRS on Phase II has been finalized. This will facilitate a phased approach in implementing both the Insurance Contracts and Performance Reporting projects in a manner which will allow for sufficient implementation time for preparers as well as sufficient time for users to absorb the significant impact these projects will have on the financial statements.

We believe that it would be more appropriate to complete Phase II of the Insurance Contracts project, i.e. the measurement issue, before proposals with respect to changing the presentation of the income statement into a disaggregated presentation of „profits before remeasurement“ and „remeasurements“ should become effective.

Specific comments to your questions:

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?

Comment of Allianz Group

We agree with the proposed scope in ED 5 which applies to insurance (reinsurance) contracts rather than insurance entities.

We ask the Board however, to clarify the accounting for policyholders in Phase I. The exclusion of accounting by policyholders from the scope of ED 5 means that there is no clear accounting standard that would apply to insurance contracts in policyholders' accounts. Such policies can be significant within the accounts of corporate policyholders and the lack of a standard could lead to diversity and to the development of different versions of fair values for technical liabilities. In fact, not addressing the accounting by policyholder's would be contrary to the IASB's objective not to issue entity-specific standards.

(i) As stated in our general remarks, we do not believe that it is appropriate that ED 5 has not considered the misrepresentation of net income and equity caused by assets measured in accordance with existing rules in IAS 39 and insurance contract liabilities measured effectively on an amortised cost basis.

The criteria within IAS 39 to classify financial assets as held-to-maturity and hence to value them on an amortised cost basis, restrict the insurer's possibility to sell these assets before maturity if more policyholders than expected lapse their contracts early or as a result of a changing economic, demographic or regulatory environment.

Insurance companies should be able to reflect in the financial statements their business model and their economic risk. Asset liability management is an important function of the management of an insurance company's economic risks. The IASB's proposals would create a misrepresentation in financial reporting of both equity and net income as a result of the different accounting measurement for assets and liabilities.

Until more definite criteria for reporting the substance of an insurer's asset liability management have been developed during Phase II of the insurance contracts project, we recommend the introduction of a separate asset class within IAS 39 for "fixed maturity assets backing insurance contracts liabilities" as an interim solution during Phase I. These assets should be valued effectively consistent with the measurement of insurance contracts liabilities at amortised cost.

"Fixed maturity assets backing insurance contracts liabilities" could be defined as financial assets with fixed or determinable payments and fixed maturity that are hold with an intent to reproduce the expected cash flows of the insurance liabilities they support. This separate asset class would be measured in the same way as assets held-to-maturity, but assets could be sold before maturity, for example if more policyholders than expected lapse their contracts early or as a result of a changing economic, demographic or regulatory environment.

We acknowledge that the problem of inconsistency is temporary in light of the Board's proposals for Phase II. However, until Phase II is complete we propose that temporary arrangements are made to resolve this problem. We believe that, as an interim solution, this is a more appropriate method than adjusting the basis of measurement of insurance contracts liabilities to mitigate the misrepresentation. Such an adjustment would not be in line with current local accounting policies (which continue to be applied for the insurance contracts liabilities).

For Phase II, a portfolio hedge of assets and liabilities on a macro-level could be developed, similarly to the approach for banks.

In paragraph BC111, the Board notes that the misrepresentation has existed for some years in US GAAP. However, the FASB mitigated part of this issue through the introduction of "shadow accounting" as described in EITF D41. In our view the proposed accounting model does not permit to truely reflect the insurer's managing of interest rate risk due to the proposal's effect of creating incongruent movement in the value of assets and liabilities.

(ii) IAS 39 does not provide adequate solutions for the accounting of certain aspects of financial instruments issued by insurance companies. For example, we believe that it is inappropriate to require fair value disclosure of financial instruments with discretionary participating features in 2005 as the treatment of such discretionary features is unclear under IAS 39.

