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28 October 2003

Mr. Peter Clark
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Mr Clark

Comments on the Exposure Draft 5 Insurance Contracts

In response to your invitation to comment on the above exposure draft please find attached a paper that sets out Old Mutual plc's comments.

If you would like to discuss any of our comments please do not hesitate to contact me or John Ross, Head of Group Finance or Katie Murray, Group Systems and Development Manager.

Yours sincerely

Julian Roberts

cc: John Ross
Katie Murray

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IASB Exposure Draft 5 - Insurance Contracts (including comments on clarifications to IAS 39)

Old Mutual Group response

31 October2003

Overall comments

1.1 *Introduction*

In general, OMG is generally supportive of the Phase I Insurance ED 5 and feel that the ED meets one of its objectives of not requiring an onerous amount of additional work at this time. However, we have strong concerns with regard to several areas of current IAS guidance (summarized) in Section 1.2 and more fully discussed in Sections 2 and 3). Lack of clarity in some areas may lead to companies making valuation decisions and/or systems modifications during Phase I that may need to be changed again upon the issuance of additional guidance.

The following sections emphasize those topics which are most relevant to OMG and which may not be represented adequately in other industry group response letters. We would like to point out, however, that OMG has contributed actively to various other industry group responses, including the EFRAG, ABI and South African Institute of Chartered Accounts ("SAICA") response letters.

1.2 *Summary*

Many of our comments on the ED address areas where further clarity would be helpful because:

- There are differing opinions in interpreting/implementing various elements of the guidance,
- Undue influence on industry practice of a few large players may arise, and
- There are internal inconsistencies in ED 5.

Our main concerns with regard to the current IAS guidance are as follows:

- The resulting non-matching of assets and liabilities due to different valuation approaches will lead to undue volatility of results and undermine the fair presentation of financial statements,
- Unit-linked business will no longer be shown separately in the financial statements. Aggregating unit-linked business (which has a lower cost of capital than non-linked business) with non-linked business in the financials is less transparent to readers of the statements. Stated another way, in combining linked and non-linked business in the financials, various analytical tools (e.g., capital ratios) are less meaningful to the users of the information,
- The present level of suggested disclosures is likely to become onerous from a systems standpoint and may be too voluminous to be meaningful, especially if required by audit firms and/or emerging industry best practises. The relevancy/benefits of the disclosures must be weighed against the cost of producing them and consideration must be given to not requiring disclosures of commercially sensitive information,
- The disclosure of fair value for insurance contracts in 2006 would require the implementation of Phase II for insurance accounting by 2006,
- There are widely differing interpretations of the criteria for insurance risk — this is an area requiring further clarification,
- There are differing interpretations with regards to fair value (FV) guidance (e.g., which elements of future cash flows to include), leading to less standardisation of the financials (which is contrary to stated IASB objectives). Furthermore, companies currently have varying interpretations of what constitutes FV — this is an area requiring further clarification to ensure consistency,

- We strongly believe that there are investment-type products for which a retrospective approach would be an appropriate FV measure,
- Phase I does not consider entity accounting. Phase I should recognise that there are different stakeholders within the same corporate entity, and that transactions among such parties must be accounted for at arms-length. The presentation of financial statements should follow this format with there being a separate estate for shareholders and policyholders,
- The ED as written is unclear as to whether the temporary exemption for financial instruments with discretionary participation features (FI-DP) applies only to the *valuation* of such contracts (as we believe the intent to be), or to other accounting and disclosures considerations as well, and
- Discounting at a risk-free rate, adjusted only for credit risk, may not be appropriate for FV calculations (as explained more fully in Section 3).

The above points are discussed in greater detail in the following sections. Given the lack of clarity with regard to various aspects of the guidance, as well as the current detail of disclosures required, we fear that companies may make valuation decisions and/or systems modifications during Phase I that may need to be changed again upon additional guidance. This is contrary to stated IASB objectives, and, from a practical standpoint, we would wish to avoid such situations.

