CL 131

12 November 2003

Peter Clark
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London
EC 4M 6XM

75 Cannon Street
London, EC4N 5BN
Tel. 020 7556 7053
Fax 020 7556 7520
E-mail: LSCA@icaew.co.uk

Dear Peter

Re: EXPOSURE DRAFT ON INSURANCE CONTRACTS (ED 5)

Firstly, we apologise for the delay in submitting this response from the London Society of Chartered Accountants (LSCA) and hope that you can still take our comments into account.

With a membership in excess of 37,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales. London members like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), and it is that Committee which has recently considered the text of the proposed International Standard on Insurance Contracts.

The Committee welcomes the IASB considering the specific and challenging issues relating to the insurance sector and its efforts to address the divergence in current reporting between countries and also between life and general insurance. Our responses to the specific questions contained in ED 5 are as follows:

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?

The Committee agrees with the scope proposals in the draft Standard. The Committee believes it is important that if an insurer also issues financial instruments that are not insurance contracts (e.g. investment products) that these should be accounted for in the same way as say a banking entity under the requirements of IAS 39. Clearly where a more specific standard is in place such as IAS 39 'Financial Instruments' or IAS 40 'Investment property' then these should be applied. Hence, the Committee considers that insurers should not be treated differently from any other company when accounting for investments held (property, bonds, equities etc.) despite these investments being held to back insurance contracts.

(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?

We certainly agree that weather derivatives, unless they meet the definition of an insurance contract, should be brought into the scope of IAS 39.

In the insurance sector weather derivatives are often used as a hedging instrument for insurance liabilities. We believe that the use of weather derivatives as a hedging instrument for insurance liabilities should be considered at the same time that they are brought within the scope of IAS 39.

Question 2 - Definition of 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?

The Committee considers the definition an insurance contract when read in conjunction with guidance set out in Appendix B of the proposed Standard to be appropriate. Clearly one of the key elements to the definition is to distinguish between insurance risk and financial risk which we believe has been achieved. In this respect the Committee particularly welcomes the approach taken by the IASB to issue guidance notes and examples to support the definition.

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?

In principle the Committee believes that all embedded derivatives should be fair valued. However, on pragmatic grounds the Committee agrees with the proposals that embedded derivatives which meet the definition of insurance contract should not be required to be separated during Phase I of the insurance contract proposals.

The Committee also agrees that derivatives that are an option to surrender a financial instrument that is not an insurance contract should be separated and measured at fair value by an insurer.

(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?

The Committee agrees that it is appropriate that embedded derivatives such as guaranteed life-contingent annuity options and guaranteed minimum death benefits are excluded from the scope of IAS 39 despite certain 'financial' characteristics since the embedded derivatives meet the definition of insurance contract. The Committee considers that the required disclosure in 29 (e) of the draft Standard will provide sufficient details to understand any potential exposure that may exist.

(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?

The Committee believes the proposed disclosure requirements in 29 (e) are appropriate. The Committee believes it would be helpful if the Standard could be more specific with regard to the term "material exposures" as used in paragraph 29 (e).

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

To our knowledge there are no other embedded derivatives that should be exempted from the requirements in IAS 39.

Question 4 - Temporary exclusion from criteria in IAS 8

(a) Paragraphs 5 and 6 of [the May 2002 Exposure Draft of improvements to] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. However, for accounting periods beginning before 1 January 2007, the proposals in the draft IFRS on insurance contracts would exempt an insurer from applying those criteria to most aspects 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?

Yes, the Committee believes it is right to have a sunset provision. The Committee however emphasizes that it is then important that the IASB need to stick to it and that Phase II does not get delayed. In order to avoid introducing unnecessary uncertainty, we believe the IASB would be advised to link the withdrawal of the ED directly into the start of the final standard.

(b) Despite the temporary exemption from the criteria in [draft] IAS 8, the proposals in paragraphs 10-13 of the draft IFRS would:

(i) eliminate catastrophe and equalisation provisions.

(ii) require a loss recognition test if no such test exists under an insurer's existing accounting policies.

(iii) require an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to report insurance liabilities without offsetting them against related reinsurance assets (paragraphs 10-13 of the draft IFRS and paragraphs BC58-BC75 of the Basis for Conclusions).

Are these proposals appropriate? If not, what changes would you propose, and why?

The Committee agrees with (i), (ii) and (iii)

However, the Committee believes reference to 'future insurance contracts' in para 10 (a) should be deleted.

In addition the Committee believes (a) the loss recognition test must be done on a portfolio basis and (b) consideration should also be given to whether the loss recognition test is sufficiently robust.

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?

The Committee agrees with the proposals in the draft IFRS that an insurer may only change its accounting policies for insurance contracts if the changes make the financial statements more relevant and reliable.