We agree that weather derivatives should be brought within the scope of IAS 39 unless they meet the definition of an insurance contract. We appreciate the Board's decision to include insurance against credit risk in the scope of ED 5. Insurance against credit risk is part of an insurer's overall insurance activity, and is managed as part of a diversified portfolio in the same way as other insurance activities. Thus, it is very different from a financial guarantee that provides for payments to be made in response to changes in certain financial variables such as interest rate, credit rating or credit index.

<u>Question 2 – Definition of insurance contract</u>

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?

Comment of Allianz Group

We agree with the definition of insurance contracts set out in ED 5.

<u>Question 3 – Embedded derivatives</u>

(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 paragraph 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?

Comment of Allianz Group

(a) We support the proposal to apply the current principles under IAS 39 to derivatives within insurance contracts – unless the derivative itself meets the definition of an insurance contract – as an interim solution for Phase I, relying on the loss recognition test to ensure that the level of provisions is adequate in Phase I. In principle, we hold the view that all guarantees and derivatives should be reported at fair value as a long term solution.

We ask to Board to clarify in Appendix C para. 1 that IAS 32 and IAS 39 apply to derivatives that are embedded in insurance contracts <u>unless the embedded derivative meets the definition of an insurance contract or is an option to surrender an insurance contract for a fixed amount.</u>

(b) In our opinion it is appropriate to exempt derivatives such as guaranteed life-contingent annuity options or guaranteed minimum death benefits from bifurcation and fair value measurement because the payout of these items is contingent on an event that creates significant insurance risk. Therefore, those derivatives meet the definition of insurance contracts rather than financial instruments and should be excluded from the scope of IAS 39 by this approach.

(c) We do not support the proposed disclosures in par. 29 (e) and IG54-IG58, if they would imply disclosing fair values of these embedded derivatives.

(d) We did not identify any other embedded derivative as requiring exemption.

<u>Question 4 – Temporary exclusion from criteria in IAS 8</u>

(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?

Comment of Allianz Group

a) We appreciate the exemption of insurance contracts from the hierarchy of ED IAS 8 para. 5 and 6. However, we feel it would be counterproductive to disrupt the basis of the Phase I requirements, if the IASB does not complete Phase II within the limited timeframe. We therefore suggest that the date for withdrawal of the exemption is removed and replaced by the phrase: "Until completion of Phase II, this (draft) IFRS exempts an insurer from applying those criteria to its existing accounting policies for: ...". In our view, the responsibility for completing Phase II rests with the IASB.

b) We acknowledge that catastrophe provisions do not meet the definition of liabilities in the IASB Framework. However, in our view, the elimination of catastrophe provisions would be a conceptual breach in system of an accounting model without having a new theoretical concept in place. In particular, catastrophe provisions are an instrument permitting the insurer to manage its long-term business risk within a portfolio approach. Since the insurer cannot estimate when the insured event (catastrophe) will occur, a provision is justified. The elimination of catastrophe provisions would ultimately lead to the non-availability of catastrophe insurance coverage as a product anymore.

We fully support the Board's proposal requiring a loss recognition test if such a test does not exist under an insurer's current accounting policy.

Whilst we agree that insurance liabilities should not be offset against related reinsurance assets in the balance sheet, we consider the offset in the income statement as appropriate (ED 5.10 d ii), as long as the notes to the financial statements provide information on the gross amounts (best practice).

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?

Comment of Allianz Group:

We believe that the proposals are appropriate.

<u>Question 6 – Unbundling</u>

The draft IFRS proposes that an insurer should unbundle (i.e. 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?

Comment of Allianz Group

(a) Insurance contracts are usually designed and calculated to offer a package of products for the policyholder. The artificial unbundling of products would not enhance the information relevance of financial statements. We agree with the proposal, that insurance components and deposit components only have to be unbundled if accounting for the complete product would mean that the insurer otherwise would not recognise obligations to repay amounts received under the insurance contract, or rights to recover the amounts paid under the insurance contract. Additionally, we recommend to make unbundling contingent on cases where the cash flows from the deposit component and the cash flows from the insurance component do not interrelate.

