CL 115

LEGAL & GENERAL

Our ref AWP/MJM
| Your ref
Direct tel 020 7528 6290
Direct fax 020 7528 6229
Date 31 October 2003

Peter Clarke
Senior project manager
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Mr Clarke,

We strongly support the development of an International Financial Reporting Standard on insurance contracts that will achieve both more meaningful and consistent reporting within the industry, and with other sectors. We appreciate the complexity and difficulty of achieving this in an industry where practices are currently diverse and are driven largely by local regulatory, legal and fiscal requirements. In this regard we acknowledge the practical approach the Board has taken in developing a two phased implementation.

However, in response to the publication of ED5 we have a number of specific concerns, and areas which we believe require clarification. These are summarised below. Responses to the specific questions raised in ED 5 are included in the attached appendix.

1. Areas of principal concern

(i) <u>Disclosures</u>

We attach considerable importance to providing users of financial statements with relevant information which aids a more comprehensive understanding of our business and acknowledge that this is particularly relevant under Phase I. In this respect we fully support the Board's approach in developing disclosure requirements in ED 5 based on high level principles rather than a long list of detailed and prescriptive requirements which could lead to obsolete, irrelevant and excessive disclosure being provided thus obscuring important information within the detail.

However, the suggested disclosures included in the implementation guidance are excessive and in some cases will result in undue cost and effort without necessarily increasing proportionately the benefit to the users of financial statements.

We are concerned that in the absence of any clarification as to the status of the guidance entities may be required (for audit purposes) to ensure compliance with all the suggested disclosures in the guidance. This will be counterproductive resulting in compliance with "a long list of requirements" rather than the principles based approach advocated by the Board and the IAS Framework. In addition, we consider it more appropriate to allow companies some level of discretion as to where in the financial statements some of the disclosures are made. For example in the UK (under the Combined Code requirements) the Operating and Financial Review already includes disclosure on the Group's risk management and mitigation policies. It would be more beneficial to users if this disclosure is expanded to incorporate ED5 requirements rather than duplicate some of this information in the notes to the financial statement.

We have detailed in our response to Question 10 and 11 the specific requirements that we consider to be excessive and of limited value to the users of our financial statements.

We request that the Board permits a level of discretion as to where the disclosure is included in the Report and Accounts and confirms that the Implementation Guidance is not mandatory, in particular the specific disclosures detailed in our responses to Question 10 and 11 in the attached appendix.

(ii) Demand features and deposit floor

We do not support the requirement that the fair value of a financial liability for a long term investment contract with a demand feature (i.e. a contract that an investor can cancel at anytime) should not be less than the amount payable on demand. This treatment will result in excessive prudence and will not reflect the true economic value of such contracts for a going concern. In addition, it will result in inconsistencies in the treatment of transaction costs depending on whether fair value or amortised cost measurement is adopted, reducing comparability between companies issuing similar contracts.

We request the Board to remove the deposit floor requirement when IAS 39 and ED5 are finalised.

(iii) Reinsurance purchased

We support the Board's view that there is no conceptual reason to define a reinsurance contract more or less strictly than a direct insurance contract (BC91).

However, some of the proposals in paragraph 18 are conceptually imperfect and will not be needed for Phase II, as acknowledged by the Board in BC92. We believe that system and process changes (for instance, the changes to profit recognition) will require significant system changes which would need to be reversed in Phase II, contrary to the Board's aims for Phase I.

In addition the requirement to undertake impairment testing of reinsurance assets under paragraph 19 of the standard would in effect require a fair value valuation approach. As the Board has not completed development of fair value measurement for insurance liabilities, it seems inappropriate to advocate these for reinsurance contracts.

Consequently, we believe that the treatment of insurance contracts and reinsurance contracts should be consistent, i.e. continuation of existing accounting policies should be permitted under Phase I. We therefore recommend that paragraph 18 and 19 are deleted from the draft standard.

(iv) Unit-linked Contracts

We believe that embedded futures in unit-linked contracts should not be regarded as embedded derivatives requiring separation. The analysis in the ED5 implementation guidance (1.9) is predicated on host contracts having the nature of debt like instruments. This analysis is counter-intuitive as unit-linked contracts are not deposit like in nature with an additional and separable "link", but are more like direct investments in the underlying equity investments. Accounting for contracts in this way would add significant complexity and would not add to the reliability or clarity of the resulting financial statements.

Further consideration should be given to the nature of the host contract and whether direct linkage of the liabilities to equity type performance may be better portrayed as an equity like instrument, where the value of the liability is simply equal to the value of the underlying pool of funds. We suggest that the ED5 implementation guidance is amended in this respect.

(v) Unallocated surplus on contracts with discretionary participating features

We support the Board's view that the unallocated surplus arising from contracts with discretionary participating features should not be classified as an intermediate category that is either a liability or equity, to ensure consistency with the overall IAS framework.