1.3 *Approach to our response*

Our response to ED 5 addresses implications for insurance contracts classified as insurance and IAS 39 clarifications for insurance contracts classified as financial instruments (FI), also referred to as investments contracts. Our comments are limited to the valuation of insurance liabilities, not assets, except where such valuation may lead to artificial volatility of results as noted in the following sections. We have not commented herein on deposit floor requirements as this will be addressed more fully in our comment letter on ED6.

Section 2 lays out our concerns and comments on a “question-by-question” basis. Section 3 gives additional considerations not specifically addressed elsewhere.

2 Responses to specific questions

Our responses to specific questions follow. Other considerations are found in the final section of this document.

2.1 *Question 1— Scope of ED 5*

Some respondents may feel that all contracts issued under the legal form of insurance, even pure FI’s, should be allowed an exemption from IAS valuation during Phase I. OMG does not take this view, and we agree in principle that the distinction between insurance and FI’s is appropriate. We further agree with the revised definition of insurance as being more appropriate than that given in prior guidance.

As for valuation, OMG agrees with the current (temporary) exemption for re-valuation of insurance contracts and financial instruments with discretionary participation features (FI-DP), subject to a floor liability equal to the amount available on demand (the latter requirement could require additional valuation work in Phase I). The scope is not clear, however, whether FI-DP is still subject to IAS 32/39 accounting (e.g., revenue accounting with presentation of premiums as deposits) and disclosures requirements. Various paragraphs in the ED refer to the exemption for *accounting* for such contracts, where perhaps the word *valuation* would be clearer. OMG has interpreted the standard to mean that IAS 32/39 presentation/disclosures *do* apply; others may take a more liberal view as the current guidance is written.

OMG is of the opinion that the ED doesn't properly address unit-linked business. For example, linked business is inherently less risky, and the required disclosures should be allowed to reflect this difference (i.e., less disclosure should be required for such business). Further, the balance sheet presentation should reflect the linkage between assets and liabilities, otherwise a less meaningful presentation could result. Aggregating unit-linked business (which has a lower cost of capital than non-linked business) with non-linked business in the financials is less transparent to readers of the statements. Stated another way, in combining linked and non-linked business in the financials, various analytical tools (e.g., capital ratios) are less meaningful to the users of the information. Thus, we feel that there should be separate financial statement categories for reporting such linked liabilities and associated assets.

2.2 *Question 2— Definition of insurance contract*

As stated above, OMG generally agrees with the revised definition of insurance risk in the ED. We would like greater clarity, however, with regard to the basis of the significance test; that is, greater clarification of the measurement basis for the test for significance of insurance (e.g., net profits, net cash flows, etc.). A simplified example in the implementation guidance contrasting a typical savings product versus a generic traditional life product would be helpful. Whilst we do *not* think that the test itself or the level of what constitutes "significant" should be made too prescriptive, additional guidance is necessary. There is one significant product in South Africa where the industry has had lengthy debates as to whether to classify the contract as investment or insurance.

2.3 *Question 3— Embedded derivatives*

OMG is in general agreement with regard to the present guidance for embedded derivatives. We have a few concerns as laid out below.

With regard to insurance embedded derivatives within insurance contracts, OMG agrees that embedded derivatives that meet the definition of insurance need *not* be *separated.* This would apply to both Phase I and Phase II. However, this does not mean that such insurance embedded derivatives/guarantees should not ultimately be *measured* as part of the total liability. Given that such measurement is temporarily "exempt" under Phase I, it should be addressed in Phase II.

2.4 *Question 4— Temporary exclusion from criteria in IAS 8*

We agree with and appreciate the temporary exemption from the IAS 8 hierarchy which has been granted for insurance (including reinsurance) business. Our main concern is that the timing of IAS guidance does not allow sufficient implementation time between the publication of the Phase II ED and first required restated results (comparatives). We would be supportive, therefore, if a specified interval of two to three years were to be allowed for implementation of the Phase II insurance standard. We are further concerned that if the Phase II insurance standard is required to be fully implemented by 2007 (with three years of comparatives), then there is a very tight timeframe for development and exposure of the Phase II standard, making the sunset clause difficult to achieve.