(b) No other cases have been identified.

<u>Question 7 – Reinsurance</u>

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?

Comment of Allianz Group

We do not believe that these proposals are appropriate. The proposals in ED 5 prevent an entity from setting up an asset in respect of rights under a reinsurance contract that is greater than the premium paid for the contract. Para. 18 d) states that if the net amounts paid by the cedant are less than the carrying amount of the related portion of its liability, the cedant shall recognise that difference as income on a systematic basis. We are concerned that the inconsistent measurement bases for insurance and reinsurance will cause significant problems for the industry.

Further, the application of IAS 36 in paragraph 19 of ED 5 effectively pushes all reinsurance assets towards a fair value approach in Phase I although the Board has not decided upon the fair value measurement of insurance obligations.

We therefore recommend that the treatment of all aspects of reinsurance accounting should be addressed in Phase II. This would allow reinsurance accounting, if necessary, to be changed consistently with the approach adopted for direct business in Phase II thereby avoiding the creation of anomalous results and the need to create financial systems solely 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?

Comment of Allianz Group

In principle, we agree with the Board's proposals. We ask the Board to confirm that the proposals in para 20 - 23 would be applicable to closed books only. This would imply that renewals in the property/casualty business would not have to be taken into account in the measurement.

<u>Question 9 – Discretionary participation features</u>

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?

Comment of Allianz Group

In principle, we support the proposals for accounting for discretionary participating features in Phase I. We understand that unallocated surplus has different meanings in jurisdictions. In Germany, it consists of a special provision for future profits to policyholders (the so called RfB) The entire RfB is legally denominated to be allocated to policyholders, so that it has to be considered as a liability. The timing of the allocation depends on the conditions and terms of the contract. We recommend the classification of unallocated surplus as a liability which would be consistent with the IASB's Framework notion of a constructive obligation.

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?

Comment of Allianz Group:

Referring to our introductory comments, we consider it as not appropriate to require the disclosure of fair values of insurance assets and insurance liabilities by 31.12.2006.

The IASB has not yet established a fair value concept for technical insurance liabilities and plans to do so as Phase II develops. The Boards tentative conclusions for Phase II (BC 6-8) have left us with many questions. We consider the proposals yet as inconsistent.

Unlike tradable securities, profit projections arising from insurance contracts have no intersubjective market value that is verifiable. According to the proposals, the fair value should therefore be based on entity-specific assumptions about future cash flows as well as actuarial assumptions (interest rates, mortality). Fair values that are based on actuaries' forecasts rather than on verifiable market values are not very useful. This is because even if the long-term assumptions were correct on average, periodic changes (for instance in interest rates) will deviate from this average and lead to a revaluation with effects on earnings that may be substantial.

The IASB proposes that, at inception of a contract, a gain may not be recognised. Even if this decision should in principle be endorsed, it leaves many questions open. In particular, since the proposals state simultaneously that acquisition costs should be expensed immediately, while a risk adjustment should be included when discounting expected future cash flow. Calculating the discounted value of future cash flows inevitably leads to a positive discounted value at inception. Irrespective of whether this balance is set to zero by discretionary selection of assumptions or by means of setting up a provision, the question as to how this balance should be distributed over the residual term remains unanswered.

As a result, the reported earnings of an insurance company could be subject to management discretion. Due to the long-term nature of the insurance business model, earnings would depend on many different factors that are difficult to quantify. Small changes in the assumptions would have significant effects on the valuation of the liabilities and thus cause earnings to be volatile irrespective of the insurer’s economic performance. The degree of subjectivity involved would not improve the transparency and comparability of insurer’s financial statements.