However, as recognised by the Board in BC103, the key question as to how this surplus should be allocated between liability and equity will not be determined until Phase II. In the UK allocation of this surplus between policyholders and shareholders is subject to regulatory constraints and the amount of any discretionary distribution to policyholders. Therefore, it would be misleading to make an anticipatory allocation of this surplus in the financial statements.

Given these constraints, and to avoid any misinterpretation, section 24 (b) of the standard should be amended so that it is clear that the usual requirement for liabilities to meet the constructive obligation criteria can be overridden in this instance for Phase I.

2. Areas of clarification

There are a number of areas in ED 5 which we believe require clarification as there is a risk that misinterpretation may result in a treatment that was not originally intended by the Board.

- confirmation that under Phase I deposit accounting will not be required for financial instruments with discretionary participating features. This is in line with 24(d) of the standard which states "that an issuer shall, in all respects not described in para 10-13 and 24(a)-(c) continue its existing accounting policies for such contracts", which also applies to these contracts as stated in para 25.

- confirmation that fair value disclosure of financial instruments with discretionary participating features is not required as the treatment of such discretionary features is to be determined in Phase II. This disclosure would be required under proposed amendment to IAS 32 detailed in C4 of the draft standard. In our opinion its seems logical to exclude this requirement for financial instruments with discretionary participating features.

We thank the Board for the opportunity to raise our concerns on the draft standard on insurance contracts. We urge the Board to review the comments raised with regard to the overall objective, as stated in paragraph 1 of the draft standard, that Phase I proposals result in limited improvements without requiring major changes that may need to be reversed in Phase II.

We look forward to working with the IASB in developing Phase II

Yours sincerely

ANDREW PALMER
Group Director (Finance)

APPENDIX I

L&G Response to Specific questions raised in ED 5

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?

(a) **We generally agree with the scope of the standard except with regard to the application of IAS 39 to Investment contracts. We support the Board's overall objective to achieve consistency both within the insurance industry and for the reporting of similar transactions by insurers and non-insurers.**

However, there are a number of difficulties in the application of IAS 39 to contracts issued by insurers that do not transfer significant insurance risk (investment contracts). IAS 39 does not provide adequate guidance for the accounting of typical features of such contracts (not common in other financial instruments) such as recurring premiums, long maturities and high initial transaction costs.

The lack of detailed guidance is certain to lead to inconsistent treatment of these features across the European insurance industry. In addition, where liabilities are measured at fair value under the option proposed in the revised IAS 39 exposure draft, the methodology for the calculation of fair value may be inconsistent with the fair value definition eventually agreed for Phase II. This may result in complex systems changes being made for Phase I that have to be changed again under Phase II.

The use of amortised cost as an alternative valuation basis has similar difficulties and in particular would require significant systems changes. The additional requirement under IAS 32 to disclose the fair value of investment contracts where the amortised valuation basis has been adopted further weakens the case for using an amortised cost valuation.

We agree with the proposed accounting for premiums received for investment contracts in BC115 (f). However, with regard to the valuation of liabilities under these contracts, as the current proposals for valuing investment contracts are unlikely to meet the Board's objective of achieving consistency, and that system changes made for Phase I may need to be reversed in Phase II, we strongly urge the Board to permit local GAAP valuation for these contracts in Phase I.

(b) We believe this is appropriate.

Question 2 – Definition of an Insurance Contract

The draft IFRS defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary' (Appendices A and B of the draft IFRS, paragraphs BC10-BC39 of the Basis for Conclusions and IG Example 1 in the draft Implementation Guidance).
Is this definition, with the related guidance in Appendix B of the draft IFRS and IG Example 1, appropriate? If not, what changes would you suggest, and why?

We acknowledge the efforts of the Board in this area and believe that these are helpful in implementing and supporting a principle based approach to classifying contracts. We consider that this supports the Boards objective of minimising system changes that may have to be reversed in Phase II.

Question 3 – Embedded derivatives

(a) IAS 39 Financial Instruments: Recognition and Measurement requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. This requirement would continue to apply to a derivative embedded in an insurance contract, unless the embedded derivative:

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

(ii) is an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate).

However, an insurer would still be required to separate, and measure at fair value:

(i) a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in an equity or commodity price or index; and

(ii) an option to surrender a financial instrument that is not an insurance contract.

(paragraphs 5 and 6 of the draft IFRS, paragraphs BC37 and BC118-BC123 of the Basis for Conclusions and IG Example 2 in the draft Implementation Guidance)

Are the proposed exemptions from the requirements in IAS 39 for some embedded derivatives appropriate? If not, what changes should be made, and why?

(b) Among the embedded derivatives excluded by this approach from the scope of IAS 39 are items that transfer significant insurance risk but that many regard as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). Is it appropriate to exempt these embedded derivatives from fair value measurement in Phase I of this project? If not, why not? How would you define the embedded derivatives that should be subject to fair value measurement in Phase I?

(c) The draft IFRS proposes specific disclosures about the embedded derivatives described in question 3(b) (paragraph 29(e) of the draft IFRS and paragraphs IG54-IG58 of the draft Implementation Guidance). Are these proposed disclosures adequate? If not, what changes would you suggest, and why?