Whilst not enforcing change at this stage upon insurers Paragraph 16 of the draft IFRS sensibly prohibits the adoption of practices that would diminish the relevance and reliability of insurer's financial statements. The Committee considers the proposals in paragraph 16 to be a sensible approach whereby one would not change an existing accounting policy to one which they would have to change again for Phase II

Question 6 - Unbundling

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?

The Committee considers unbundling to be appropriate where contracts contain both an insurance and a deposit component. We understand from an actuarial perspective that the unbundling of contracts is feasible.

(b) Should unbundling be required in any other cases? If so, when and why?

The Committee are not aware of any other cases where unbundling would be required.

(c) Is it clear when unbundling would be required? If not, what changes should be made to the description of the criteria?

The Committee believes that the Draft IFRS makes it clear when unbundling is required.

Question 7 - Reinsurance purchased

The proposals in the draft IFRS would limit reporting anomalies when an insurer buys reinsurance (paragraphs 18-19 of the draft IFRS and paragraphs BC89-BC92 of the Basis for Conclusions).

Are these proposals appropriate? Should any changes be made to these proposals? If so, what changes and why?

In principle the Committee believe the proposals to be appropriate but consideration should be given to practicalities before finalising. e.g. System changes and related costs

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?

The Committee agrees that it is appropriate for fair value to be applied to acquired insurance contracts. Indeed, the Committee believes that any exclusion for insurance contracts would be wholly inappropriate.

The Committee considers that the expanded presentation proposed during phase I to be extremely helpful. It and adds to transparency and aids comparability by disclosing liabilities (and related assets) on a consistent measurement basis to that of directly issued contracts. For that reason the Committee believes consideration should be given to requiring as opposed to permitting an expanded presentation as opposed to only permitting it.

Question 9 - Discretionary participation features

The proposals address limited aspects of discretionary participation features contained in insurance contracts or financial instruments (paragraphs 24 and 25 of the draft IFRS and paragraphs BC102-BC108 of the Basis for Conclusions). The Board intends to address these features in more depth in phase II of this project.

Are these proposals appropriate? If not, what changes would you suggest for phase I of this project and why?

Whilst the Committee regard the requirements of paragraphs 24 and 25 as sounding ‘sensible’ we note the concerns expressed by International Actuarial Association (IAA) who express conceptual and technical concerns regarding the rules on discretionary participation features.

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 30-33 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?

The Committee has concerns regards imposing requirements from a specific date (31 December 2006). The insurance project has always been a difficult issue and acknowledgement of the difficulty has already led the project to be split into 2 phases. With grave concerns expressed by the insurance industry regarding the proposals the Committee believes that it would be more appropriate instead of requiring disclosure of fair values of insurance assets and liabilities from 31 December 2006 that transitional provisions are introduced when Phase II of the project is finalised. Whilst clearly some comparability may be lost without this bridging disclosure it does provide more flexibility for insurers.

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.

The Committee considers the proposed disclosures to be appropriate.

(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?

The Committee supports the approach taken.

(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?

The Committee considers that details of claims development should not be disclosed by insurers before their date of transition to IFRS (1 January 2004 for a 31 December year-end insurer).

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

The Exposure Draft proposes that the transferor of a non-financial asset or liability should apply IAS 39 *Financial Instruments: Recognition and Measurement* to a financial guarantee that it gives to the transferee in connection with the transfer (paragraphs 4(e) of the draft IFRS, C5 of Appendix C of the draft IFRS and BC41-BC46 of the Basis for Conclusions). IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or liabilities.

Is it appropriate that IAS 39 should apply to a financial guarantee given in connection with the transfer of non-financial assets or liabilities? If not, what changes should be made and why?

The Committee agrees that financial guarantees that an entity incurs or retains when it transfers financial or non –financial assets or liabilities to another party are best dealt with in IAS 39 “financial instruments” and that the substance of the contract should be followed regardless of whether they are described as financial guarantees, letters of credit or insurance contracts.

Question 13 - Other comments

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

[Draft] International Financial Reporting Standard X *Insurance Contracts* ([draft] IFRS X) is set out in paragraphs 1-35 and Appendices A-C. All the paragraphs have equal authority. Paragraphs in bold type state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the [draft] Standard. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its objective and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements.* These provide a basis for selecting and applying accounting policies in the absence of explicit guidance.

The Committee has no other specific comments to make on the proposed draft other than it believes it is essential to keep the momentum of the insurance contract project going. To this end and in order to avoid any slippage in Phase II the Committee believes that the IASB must ensure that adequate resources are allocated to this project.

On behalf of the Committee, I trust you find the above comments helpful and If there are any matters arising from this letter you would like to discuss, please do not hesitate to contact Steven Brice on 0207 220 3231 who chaired the working party.

Yours sincerely

Margaret Cassidy
Chairman, LSCA Technical Committee