As for various "conditions" (e.g., elimination of catastrophe reserves, loss recognition etc.) for insurance liabilities under Phase I, OMG generally agrees with these constraints. A couple of clarifications would be helpful, however. In our opinion, an explicit loss recognition test should not be required during this phase where an insurer can demonstrate (quantitatively or qualitatively) that the local valuation method for insurance contracts implicitly precludes loss making reserves. Furthermore, the ED should be clarified as to the outcome of such testing. That is, paragraph 11 of the ED states "the insurer shall recognise the entire deficiency in profit or loss." We assume that the IASB intent is that the liability should be increased by the amount of the loss, and the ED should be reworded to state this explicitly.

2.5 ***Question 5 — Changes in accounting policies***

Paragraph a) — Changes to accounting policies are allowed, subject to certain considerations. OMG generally agrees with this guidance and has chosen not to comment herein.

Paragraph b) — Assets are allowed to be reclassified and measured at fair value, with changes put through the profit and loss account. OMG agrees with this and feels it is important that such asset valuations continue to be allowed in Phase II.

2.6 ***Question 6— Unbundling***

OMG is generally supportive of the current unbundling requirements and appreciative of the more relaxed conditions for unbundling versus prior guidance.

2.7 ***Question 7— Reinsurance purchased***

OMG generally agrees with the present guidance, subject to a few concerns. We also feel that cedants should not be required to change their local accounting for reinsurance, i.e., reinsurance is a subset of insurance and should be subject to the same exemption during Phase I.

First, the ED should not result in accounting which is less meaningful, e.g., presentation which is contrary to the fundamental pooling nature of reinsurance. Further, the anti-abuse rules discouraging "skewing" of the financials should not prohibit recognition of genuine reinsurance assets where there is no obligation to repay.

We think that paragraph 19 is inappropriate and should be deleted. This paragraph would require a cedant to apply IAS36 (Impairment of Assets) to its rights under a reinsurance contract. Under 1AS36 the recoverable amount is the higher of an assets' net selling price or value in use. Value in use is determined by discounting the estimated future cashflows associated with the asset and applying an appropriate discount rate to them. For reinsurance recoveries, however, this would require discounting even when the associated reinsured claims are not discounted.

2.8 ***Question 8— Insurance contracts acquired in a business combination or portfolio transfer***

OMG generally agrees with this guidance and has chosen not to comment herein.

2.9 ***Question 9— Discretionary participation features*** **See also our QI comments.**

OMG believes that these contracts should not be subject to the disclosure requirements in Phase I, because the valuation approach has not been finalised. Earlier disclosure could result in inappropriate information being disclosed, since the valuation and disclosures should be aligned.

2.10 ***Question 10— Disclosure of the fair value of insurance assets and insurance liabilities***

OMG's main concern here is that FV disclosures should *not* be required in the absence of adequate FV guidance. This could lead to potentially onerous systems changes and less transparent/consistent disclosures, contrary to Phase I objectives. Thus, in our opinion, FV disclosures should not be required before the Phase II standard is published, at the earliest.

Additionally, the ED addresses disclosures for *insurance* assets. We are not sure why such assets are different from *financial* assets? That is, the IASB has taken care to state that there should be no difference for the valuation of financial liabilities issued by insurers versus other financial institutions, and we are unclear as to why the distinction is made for assets.

2.11 ***Question 11 — Other disclosures***

a)

We believe that it is appropriate for the standard to provide high-level guidance with regard to insurance disclosures. There should be more clarity, however, in that the ED provides guidance *only* and should not in any way be construed as a set or requirements having in effect the same status as the provisions of the IFRS itself.