(d) Should any other embedded derivatives be exempted from the requirements in IAS 39? If so, which ones and why?

(a) We believe this is appropriate

(b) We believe this is appropriate.

(c) We consider the requirement in 29(e) to be appropriate to the extent that it does not require the calculation of fair value of the embedded derivatives, but only information about material exposures under embedded derivatives. Fair value of embedded derivatives will be addressed under Phase II.

(d) As indicated in the covering letter, we believe that embedded futures in unit linked contracts should not be regarded as embedded derivatives requiring separation.

<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?

(a) We are concerned about the implications if Phase II is not delivered within the required timetable. We suggest that the date for the withdrawal of the exemption is either removed or its application only effective if Phase II is delivered by a explicitly stipulated date.

(b)We believe these proposals are appropriate.

<u>Question 5 – Changes in accounting policies</u>

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?

We believe that proposals in (a) and (b) are appropriate.

<u>Question 6 – Unbundling</u>

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?

(a) We believe that it is inappropriate to require unbundling under Phase I as it is likely that Phase II proposals will address the Boards concerns in relation to certain rights and obligations not being recognised, thus removing the need for unbundling. i.e. we do not believe that any additional liabilities or assets will be recognised as a result of unbundling. We request the Board to reconsider its approach for Phase I as unnecessary systems changes may be made which are not required in Phase II.

(b) None identified.

(c) If unbundling is required, we believe that the criteria for unbundling should consider when the cash flow of the insurance component and the investment component do not interact at all rather than the one-sided test of whether the cash flows from the insurance component do not affect the cash flows from the deposit component.

Question 7 – Reinsurance

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?

As stated in the covering letter, we believe, again, that as key areas of accounting for reinsurance contracts will be addressed in Phase II, any major changes should be excluded from the scope of Phase I.

In particular, the requirement to recognise profit as a result of a reinsurance contract over the life of a contract will require significant system changes which would need to be reversed in Phase II, contrary to the Board's aims for Phase I.

Question 8 – Insurance contracts acquired in a business combination

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?

We regard these proposals as appropriate.

<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?

Subject to the issues raised in our covering letter we consider the proposals to be appropriate.

<u>Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities</u>

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?

As noted in the covering letter to this response, we regard the requirement for the disclosure of the fair value of insurance contracts in 2006 as premature. If a date is to be set for disclosure, then it should be dependent on a stipulated date for issuing the Phase II standard. i.e. this standard should make it clear that disclosure would only be required if the Phase II standard is issued by 1st Quarter 2005.

<u>Question 11 –Other disclosures</u>

(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?

(a) Please note our comments in the covering letter. The specific areas that we consider should be removed from the implementation guidance are:

- **Details of movements between aggregate insurance liabilities and assets (IG27 and IG29)**
  In our opinion, complying with this requirement will be commercially sensitive and particularly onerous, as it will require a policy by policy analysis. We estimate that a significant amount additional resource, both systems and people, will be required during a critical time in the production of our financial statements. We seriously question the usefulness of this information to the users of our accounts, especially if it results in reporting delays as a result of the time constraints.

- **Estimates of future insurance cash inflows and outflows (IG39)**
  This requirement to estimate the occurrence of future cashflows is extremely onerous. In addition, the impact on these cashflows of predicted policyholder behaviour appears to be excessive. We consider this whole section to be inappropriate and do not consider that it will aid users in understanding our business, in fact we believe it may cause misunderstanding as it is likely to be based on set of assumptions, with variances requiring explanation and analysis on an annual basis. We urge the Board to delete this suggested disclosure from the guidance.

- **Level of disaggregation (IG33)**
  The implementation guidance recommends publishing some disclosures at a level lower than required under segmental reporting. This could mean significant systems development with little additional benefit to users of this level of detail. We request the Board to amend the wording of this section so that the overriding principle would suggest a level of aggregation appropriate to the company and its business.

- **Interest and Credit risk and Sensitivity analysis(IG50 to IG53 and IG41 to IG43)**
  We believe that this requirement is inappropriate for Phase I as liabilities will be based on existing accounting policies and therefore is likely to require substantial effort which will become redundant in Phase II.

- **Disclosure on supplementary information (IG8)**
  We consider that it is inappropriate for accounting standards to stipulate disclosure requirements for supplementary information.

As noted in our covering letter, we believe that it is more appropriate to develop effective disclosure regimes within the principles outlined in paragraph 26 and 28 that provide the user with relevant and material information that will aid rather than complicate understanding as a result of excessive detail.

(b) We request that the Board clarify that the Implementation Guidance is not part of the final IFRS and therefore is not mandatory.

(c) We do not believe that any further changes should be made.

<u>Question 12 – Financial Guarantees</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?

We agree that the Board's proposals are appropriate.

<u>Question 13 – Other comments</u>

Do you have any other Comments on the Exposure Draft and Implementation Guidance?

We have no further comments.