Furthermore, the proposal that the estimated fair value of an insurance liability shall not be less, but may be more than the entity would charge to accept new contracts with identical contractual terms and remaining maturity (BC 6 b ii) would be unrealistic for the majority of insurance contracts. Comparable new contracts do simply not exist as each single contract has to be regarded as “individual” as a result of its specific terms and conditions in the contract. In general, there is also a question as to how the “start fair value” of existing contracts would be established when changing to a fair value system.

With a view to the current status of the discussions of Phase II and the many unanswered questions in this complex issue we consider it as premature and not responsible to require fair value disclosures from 31.12.2006 onwards. As noted in our general comments, this would effectively imply, that for internal quality control purposes, a change of systems would have to be implemented by the end of 2005, which would not be feasible.

As an alternative, we propose the disclosure of embedded values. As you know, the CFO Forum works on an European-wide accepted concept of embedded values. Feedback from independent financial analysts support the disclosure of embedded values as useful for capital market decisions.

Prior to setting a specific timeframe, we recommend to first establish a sound measurement concept that would appropriately reflect an insuer‘s business modell. The Allianz Group, together with the CFO Forum, is fully committed in collaborating with the

IASB in establishing an internationally harmonised sound valuation model for insurance liabilities.

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?

Allianz Group Comment

We ask the IASB to clarify in the IFRS that compliance with the Implementation Guidance is not a necessary precondition to satisfy the high level disclosure requirements (BC 124), as we have serious concerns as to the level of detail that would be implied by the 56 paragraphs set out in the Implementation Guidance, in particular in our position as a SEC registrant. In our view, these proposals are excessive. Disclosures should be relevant and useful to the investor and should not overload the investor. At the same time, the information should not be commercially sensitive to disclose.

We are also concerned on the audit implications of the disclosure requirements for which neither the auditing profession nor the industry is prepared without substantial investment of time and ressources.

We believe that in particular the risk-related disclosures should be included in the Operating and Financial Review (OFR) provided with the financial statements. This approach would be the most practical to apply and provide consistency with many local reporting frameworks, including SEC reporting requirements in the MD&A as well as German reporting requirements in the *Lagebericht.* Disclosure within the OFR would also allow entities to ensure that the discussion on risk will cover aspects of both financial risk and insurance risk whilst ensuring that those items that need to be disclosed in the financial statements (in accordance with IAS 32) are appropriately cross referenced. This will provide users a comprehensive overview of risk exposures whilst ensuring that the requirements under existing IFRS are met.

We do not agree with some of the disclosure requirements set out in para. 26 – 29 in ED 5. In particular, we believe that disclosure of the following would require undue time and effort or could be onerous:

- Para 29 c) requires an insurer to disclose information about insurance risk <u>both before and after risk mitigation by reinsurance.</u> In line with the German requirements on risk reporting we consider only information about insurance risk <u>after mitigation by reinsurance</u> to be useful and appropriate. If a risk can be mitigated reliably by means of effective risk-reduction techniques, disclosures should only be made about the residual risk (DRS 5.21).
- Para 29 c) requires an insurer to disclose information about claim development tables and the sensitivity of reported profit or loss and equity to changes in key varables. There may be undue effort in obtaining historical data, and further it may not be possible for an auditor to audit this disclosure requirement. Moreover it should be noted, that the SEC does not require such analysis for life business (Guide 6).
- Para 29 e) requires an insurer to "give information about significant exposures to interest risk or market risk under embedded derivatives contained in a host insurance contract, if the insurer is not required to, and does not, measure the embedded derivative at fair value." We believe disclosing the fair value of these

embedded derivatives, as proposed in para 58 of the Implementation Guidance, would require undue time and efforts.

- We regard the guidance in IG 39 to be a particularly commercially sensitive information requirement which would permit competitors to calculate an entitiy' s profit margins. This information, which is a step towards fair value, could be very onerous to disclose.