OMG feels that the ED should make more allowance for *not* reporting commercially sensitive information. For example, individual disclosures may not be commercially sensitive in themselves, but they may be when taken in aggregate. For example, disclosures of individual assumptions are not particularly sensitive, but disclosures of all assumptions may effectively represent an insurer's pricing basis. A related point is that further clarity should be given with regard to which disclosures must be given qualitatively versus quantitatively. Continuing with the assumptions example, it is less commercially sensitive to describe one's assumption setting process than to quantitatively specify actual assumptions used.

Another concern is that certain disclosures are irrelevant to the users of the financial statements or that the amount of disclosures required could be too voluminous to be meaningful.

Additionally, some of the indicated disclosures may require significant systems modifications in Phase I, for example, disclosures of movement analyses which would require investment and insurance liabilities to be split and analysed separately.

b) In our opinion, the IASB should give clearer guidance as to the appropriate level of disaggregation for disclosures purposes to enhance the comparability of such disclosures within the industry.

2.12 ***Question 12- Financial guarantees by the transferor of a non-financial asset or liability***

OMG generally agrees with this guidance and has chosen not to comment herein.

3 Other Comments

Other concerns with respect to current FV guidance relate to discounting at a risk-free rate, adjusted (only) for the credit risk of the issuer. Admittedly, the choice of the appropriate discount rate for fair value calculations is an ongoing debate among practitioners, but specific concerns with the current guidance include:

- Such discounting may not properly reflect all risks associated with the uncertainty of future cash flow streams,
- Alternatively, the use of risk-free rates may be deemed to be excessively prudent, contrary to stated IASB objectives,
- There is ongoing discussion that discounting at a risk-free rate independently of earned rates, and movements in earned rates, may lead to undue increased volatility of results,
- It is unclear whether future risk-free rates should be deterministic or stochastically determined for valuation and/or disclosures purposes, and

Adjusting the discounting for the credit risk of the issuer implies *higher* equity values as one's credit is *worsening.*

While we believe that there should be a choice regarding the use of FV or AC, we have various concerns and considerations detailed below:

- FV methods require full expensing of acquisition costs (possibly offset by discounted asset management charges), while there is an implicit amortisation of such costs in an AC approach,
- FV methods will likely preclude the capitalisation of excess interest credits (e.g., bonus interest credited in year one as a sales inducement) which would be implicitly spread in an AC approach,
- If AC is chosen over FV because of a preference for the resulting profit profiles under AC, this could lead to excessive and perhaps inappropriate systems modifications in Phase I, contrary to stated IAS objectives (as above); the need for systems modifications may be further exacerbated by the potentially complex calculations required for calculating the "value to surrender" under an AC method,
- Under either a FV or an AC approach, the definition of "acquisition costs" or "transaction costs" needs further clarification (e.g., external only? directly attributable? etc.)
- AC methods require a maturity date (actual or assumed), which is often not present in many FI's (for example, many deposit type contracts do not have stated maturity dates)
- AC may require embedded derivatives to be separated and valued separately, where a FV approach need only ensure that embedded derivatives are also fair valued,
- Further guidance would be helpful as to which elements of future cash flows (e.g., contractual versus expected) should be included under either FV or AC,
- It would be useful if the implementation guidance includes simplified numeric examples of FV versus AC calculations for a sample of representative products; this would greatly enhance clarity and demonstrate some of the inherent differences in results,
- The choice of AC may lead to increased volatility of results when unrealised gains/losses on assets flow through earnings, especially since the internal yield is fixed at inception (i.e., only best estimates of future cash flow elements are updated at valuation dates), and
- Finally, the loss recognition requirements may be more onerous under an AC methodology, especially in light of the above "lock-in" of the effective yield.

Thus, it is unclear how various insurers will choose AC versus FV for various types of contracts. It is likely that there will not be consistency of valuation for like contracts across issuers. This would lead to less transparency and comparability of financials, which is contrary to stated IASB objectives.