We identified the following paragraphs in the Implementation Guidance, that are in general, not required by US GAAP and/or the SEC:

ED 5 Implementation Guidance	**US GAAP /SEC**
IG 7 a)	**Not required:** ...renewals and lapses, premiums collected by agents and brokers but not yet passed on and premium taxes or other levies on premiums.
IG 7 d)	**Not required:** ...if they are discounted, explains the methodology used. Only range of interest rates used is required.
IG 7 h)	**Not required:** salvage, subrogation or other expected recoveries from third parties.
IG 12 b) and c)	**Not required:** to be broken out
IG 14 a) – d)	**Not required:** to be broken out separately unless certain threshold is met
IG 16 c) i -ii	**Not required:** Only required is amount of discount, discount rate used, and basis of selection.
IG 17	**Not required**
IG 18	**Not required**
IG 19	**Not required**
IG 20	**Not required**
IG 21	**Not required**
IG 22	**Not required**
IG 23	**Not required**
IG 24	**Not required**
IG 25	**Not required**
IG 26	**Not required**
IG 27 d)	**Not required:** it has to be shown net
IG 28	**Not required:** reinsurance assets – only movement in total balance
IG 29 d)	**Not required:** impairment losses recognised during the period
IG 31	**Not required**
IG 32	**Not required**
IG 33	**Not required**
IG 34	**Not required**
IG 35	**Not required**
IG 37	**Not required**
IG 39	**Not required**
IG 40 a) – e)	**Not required**
IG 42	**Not required**
IG 43	**Not required**
IG 47	**Not required**
IG 48	**Not required:** for life business
IG 49	**Not required:** for life business
IG Example 4	**Not required:** effect of discounting

Whilst we fully support the requirement of providing information about the overall risk position, we recommend to bring the risk-related reporting requirements in ED 5 in line with the German Accounting Standard GAS 5-20 *Risk Reporting by Insurance Enterprises*, which provides a clear structure in line with different risk categories.

In our view, ED 5 would require entity-specific disclosure requirements for insurers that are not comparable to those in existing IAS. We ask the Board to establish a level playing field for disclosure requirements between all sectors. So far, the IASB has not established business risk reporting requirements for other industries. We ask the Board to develop comparability in this respect with its project Financial Risk Disclosures.

In general, we support the regulatory approach to frame high level requirements, supplemented by an Implementation Guidance. However, this approach might not improve the comparability of disclosures. We ask the Board to aim for balance and convergence in disclosure requirements as much as in valuation principles.

In line with the IASB's objective of developing "principle based rules", we recommend to clarify in the IFRS that companies would have to comply with the spirit of the principles without literally applying the letter of the guidance.

<u>Question 12 – Financial guarantees by the transferor of a non-financial asset or liability</u>

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?

Comment of Allianz Group

We agree that IAS 39 should apply to a financial guarantee given by the transferor in connection with the transfer of non-financial assets or liabilities. In contrast, insurance against credit risk, even when it is given in connection with non-financial assets or liabilities, falls under the definition of insurance contracts in accordance with ED 5.

Question 13 - Other comments

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

Comment of Allianz Group

- B 15 states that “lapse or persistency risk ... is not insurance risk”. This statement may disregard the circumstances of the German health insurance. Whereas in life insurance the policyholder that has surrendered a contract, receives the proceeds of the contract, in health insurance a policyholder does not receive his deposit back. Instead, the amounts paid in are allocated to the remaining policyholders and increase their value of the remaining contracts. Hence, similarly to the risk of mortality, in health insurance, lapses are a component of pricing.
- We believe IAS 39 should be amended to deal conceptually with the particularities of investment contracts issued by insurers. This general concern relates to the treatment of transaction costs and especially to the measurement of demand deposits which should not be limited by a deposit floor, if valued at fair value, but reflect the typical stochastic surrender pattern. Otherwise contracts with a demand feature might have to be reported at a loss at inception.

We would be pleased to discuss our comments with you.

Yours sincerely,

(signed)
Dr. Helmut Perlet

Member of the Management Board
and Chief Financial Officer

(signed)
Dr. Susanne Kanngiesser

Head of Group Accounting